



ISLAMIC FINANCIAL SERVICES BOARD

and



**INTERNATIONAL ASSOCIATION OF
INSURANCE SUPERVISORS**

[Consultation Draft]

**ISSUES IN REGULATION AND SUPERVISION OF
MICROTAKĀFUL (ISLAMIC MICROINSURANCE)**

22 JUNE 2015

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ABBREVIATIONS

AML/CFT	Anti-money Laundering, Combating the Financing of Terrorism
BOD	Board of Directors
CGAP	Consultative Group to Assist the Poor
CRF	Cooperative Risk Fund
ECAI	External Credit Assessment Institution
FISC	Financial Inclusion Subcommittee
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFSB	Islamic Financial Services Board
JWG	Joint Working Group
MCCO	Mutuals, Cooperatives and other Community-based Organisations
MP	<i>Microtakāful</i> Provider
MRF	<i>Microtakāful</i> Risk Fund
PRF	Participants' Risk Fund
RSA	Regulatory and Supervisory Authorities
RTO	<i>ReTakāful</i> Operator
SB	<i>Sharī'ah</i> Board
SHF	Shareholders' Fund
TC	Technical Committee
TO	<i>Takāful</i> Operator

A. INTRODUCTION OF THE RESEARCH PAPER

I. Background of the joint work between IFSB and IAIS

1. The IFSB, in its inaugural Seminar on Regulation of *Takāful* held in Jordan on 10-11 January 2005, adopted several recommendations in which one of them is for the IFSB to play “an active and complementary role to that of the International Association of Insurance Supervisors (IAIS) by issuing prudential and supervisory standards for *Takāful* that would safeguard the interests of the consumers and the soundness and the stability of the financial system as a whole” (IFSB & IAIS, 2006).

2. Pursuant to that, a joint working group (JWG) was established by the IFSB and IAIS in 2005 to produce an Issues Paper on the applicability of the existing IAIS Core Principles (ICPs) on *Takāful* sector and the regulatory and supervisory standards to be developed by the IFSB on *Takāful*. This JWG prepared the paper titled “*Issues in Regulation and Supervision of Takāful (Islamic Insurance)*”, which was issued in August 2006, providing a background to *Takāful* as well as an analysis of the applications of ICPs to the *Takāful* industry.

3. In this paper, four major themes were outlined to address the regulatory and supervisory issues within the *Takāful* industry:

- (a) Corporate Governance
- (b) Financial and Prudential Regulation
- (c) Transparency, Reporting and Market Conduct
- (d) Supervisory Review Process

4. Based on these themes, the IFSB has in subsequent years produced the following standards and guidelines:

- (a) IFSB – 8: Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings [December 2009]
- (b) IFSB – 11: Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings [December 2010]
- (c) GN – 5: Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Takāful* and *Retakāful* Undertakings [March 2011]
- (d) IFSB – 14: Standard on Risk Management for *Takāful* (Islamic Insurance) Undertakings [December 2013]

5. In July 2013, the IFSB participated in the IAIS Financial Inclusion Subcommittee (FISC) meeting held in Manila, Philippines¹. A proposition was made during this meeting for a second joint-initiative to be conducted between the IAIS and the IFSB, similar to the first *Issues Paper* in 2006. Following this, both organisations came to an understanding to prepare a paper focusing on regulatory issues prevailing in the *Microtakāful* sector and its role in enhancing financial inclusion. It was also agreed that a JWG – comprising members from both organisations – would work on this project.

¹ The IAIS has since 2006 worked on its “access agenda” by way of the IAIS-Microinsurance Network Joint Working Group and the Access to Insurance Initiative. Three papers on Microinsurance have since been developed: (a) Issues in Regulation and Supervision of Microinsurance, June 2007, (b) Issues Paper on the Regulation and Supervision of Mutuals, Cooperatives and other Community-based Organisations in increasing access to Insurance Markets, October 2010, and (c) Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets, October 2012.

6. Recognising the issues that the *Takāful* sector's regulatory and supervisory authorities (RSAs) face in relation to enhancing and strengthening the role of *Microtakāful* institutions, the Technical Committee (TC) of the IFSB, in its 32nd meeting in Basel, Switzerland recommended to the IFSB Council to approve preparation of a research paper in this area. Consequently the Council of the IFSB, in its 24th meeting in Brunei in March 2014 approved the development of a research paper on *Microtakāful* to be part of IFSB 2014 Workplan.

II. Objective of the Research Paper

7. Taking into consideration the fact that there is currently lack of studies on the operations of *Microtakāful* sector and associated regulatory issues, the objectives of the joint initiative are:

- (a) to identify the current practices and models used for offering *Microtakāful* products, and the challenges and potential issues arising from *Microtakāful* transactions;
- (b) to review the current regulatory framework for the *Microtakāful* sector in various jurisdictions and suggest initiatives to strengthen the framework and thus enhance financial inclusion through the *Takāful* sector; and
- (c) to provide guidance to the RSAs in putting in an enabling environment for the overall development and growth of the *Microtakāful* sector

B. ABOUT MICROTAKĀFUL

8. A research conducted in 2010 suggests that in Muslims populated countries such as Indonesia (207 million), Pakistan (160 million), India (151 million) and Bangladesh (132 million) where they were classified under the World Bank as lower-middle and low-income countries, insurance penetration is low due to the contradiction of insurance principles with *Sharī'ah* principles (Erlbeck, 2010).

9. *Microtakāful* is widely known in the industry as *Takāful* for the low-income population. In the general *Takāful* terms, low-income means the section of population that is customarily not eligible and not invited to participate in any of the *Takāful* plans of any *Takāful* Operator. This group's ineligibility is attributed to their inability to meet the basic financial and underwriting requirements set forth by *Takāful* regulation, for reasons relating to medical history, hazardous occupation, irregular income, insurable interest and various other considerations that fall within the purview of prudential regulation of exclusive finance. An important cause is the unavailability of suitable insurance products that fit the needs of this specific group of customers in combination with their lack of awareness and understanding of the usefulness of insurance to manage the risks in their private and professional lives. Another contributing factor is the lack of expertise and will of *Takāful* operators to make the investment needed to reach these markets.

10. With the financial industry's focus shifting towards inclusive finance, major initiatives have been undertaken worldwide to take up the responsibility to include this low-income population into the financial system, to ensure that they are as privileged as the high-income population. The industry sees the need for this low-income group to be allowed to participate in various products and plans offered by the banks, insurance/*Takāful* companies as well as any other facilities offered by these financial institutions. The condition of this segment of society makes it more vulnerable towards financial losses therefore there is a great need for it to have some sort of financial protection. *Microinsurance/Microtakāful* is therefore an important tool to protect it from financial losses, and help it break the cycle of poverty.

11. From the perspective of the *Takāful* industry, more *Takāful* Operators have started shifting their focus to include the low-income segment via *Microtakāful* products. In 2014, under the Malaysian Government Bantuan Rakyat 1 Malaysia (“BR1M”) or 1 Malaysia Public Relief programme, an initiative to help low income earners lessen their financial burden has done exactly that. This initiative has brought all of the *Takāful* operators operating in Malaysia together to provide i-BR1M scheme to earners of below USD 1119 and USD 839 monthly household income (Takaful Ikhlas, 2014)².

12. Various definitions of “*Microtakāful*” have been established to categorize this group of low-income participants. Some jurisdictions categorise them based on the minimum annual income, some categorise them based on product features, some categorise them based on location of the potential participants, others may categorise them based on distribution channels.

13. While in certain jurisdiction *Microtakāful* products are focused on low-income, in some other jurisdictions, *Microtakāful* products are targeted at not only low-income, but rather low-income Muslims. In research paper, it was cited that “*Microtakāful* is a concept developed for deprived people in Muslim countries” (Gor, 2013). In Africa, *Microtakāful* is defined by *Takāful* Insurance of Africa as “A mechanism to provide *Shari’ah* -based protection to the blue-collared, under-privileged individuals at an affordable cost” (Takaful Insurance of Africa, 2012). Whilst there are various other definitions for *Microtakāful* that can be cited in numerous academic papers, the objective nevertheless remain the same, that is to include certain section of the population to be part of the financial system in which under normal circumstances are excluded.

14. For the purpose of this paper, *Microtakāful* shall be defined to be consistent with the definition of *Takāful* as provided in the IFSB – 8 (IFSB, 2009), taking into account the core principles embedded in the concept of mutual assistance:

“Microtakāful is the Islamic counterpart of microinsurance³, and exists in both Family and General forms. It is a joint-guarantee initiative, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks, under the core principles of Tabarru’ (donation), Ta’āwun (mutual assistance) and Prohibition of Ribā (usury). Microtakāful is generally offered to low-income and under-privileged segment of the population (which is usually excluded from the general Takāful terms and conditions) by various entities which are regulated and supervised by regulatory and supervisory authorities of Takāful insurance or any other competent regulatory and supervisory authority under the national laws of any jurisdiction”.

15. Given the evolving nature of *Microtakāful*, the definition shall be subject to periodic review for appropriateness as the *Microtakāful* industry grows and matures.

16. While the distinction between *Microtakāful* and *Takāful* is made based on the inclusivity and exclusivity of the financial system, it is worthy to reiterate that conceptually, *Microtakāful* does not differ

² i - BR1M is a one (1) Takaful plan that provided protection to recipients BR1M categories of households / families. i - BR1M aims to ease the burden of the recipient and/or recipient’s families in the event of his or her death (accidental and non-accidental) or accidental total permanent disability. i - BR1M contribution is borne entirely by the Government of Malaysia. Furthermore, i - BR1M is managed by Takaful operator consortium.

³ The IAIS has defined “microinsurance” as insurance that is accessed by low-income populations, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which include the ICPs) (IAIS 2012). The IAIS also uses the term “inclusive insurance” as all insurance products that are aimed at the excluded or underserved insurance market. In practice the term “microinsurance” is often used interchangeably. Where the term microinsurance is used in this paper it is considered to mean inclusive insurance.

from *Takāful*. It is a subset of *Takāful*. It exists under the premise that microinsurance⁴ does not meet the basic principles of *Sharī'ah*, where elements of Riba (usury), Maysir (gambling) and Gharar (uncertainty) are prohibited⁵. However, due to the exclusivity nature of *Takāful* products, the specific regulation of *Microtakāful* has not been given much attention by the regulatory and supervisory authorities despite the new development in promoting inclusive finance in the financial industry. This might be due to the mere fact that little experience or empirical data is available for prudential regulation to take place effectively without dampening the growth for inclusiveness.

17. Sections B.I. – B.III. of this paper aim to provide basic background information on the types of *Microtakāful* models that are currently being used in the industry, key differentiating elements between *Takāful* and *Microtakāful*, as well as differences between *Microtakāful* and microinsurance. Section B.IV. will highlight the survey findings of the survey conducted by both the IFSB and the IAIS for the purpose of this paper.

18. The next Section C shall consequently draw upon the various *Microtakāful* (and in some scenarios, microinsurance) issues and challenges that have also been observed in the *Takāful* /insurance industry from regulatory perspective. This section shall divide the issues on regulation of *Microtakāful* into four different segments which are (i) Corporate Governance, (ii) Financial and Prudential Regulation, (iii) Transparency, Reporting and Market Conduct, and finally (iv) Supervisory Review Process. In addition, where appropriate, practical examples faced by some of the RSAs that have initiated regulations on *Microtakāful* / microinsurance will be provided to give insights on the various approaches that have been proven to be successful or unsuccessful in regulating *Microtakāful*.

I. Models / Types of *Microtakāful*

19. In following the due process of research paper development, the JWG undertook a survey⁶ to attain an understanding on the various models used to develop *Microtakāful* products. While two models, *Wakālah* and Cooperative, proved to be popularly used by the survey respondents, this paper provides various other *Microtakāful* models that are known to be used in certain jurisdictions that did not respond to the survey.

(a) *Wakālah*

20. Under a *Wakālah* model, the *Microtakāful* Provider (MP) and the participants form a principal-agent relationship whereby the MP acts strictly as a Wakil (agent) on behalf of the participants, to manage the risks and also to manage the investment of the contributions. In return for the service rendered by the MP as Wakil, the MP receives a management fee, called a *Wakālah* fee, which is usually a percentage of the contributions paid. The *Wakālah* fee must be pre-agreed and expressly stated in the

⁴ The International Association of Insurance Supervisors (IAIS) published “Issues in Regulation and Supervision of Microinsurance” in June 2007, entailing definition of microinsurance and the issues and challenges in regulating the sector.

⁵ IFSB – 8: Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings states that the concept of Takaful is significantly defined by *Tabarru'* commitment, *Ta'awun* and Prohibition of *Riba* (usury).

⁶ Two sets of Survey Questionnaire (Set A for Market Players and Set B for Supervisory Authorities) were sent to the IFSB's and the IAIS' member countries, for a survey duration between 10 July 2014 – 15 August 2014. A total of 25 institutions responded in which 10 indicated their non-participation due to the absence of *Microtakāful* in their respective jurisdiction. The remaining 15 participating respondents were made up of six regulatory authorities and nine *Microtakāful* providers. The low participation rate was believed to be contributed by the fact that *Microtakāful* is still not popular in many jurisdictions of the IFSB's and IAIS' member countries, as compared to its conventional counterpart, microinsurance.

Microtakāful contract. For the MP, the *Wakālah* fee is intended to cover the total sum of: (a) management expenses and (b) a margin of operational profit to the MP. In this respect, an MP will be profitable if the *Wakālah* fee it receives is greater than the management expenses incurred. It does not directly share in the risk borne by the *Microtakāful* Risk Fund (MRF) or any of its investment profit or surplus/deficit.

21. In addition, the *Wakālah* model may permit the MP to receive part of its remuneration as Wakil in the form of a performance-related fee. A performance-related fee, as agreed in the *Microtakāful* contract, is typically related to the underwriting result of the MRF. The underwriting result arising in the MRF, after payment of the *Wakālah* fee, including any performance-related element, and after crediting any investment income, is attributable to the participants collectively.

(b) *Wakālah-Muḍārabah*

22. In a *Wakālah-Muḍārabah* model, as commonly practiced, the MP acts both as a Wakil as well as a *Muḍārib* (entrepreneur) to the participants: typically as Wakil to manage the underwriting activities of the MRF, and as *Muḍārib* to manage its investment activities, though the exact relationship and basis of remuneration in respect of these activities will be specified in the *Microtakāful* contract. The MP receives a *Wakālah* fee, which is usually a percentage of the contributions paid, as described above, and may (where the contract permits it) receive a performance fee based on the underwriting result. In addition, the MP is remunerated by a predetermined percentage share in the investment profit.

23. Some RSAs permit extension of the *Muḍārabah* element of the model to cover also the underwriting results of *Microtakāful* operations.⁷

24. As with the *Wakālah* model, the residue in the MRF after payment of all contractual obligations including profit shares due to the MP is attributable to the participants collectively.

(c) *Wakālah-Waqf*

25. Under a *Wakālah-Waqf* model, the MP's shareholders and potentially also *Microtakāful* participants contribute seed money to the establishment of the *Waqf* MRF. In addition to acting as a *Waqif* (trustee) to the *Waqf* MRF, the MP also undertakes the role of a *WakĒl* to manage the underwriting activities. The *Wakālah* fee must be pre-agreed and expressly stated in the *Microtakāful* contract.

26. The residue in the MRF after payment of all contractual obligations including profit shares due to the MRF is attributable to the *Waqf* fund.

(d) *Cooperative*

27. In a Cooperative model, the MP's shareholders and the participants establish a Cooperative MRF. All management expenses and acquisition costs are paid out of the Cooperative MRF. There is however a difference between the Saudi Cooperative Model and Sudan Cooperative Model. In the

⁷ Many scholars disagree with the MP taking any percentage of an underwriting surplus under a *Muḍārabah* contract, on the ground that an underwriting surplus is not a profit, though some consider that a performance fee may be permitted. In any event, none of the respondents to our survey claimed to be using a pure *Muḍārabah* model.

former, the MP 'applies the *Wakālah* contract to its *Takāful* scheme hence entitles itself to a *Wakālah* fee. It also takes a share of underwriting surplus from the Cooperative MRF. In contrary to the former, the latter does not allow the sharing of surplus between the MP and the participants, rather all surplus belongs to the participants. Furthermore the latter applies the *Muḍārabah* contract to its *Takāful* operation hence it would be remunerated via a predetermined share of investment income for being a *Muḍārib*. Another important feature of this model is that the participants have their own representatives appointed by them in the BOD.

(e) *Mutuals*

28. Usually, the Mutual model is a not for profit model applied by the MP. In this model, the MP's shareholders who are also participants establish a Mutual MRF. Participants of a Mutual model automatically become owners of the Mutual MRF at the inception of participation. Participants jointly contribute to the MRF which is used to serve claims of member participants. Similar with Cooperative model, all management expenses and acquisition costs are paid out of the Mutual MRF. Participants comprise the general assembly of the MP, which is responsible for appointing the BOD. Also, participants may either receive a share of surplus or reduction in future contribution if surplus is retained.

(f) *Sharing of Surplus*

29. Surplus sharing is an element of *Takāful* which to date is still deliberated at length by the *Takāful* industry. Well known for its unique payback feature to the participants, many industry players still use this surplus sharing mechanism as an enticement feature to attract the general public to participate in *Takāful* plans. This is especially obvious in General *Takāful* products which are renewable annually. It is usually at the end of the certificate term that any surplus generated from the PRF will be shared between the participants and the shareholders of the TOs. As envisaged in *IFSB – 8*, surplus generated from the underwriting funds will usually be shared at a pre-agreed percentage between the shareholders and the participants. The portion for participants will either be distributed to the participants themselves or be retained in the PRF to build up the reserves to strengthen the fund for solvency purposes (IFSB, 2009).

30. Although the issue with regards to surplus sharing remains to be the responsibility of each *Sharī'ah* Board of each respective jurisdiction and likely to remain also an issue for MPs, it is not this feature that creates concern with the MPs and its stakeholders. The real predicament is on whether surplus should be distributed to the participants or should it ideally be required to remain in the MRF. In a sector where the obligation to honor claims is much higher than the need to make profit out of product offerings, the need to ensure sufficiency of MRF creates greater burden on the MPs. This makes it even more crucial for solvency of MRF to be observed. To achieve this, some MPs argue that the most appropriate mechanism is to retain surplus in the MRF. The objectives of surplus retention must be disclosed to participants to ensure transparency is observed especially in practices where there are no participants' representation in corporate governance of the MPs.

31. However, whether this approach is feasible or practical remains to be an open question that needs to be answered by the MPs and its RSAs. There needs to be proper judgment on whether it is more viable to retain surplus in the MRF (to build capital strength of the fund) or to distribute surplus to the *Microtakāful* participants (in an attempt to increase their interests in products that have a payback feature). An alternative that has been found to be practiced in certain jurisdictions is to direct the surplus

to the general welfare of the low income group or to enhance the benefits of the product. This practice provides the low income group a general sense of gaining something back through the enhanced benefits and better welfare. Another suggestion provided by a research mentioned that it would be more appropriate for surplus to be ploughed back as *Tabarru'N* for additional coverage on personal accident cover since the amount of surplus generated from the small contribution of *Microtakāful* participants do not normally count as a form of savings for this low-income population. It would benefit them more if extended coverage is provided (Mokhtar, Sulaiman, & Ismail, 2012).

32. An example of surplus distribution being done is the declaration of surplus by *Takāful* Insurance of Africa (TIA) in Kenya whereby all its policyholders, including the *Microtakāful* participants received a total of USD120,000 for the financial year ending December 2012 (Chao-Blasto, 2014). TIA believes that “Surplus distribution is the beauty of *Takāful* and a testimony to *Sharī'ah* compliance, fairness and equity of the process” (Takaful Insurance of Africa, 2013).

II. Differences between *Takāful* and *Microtakāful*

33. Given the conceptual similarities between *Takāful* and *Microtakāful* as explained in paragraph 14, the following shall illustrate the differences between these two prior to exemplifying the necessity to change the current regulatory framework of the *Takāful* industry for regulation of *Microtakāful*.

(a) Type of *Microtakāful* Providers (MPs)

34. *Takāful* exists in a highly regulated financial environment whereby the *Takāful* Operators (TOs) are required to be licensed prior to being allowed to offer *Takāful* products to the industry. Among the key requirements to be fulfilled include the need to be *Sharī'ah* compliant in their operational model, to meet minimum capital requirements, to have in place a governance framework that addresses the interests of all key stakeholders, to have in place a *Sharī'ah* governance framework to ascertain *Sharī'ah* compliance at all times as well as to have in place investment and risk management framework for prudential management of the funds overseen and managed by the TOs, i.e. Shareholders Fund (SHF) and Participants' Risk Fund (PRF)⁸. The current regulations on these TOs are pertinent since they are profit-oriented and competition is stiff between the various TOs. RSAs are responsible for prudential and/or market conduct supervision to protect the interests of the *Takāful* participants and might consider that the profits generated by the TOs are not achieved at the expense of the *Takāful* participants.

35. *Microtakāful* on the other hand exists in an environment which to date is yet to be strictly regulated in many jurisdictions. With the worldwide financial system opening its door to financial inclusion, many RSAs in various jurisdictions remain elusive when it comes to regulating the MPs. This elusive approach has led to the existence of MPs that may or may not be licensed by the *Takāful* /insurance RSAs to offer *Microtakāful* products to the participants. Some of these MPs hence may not fulfill the regulatory and supervisory requirements of normal TOs. Three types of MPs have been identified to provide *Microtakāful* products to the participants (“MPs” shall henceforth be referred to institutions offering *Microtakāful* products, including the licensed TOs).

⁸ IFSB-8: Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings recommends six guiding principles as reference for establishment of a TO's governance framework. IFSB-11: Standard on Solvency Requirements for Takaful (Islamic Insurance) provides seven key features to be followed in constructing a solvency structure for TOs. IFSB-14: Standard on Risk Management for Takaful (Islamic Insurance) Undertaking provides key elements in constructing a risk management framework for TOs.

(i) The first type of MP is the TOs themselves. These are formal institutions which are regulated by the RSAs of *Takāful* /insurance in their own jurisdictions. Governed by *Takāful* regulations, these licensed TOs create products which are specifically targeted at the low-income population. Although some of these products may or may not follow the same guideline of the normal *Takāful* products, they nevertheless go through a thorough product development process required by the RSAs using a proportional approach⁹. Although some TOs do not specifically term their products as 'products for the low-income' or *Microtakāful* products, several TOs have started this initiative when plans with as low as USD 3.00 in annual contribution started to be offered to rural population¹⁰. Many TOs in the industry have since taken up the challenge to provide *Microtakāful* products to the low-income population by modifying their underwriting requirements through the creation of simple and easily comprehensible products. These are done with the conscious mindset to uphold the *Maqasid*¹¹ of *Sharī'ah* within the population (Vejsagic & Smolo, 2015).

Example: Prime Islami Life Insurance Ltd in Bangladesh launched several products (Monthly Small-Savings Assurance Plan, Prime Islami Deposit Pension Scheme and Kalyan-Bima Two Payments Deposit Pension Scheme) for the poor people of Bangladesh since 2001. These products were created for agricultural and factory workers, small traders and housewives, as well as self-employed workers. These are groups of people who are not able to make huge annual contribution but are able to contribute US\$2 monthly (ICMIF Takaful, 2014).

(ii) The second type of MP consists of the institutions regulated by formal entities other than RSAs of *Takāful* /insurance, under laws other than *Takāful* /insurance law in their jurisdictions. These are formal institutions which may or may not exist to generate profits. Their main source of income does not come from insurance/*Takāful* activities. They may or may not be licensed, but nevertheless they are regulated. These organisations range from Zakat collectors, Sadaqah collectors, and many other types of charity-driven institutions or associations which main reason of existence is to provide for the low-income and the poor. These MPs may also be government agencies which work together with TOs to come up with *Microtakāful* products, or may also be microfinance institutions (MFIs) which provide loans to low-income population, and the *Microtakāful* products that they offer are just side products which are bundled together to cover the loans provided by these MFIs¹². Products coming from these formal entities are usually driven by state or national initiatives to promote financial inclusion. Contributions from this second type of MPs may come from the participants themselves, from Zakat or Sadaqah funds, from donations, or even national budget to provide *Microtakāful* protection for the low-income section of the population. The regulations that govern their activities may not be as stringent as the regulations imposed by RSAs of TOs.

⁹ The IAIS' *Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets (October 2012)* provides guidance on proportionate approaches to be used for inclusive finance. The proportional principle works two ways: for low risk activities, simpler and less burdensome guidelines are used. For complex and riskier activities, more sophisticated methods and techniques will be used.

¹⁰ Syarikat Takaful Malaysia has since its incorporation in year 1984 offered inexpensive funeral expenses group plans to the poor. This initiative is followed by Etiqa Takaful Bhd, also in Malaysia when the organisation started in year 1993. These products are also made available to rural population. Amana Takaful of Sri Lanka, has since 1998 been providing coverage to the cottage industry and to self-employed individuals in Sri Lanka, with a focus on people running small businesses.

¹¹ *Maqasid of Shariah* means the objectives of Shariah. Under Islamic Jurisprudence, the main five objectives of Shariah to protect the interest of mankind are (1) Protection of Al-Din (Religion), (2) Protection of Al-Nafs (Life), (3) Protection of Nasl (Lineage & Family), (4) Protection of Al-'Aql (Intellect or Mind) and (5) Protection of Al-Mal (Property)

¹² In Sri Lanka, this practice is widespread due to the absence of the licensing requirement on MPs.

Example: An example of government-driven initiative is the *Microtakāful* scheme launched together with the Farmers Welfare Federation of Malaysia (an NGO). The product which was developed by *Takāful* Ikhlas in 2007, was funded by the Malaysian government with contributions as low as US\$6.00 per annum. It provides immediate death benefit of US\$140.00 covering 100,000 members (Mokhtar, Sulaiman, & Ismail, 2012).

(iii) The third type of MP is the unregistered and unregulated institutions. These are informal entities that are unregulated by RSAs of *Takāful* /insurance law, or any other formal entities under laws other than *Takāful* /insurance laws. These MPs may be informal groups or community associations that are created to provide *Microtakāful* coverage to their own members. Some of these guaranteed benefits include funeral expenses benefits, or simple death or total permanent disablement benefits. The participants of these MPs are not protected under any type of legal settings.

(iv) **Example:** In Malaysia, especially in rural areas, members of the community often establish a Funeral Expenses fund where contributions are collected from members of the village at an amount as minimal as USD1,40 per annum. These are unregistered groups where contributions are paid to and collected based on good faith by the collectors appointed by the village's mosque.

(b) Type of Participants

36. **Takāful** participants are regular income earners. Most often than not, they are average and above average income earners. Although different jurisdictions may define 'basic infrastructure' differently from one another, most of the *Takāful* participants live in areas with basic infrastructure including roads, market, water and electricity. Their socioeconomic conditions allow them to have easy access to common financial products offered by the *Takāful* industry. *Takāful* participants are also more exposed to various financial products offered by financial institutions hence making information asymmetry less of an issue for them. They are also very much aware of the importance of *Takāful* products through the various campaigns done by the TOs in these areas that are easily accessible by intermediaries of TOs.

37. **Microtakāful** participants are on the other hand irregular or low-income earners. Many *Microtakāful* participants do not enjoy basic amenities. They have less exposure to financial products simply because of the lack of campaign done by financial institutions in the areas that they live in due to the lack of basic infrastructure. Under the general financial terms, they may not have access to financial services due to their socioeconomic conditions which may include residing in the areas which are unreachable by the common means of communication and transportation due to lack of development. In general *Takāful* terms, *Microtakāful* participants are commonly the group of people who do not fulfill the financial and underwriting requirements due to their inability to meet the basic health and financial requirements as stipulated by the TOs' underwriting and financial requirements. It has been observed that the profile of *Microtakāful* clientele would mostly coincide with the profile of microfinance participants. This however, may extend to include people who do not necessarily need a loan but are low-income and possess insurable risks.

38. **Example:** Amana *Takāful* Insurance¹³ works together with Muslim Aid Sri Lanka to implement Islamic microinsurance in Sri Lanka through its scheme named Micro Insurance Navodaya (Navodaya means 'dawn of a new era'). Among the targeted groups are garment manufacturing companies to promote *Microtakāful* to factory workers who fall under the low-income bracket and is able to pay only USD0.22 a month. Amana *Takāful* Insurance also targets workers of tea estates.

¹³ <https://www.takaful.lk/>

(c) Product Features and Contribution

39. **Takāful** products generally come with various kinds of product features, from simple to complicated. Simple product features are products which require minimum explanation and minimum prerequisite knowledge on the part of the participants prior to participating in the plan. Two examples of simple products features are death and total permanent disablement benefits whereby the MP does not require extensive and comprehensive explanation in enabling the participant to understand the product. The terms and conditions for participation are also easy to comprehend since the exclusions are minimal. Complicated products features on the other hands require certain prerequisite knowledge on the part of the participants and thorough explanation on the part of the MP. A good example is the hospital and surgical plan for participants. The participants need to be able to comprehend the types of hospitalization and surgical procedures that are covered under the plan, as well as the limit that they are able to claim under the plan. This requires time and efforts on the part of the MP, with appropriate follow-up clarification for better understanding of the participants, especially in understanding the terms, conditions and exclusions that come with such product features. Sophisticated products are made available for *Takāful* participants since they are generally easily reachable by *Takāful* intermediaries through common means of communication and transportation. With these variations in product features, the contribution amount required of these products will reflect its simplicity or sophistication, which does not pose economic constraints to those who can afford these products.

40. **Microtakāful** products on the other hand are in practice generally simple and easy to understand. Its simplicity is pertinent in reaching out to participants residing in areas that may not be easily accessible by normal means of communication and transportation by the MPs. Simplicity is also key consideration in product design given the economic capability of participants to obtain such coverage at an affordable contribution. It is also worthy to mention that simple product features translates to simple claims procedures and verification, which is key operational requirement of a successful *Microtakāful* initiative.

41. **Example:** Credit *Microtakāful* plan was introduced by Takmin (*Takāful* Mikro Indonesia) in year 2006, a joint partnership between *Takāful* Indonesia and Peramu, an NGO. Takmin works together with cooperative bodies that act like MFIs in the island of Java to provide loans to start up business or to help expand the current business. These MFIs provide Grameen style microfinance for women from poor families in which 25 – 30 women provide mutual help to each other with the financing provided based on Qard Hassan (Mokhtar, Sulaiman, & Ismail, 2012).

(d) Distribution Channels

42. **Takāful** products are known to have complex and costly distribution channels. Given the range of products from simplest to the most sophisticated ones, TOs need various channels that are able to meet the requirements of different categories of participants. The most common ones are individual agents, corporate agents and brokers. These distribution channels survive based on the various layers of the agency and brokerage commission structure. The pricing of *Takāful* products is hence dependent on the type of distribution channel used to distribute the products to the participants. The more complex the product channel is, the higher the transaction costs will be manifested in the contribution paid by the normal participants who expect better services to be provided by these intermediaries.

43. **Microtakāful** products on the other hand are simple yet challenging to distribute to the participants due to the demographic characteristics of the participants. The need to remain simple yet affordable make distribution taxing since majority of the participants may reside in areas that are unreachable by normal means of communication and transportation. Low cost distribution is essential to

a successful *Microtakāful* development. Some of the popular distribution channels that have been identified in the industry include the use of mobile phones. The transactions (exchange of aqad and payment of contribution) take place via deduction of mobile phone credits and an exchange of simplified contract wordings which are comprehensible based on the simplicity of the terms and conditions of the *Microtakāful* products. Some MPs have indicated that they appoint small grocery stores or pawn shops to be the distribution channels since these are frequently visited by *Microtakāful* participants. There are also instances where distribution channels are provided by government or associations providing social welfare initiatives which are tied up together with the MP's products. With these simple and non-complex distribution channels where there are not many agency layers to share commissions, the transaction costs for distribution of *Microtakāful* products are easily driven down. It is also shown that trust plays an important role in the use of certain type of distribution channel. Where products are distributed via local mosques, religious groups or trade union, the participation rate seems to be higher. Another channel that is slowly paving its way through *Microtakāful* participants is through MFIs. With product bundling being one of the mechanisms to distribute *Microtakāful* products, *Microtakāful* products are automatically attached with the products of the MFIs.

44. **Example:** Takmin (*Takāful* Micro Indonesia) works together with an NGO, Peramu in empowering the poor in Indonesia through *Microtakāful* products. Peramu works closely with Baytul Maal Wat Tanwil Cooperative in various small districts in Indonesia to distribute *Microtakāful* products in Bogor, Indonesia (Haryadi, 2006).

(e) Consumer Education

45. **Takāful** objectives and values are widely understood by the middle income earners which lead the purchasing power among the Muslim consumers. The high level of awareness among the middle income earners can be attributed to the development of Islamic finance as well governments' direct involvement in supporting the conducive atmosphere and enabling environment for growth of the *Takāful* industry. This is especially true for countries such as Malaysia, Pakistan and Nigeria whereby the RSAs have issued various guidelines and frameworks particularly for *Takāful* market players.

46. **Microtakāful** objectives and values are not known or understood by the target market itself. This is due to the low level of education and financial literacy it has, which makes it incognizant towards the risks that may cause it further suffering and financial losses. More often than not, potential *Microtakāful* participants see no value in paying contribution for future benefits that may or may not be paid to them. This phenomenon has led to weak demand for *Microtakāful* products. Lack of awareness and understanding of *Microtakāful* has also opened doors to deliberate misseling of *Microtakāful* products by irresponsible agents which further damages the reputation of *Microtakāful*. Some studies have suggested that awareness programs could be conducted by mosques, *MuĀllas*, and Zakat institutions as they are within the reach of the aforementioned target market.

47. **Example:** The collaboration between Amana Takaful and Muslim Aid has contributed immensely to the development of *Microtakāful* and *Takāful* understanding amongst the low income segment in Sri Lanka. Muslim Aid specialises in providing *Shari'ah* compliant microfinance services to the financially under privileged making it the best platform for dissemination such information. Dissemination of information is done through regular meetings and awareness programs which coincide payment of microfinancing dates which gave the aforementioned institutions to interact with the low income earners directly. This has boosted the demand for *Microtakāful* in Sri Lanka (Lanka Business News, 2010).

(f) Operations

48. **Takāful** operators operations are usually lengthy due to the complex structure that they adopt. In certain countries, potential participants would have to go through agents in order for them to participate in a **Takāful** scheme. Usually it would take a few days for the applications to be processed and approved by the TOs. Claims management also goes through the same length process. Although TOs are required to ensure that claims management are conducted amicable, they have a set of process and procedures that they have to follow in order for them to pay the claims made by participants or their beneficiaries. This lengthy process is to prevent fraudulent claims or payment of invalid claims that may affect their funds.

49. **Microtakāful** operators operations are less complicated to that of TOs. Subscription of **Microtakāful** schemes are made simple and within reach of potential **Microtakāful** participants. Furthermore, just like the TOs, MPs are required to ensure claims processing and payments are done promptly without unnecessary delays. However, MPs claims management process is usually simple while still having proper mechanism to control fraud in place. In practice, some MPs transfer their processing and approval of applications, and claims process to its non-governmental organization or government agency partners.

50. **Example:** In Malaysia, Etiqa Takaful and Angkatan Koperasi Kebangsaan Malaysia (a government agency) launched Tabarru' Koperasi scheme whereby it covers death and total permanent disability up to 80 years old. This scheme is only open to the members of the cooperative only, and also members of cooperatives that are overseen by Angkatan Koperasi Kebangsaan Malaysia (Angkatan). The contribution for this scheme is as low as USD 1.30 to as high as USD 6.80 per year which pays a death benefit as high as USD 5159.00. Operations for this particular schemes has been simplified in the sense that all management of scheme such as applications and claims are done by participating cooperatives for their members (ICMIF, 2014).

III. Differences between Microtakāful and Microinsurance

51. The differences between **Microtakāful** and microinsurance are similar with the differences between **Takāful** and insurance. The non-existence of the elements of Riba, Maysir and Gharar in **Takāful** as explained in IFSB – 8 in the product features and contractual relationship between the MPs and its participants (IFSB, 2009). This makes **Microtakāful** products more appealing to the section of population who are conscious about the religious implication of their participation in financial services offered by various types of financial institutions. In Pakistan for example, 96% of the populations are Muslims. They believe that the principles set forth in the conventional insurance mechanism are against their faith and belief. On the contrary, they accept that the principles in **Microtakāful** promote cooperation among the members of the community and are able to serve the people better (Khan, 2013).

52. The Core Principles of **Takāful** as outlined in Paragraph 14 of the IFSB – 8 is equally applicable for **Microtakāful**¹⁴.

¹⁴ The three principles cited in IFSB – 8 are *Tabarru'* Commitment (*Tabarru'* commitment is a type of Islamic financial transaction that is fundamental to **Takāful** schemes. It is the amount contributed by each **Takāful** participant to fulfil obligations of mutual help and to pay claims submitted by eligible claimants), *Ta'awun* (The concept of *Ta'awun*, or mutual assistance, is another core principle to the operation of **Takāful**, with participants agreeing to compensate each other mutually for the losses arising from specified risks. As **Takāful** has often been perceived as a form of cooperative or mutual insurance, the initial objective is not to gain profit but to assist one another mutually, under the principle of *Ta'awun*) as well as Prohibition of *Riba* (Conventional insurance business involves the element of *Riba*).

IV. Survey Findings on Industry & Regulatory Practices of *Microtakāful*

53. In an effort to understand the *Microtakāful* sector better, the IFSB and the IAIS undertook a survey on *Microtakāful* in the third quarter of 2014. This section provides an analysis made out of the responses received from the survey result bearing in mind that the number of responses received may not be sufficient to form any concrete conclusion as to the nature of the *Microtakāful* industry. It however serves as guidance for the development of the remaining part of this paper.

54. When the survey was sent out, it was intended to target institutions providing *Microtakāful* products. While the survey was sent to 64 institutions/RSA's, only 25 respondents provided feedback. A concrete reason which contributed to the low response was the non-offerings of *Microtakāful* products where 10 out of the 25 respondents stated 'non-offerings' as their main reasons for not participating in the survey.

55. Based on the limited information provided by 15 participating respondents, the survey result gave an indication that while *Microtakāful* is still not as widespread as the normal *Takāful* products, a few institutions have already taken the steps to provide coverage to the low income population via low-contribution and simple products, most commonly death, total permanent disablement and credit *Takāful*. Although the infrastructure for *Microtakāful* administration is not fully in place for many of these 15 institutions, steps have been taken to ensure simplified products and simplified claims administration provide ease of transactions for participants.

56. From regulatory perspective, the survey result indicates that there is currently no specific regulation on *Microtakāful* in place. Where the MPs are non-TOs, there may not be a specific regulation to oversee their operational framework. Where MPs are TOs, they may be required to adhere to existing regulations and guidelines of the normal TOs. These include the requirements on licensing, requirements on appointing intermediaries, solvency requirements as well as the separation of the MRF and the Shareholders' Fund.

57. In preserving the interests of participants, MPs are required to have similar governance framework, in which the key organs to preserve interest of stakeholders are Board of Directors, *Sharī'ah* Board as well as Senior Management. In circumstances where conflict arises, three RSAs indicated that the similar rectification mechanism that is already in place for the normal TOs will be used on the MPs.

58. While the findings do provide certain insight on what is currently going on in the industry, the amount of information acquired through this survey exercise may not be indicative of what the majority of the MPs are currently doing or not doing. Nevertheless, it could provide an avenue to highlight all the potential areas requiring attention of the regulators of MPs.

59. To quote a paragraph from IAIS' paper on *Issues in Regulation and Supervision of Microinsurance (June 2007)*, 'Regulators and supervisors in emerging market jurisdictions have little experience or empirical data to support their role in creating an 'inclusive' insurance market that works effectively for the upper as well as the lower income segments, with the latter being the focus of microinsurance, this lack of data exemplifies the fact that the RSAs of MPs may be encountering similar

Hence, it is important that investments in both the *Takāful* funds and the shareholders' funds are *Riba*-free types of investment).

challenge in regulating the *Microtakāful* sector¹⁵ (International Association of Insurance Supervisors, 2007).

60. The following section aims to highlight the issues and challenges of *Microtakāful* in the areas of (i) corporate governance, (ii) Financial and Prudential Regulation, (iii) Transparency, Reporting and Market Conduct and (iv) Supervisory Review Process. Appropriate examples, may be cited from relevant sources to provide a better understanding of the issues, challenges and opportunities that are engulfing the *Microtakāful* sector.

C. SUPERVISORY AND REGULATORY FRAMEWORK FOR MICROTAKĀFUL

61. Given the background of *Microtakāful* in the previous section and its differing features from *Takāful*, this section shall look at the issues and challenges arising from prudential regulation of *Microtakāful* practices in the industry. Relevant examples from various jurisdictions on the specific issues faced shall also be highlighted in this section to provide reference on how certain regulatory issues may be handled effectively. Specific reference shall also be made to some of the work that has been done by the International Association of Insurance Supervisors (IAIS) on microinsurance, specifically on the proportionate application of ICPs to regulation of microinsurance. The relevance of these ICPs to *Microtakāful* shall also be highlighted.

I. Corporate Governance

62. The corporate governance structure of an MP is as important as the corporate governance structure of any financial institution. MPs carry with them the responsibility to uphold not only the economic obligation towards the participants, but at the same time the responsibility to uphold the principles of *Sharī'ah*. It is hence significant that issues pertaining to the governance structure of MPs are highlighted in this section.

63. Similar to *Takāful*, various stakeholders play key roles in the sustainability of the *Microtakāful* sector. These stakeholders include the *Microtakāful* participants, government agencies, RSAs, *Sharī'ah* Board, and most of all, the MPs which may be the formal or informal entities.

(a) Interests, Roles and Responsibilities of External Microtakāful Stakeholders

(i) Government

64. The welfare of the low-income is highly dependent on the social security services of the state government of every jurisdiction. In many jurisdictions, the social security provides subsistence to individuals with inadequate or no income. In certain countries, developed nations such as the United States of America and the United Kingdom, their social security system is well planned and covers all qualified citizens in the countries. In other parts of the world such as Indonesia where there are over 220 million population, only 17% of the working population is covered under the contributory social insurance (International Labour Organization, 2015). The rest of the population in informal economy relies on local mutual support arrangements. In Pakistan, there are two types of social security programmes; one

¹⁵ When the IAIS conducted its survey in 2006 where participants were all IAIS' members, only 35 institutions provided feedback.

provides benefits to needy Pakistani Muslim citizens, the other to needy Pakistani citizens (U.S Social Security Administration Office of Policy, 2006). Similar to Indonesia, Pakistani's social security program covers employed citizens only. Family labor and self-employed persons are excluded from these schemes.

65. There have been efforts to expand the scope of coverage in these mentioned countries through various outreach programs such as the one done by International Labor Organisation (ILO) in Indonesia. Various initiatives are being done to expand the scope of coverage for social security. The ILO for example, formulated the National Employment Guarantee Programme for Indonesia to help alleviate situations of poverty, unemployment and underemployment, particularly among youth and in rural areas, as well as to create productive assets and services for the economy (National Planning Agency & International Organisation , 2005).

66. This outreach program is an example of how state governments of various jurisdictions may include the population in rural areas that are not easily accessible by normal means of transportation, where access to basic amenities are limited and the low-income in these areas are generally shun from participation of the simplest form of financial services. Government, based on the collection of taxes and contributions from higher income segment of the population would use the amount collected to provide for the basic needs of the low-income.

67. While it is still uncommon for many government agencies to provide *Microtakāful* coverage to its low-income, for the simple fact that not many *Microtakāful* products are being offered by majority of the formal MPs, there may be a need for these agencies to work towards creating awareness among the low-income, educating them on the need to have simple coverage to protect their loved ones in the unfortunate event of their demise. In addition, these government agencies may need to work together with formal MPs in coming up with simple protection schemes which are not detrimental to the financial condition of the formal MPs but at the same time serves as an avenue to widen the scope of financial services to include the low-income population. Another viable option would be for the government to work together with established grassroots organization. Such collaboration help build these organizations' capacity to deliver *Microtakāful* products to their members.

68. Comprehending the roles and functions of RSAs and regulators of other formal entities in regulating the *Takāful* industry is crucial especially when stability and soundness of the industry is key to the sustainability of MPs. This will ensure that the product offerings to the low-income will be successful and not detrimental to the survival of any of the key stakeholders.

69. Lack of cooperation between government and MPs might lead to conflict. An example would be when the contribution provided by the government is insufficient to cater for the solvency requirements of the MPs, especially if these MPs are TOs which are required to fulfill the regulatory solvency requirement under their *Takāful*/insurance law. Since claims are paid from the risk funds of the MPs, insufficient contribution may lead to high claims ratio of the MPs. This in consequence may affect other participants of the MPs especially if the MPs lump the contribution of *Microtakāful* products together with the contribution of normal *Takāful* products.

(ii) Regulatory and Supervisory Authorities (RSAs)

70. RSAs of MPs which are TOs play key role in understanding the nature of *Microtakāful* participants prior to regulating the *Microtakāful* industry. This is since literacy, financial stability and accessibility may be constraints for the low-income population's participation. This thorough understanding will facilitate the RSAs in playing a supporting role in helping the *Takāful* industry expand the scope of *Takāful* coverage to the low-income via *Microtakāful* products. Some of the areas by which RSAs may play a supporting role include:

- (a) Introducing proportionate regulatory and supervisory requirements (which cover corporate governance, financial and prudential regulation, market conduct as well as supervisory review process) for both low and high risk *Microtakāful* participants.
- (b) Providing an avenue for all stakeholders of *Microtakāful* to interact and understand the roles and functions of each stakeholder. These include government agencies, charity organisations, MPs, central *Shar'ah* advisory board, intermediaries and potential participants.
- (c) Providing accessible channel of communication/recourse for *Microtakāful* participants in cases of misrepresentation/fraud.
- (d) Ensuring products developed by MPs actually address the needs low-income segment
- (e) Ensuring that the MPs entering the market are there for the long term and not for short term gains to demonstrate the value of *Takāful*.
- (f) Understanding the demographic nature of *Microtakāful* participants through development of separate mortality and morbidity tables which capture all insured and uninsured population, understanding the risks revolving around them which may be uncommon among the insured population, understanding the nature of occupation of these participants as well as comprehending their barrier to participation to see if it is due to real barriers or mere misconception of financial products.
- (g) Outlining a different monitoring mechanism on intermediaries which may include non-conventional intermediaries such as pawn shops, small grocery stores, mobile-phone service providers, etc.
- (h) Ensuring a close monitoring of financial condition of formal MPs to ensure that the offerings of *Microtakāful* products are not made at the expense of stability and soundness of the MPs, and the risks taken in by the TOs to include the high risks low-income population will not affect the *Takāful* industry in the long run.
- (i) Identifying the various types of MPs that offer *Microtakāful* plans in their jurisdictions which may or may not be regulated by these RSAs for the purpose of understanding the risks that these MPs might pose to financial stability.
- (j) Understanding the regulations of other jurisdictions that have been established for microinsurance/*Microtakāful*, prior to coming up with its own regulation to suit the local requirements and adaptability¹⁶.

¹⁶ The Republic of South Africa in year 2011 issued "*The South African Microinsurance Regulatory Framework*" to facilitate a more conducive financial environment for financial inclusion. This framework which was developed by The National Treasury aimed to (a) Extend access to a variety of good-value formal insurance products appropriate to the needs of low-income households, thereby supporting financial inclusion, (b) to facilitate formalised insurance provision by currently informal providers, and in the process promote the formation of regulated and well-capitalised insurance providers and *small business development*, (c) *Lower barriers to entry*, which should encourage broader participation in the market and promote competition amongst providers, further supporting poverty alleviation through economic growth and job creation, (d) Enhance consumer protection within this market segment through appropriate prudential and business conduct regulation, improved enforcement of regulatory transgressions, and consumer education interventions targeted at understanding insurance and its associated risks and benefits and (e) Facilitate effective supervision and enforcement, supporting the integrity of the insurance market as a whole.

71. In jurisdictions where *Microtakāful* initiatives are government-funded program, the question arises as to whether these RSAs should be held responsible for programs that they cannot prudentially supervise effectively. This is a delicate area especially if the program is subsidized by the government or funded by charity. The MPs themselves might not be able to fully enforce underwriting requirements on participants. The possibility will then arise for RSAs to be in conflict with the government. To ensure the success of government-funded *Microtakāful* programs, cooperation between the government and RSAs play a key role. The RSA would act as facilitator of the scheme, moderator in the event of conflicts and protector in upholding participants' rights.

(iii) Retakāful Operators

72. Licensed MPs that are regulated by RSAs have access to services provided by the *Retakāful* Operators (RTOs). In circumstances where RTOs are required to provide coverage for *Microtakāful* products of the MPs', a comprehensive understanding of the nature of *Microtakāful* participants is crucial to ensure that these RTOs are aware of the type of risks involved when *Microtakāful* participants are concerned.

73. Just like the TOs, the licensed MPs are exposed to the risk of insolvency of the MRF due to high claims, poor underwriting and insufficient contributions. Particularly MPs that are involved in government funded *Microtakāful* initiatives whereby the contributions are subsidized by the government. Since it is the MPs fiduciary duty to ensure that claims are paid, it is essential that *Retakāful* arrangements are in place is in initiatives such as these. It is important that RTOs have the capacity to underwrite risks that are relatively new to them.

74. Difficult circumstance may arise when an MP is not licensed under any jurisdiction's *Takāful* or insurance law. The MPs may not be able to have access to *Retakāful*/reinsurance services hence limiting its ability to expand the scope of coverage.

(iv) Regulated MPs (by regulators of formal entities other than RSAs)

75. Entities which are not regulated by the RSAs, but maybe regulated by other regulator of formal entities such as the *Zakat*, *Waqf* and other types of charitable entities may sometimes be involved in *Microtakāful* initiatives. When this happens, the products sold may not go through stringent product development process the way it would have been had an RSA is required to provide approval. This may pose a challenge to the various stakeholders of the *Microtakāful* schemes, especially the *Microtakāful* participants. No specific requirements for clients' protection might be imposed hence making participants more susceptible to misselling, misconduct of *Microtakāful* intermediaries, and damaging poverty alleviation efforts.

The role of the regulator of formal entities responsible in supervising non-*Takāful* related entities is essential in ensuring that entities attempting to replicate *Takāful* products for the benefit of the low-income are not made at the expense of the participants themselves. Respective laws of these regulatory agencies may wish to consider defining the requirements prior to allowing non-*Takāful* entities to offer *Microtakāful* products.

(b) Interests, Roles and Responsibilities of Internal Microtakāful Stakeholders

(i) Takāful Operators

76. In expanding the product offerings to include the low-income population, the *Takāful* Operators may need to take a comprehensive approach to better understand the new segment of the target market. It is crucial for these TOs to take the interests of all stakeholders at hand and identify the gaps that may arise when high risk low-income groups are offered *Takāful* products.

- Shareholders: the shareholders of *Microtakāful* operators need to be assured that the *Microtakāful* products offered to the high risk segment will not jeopardize the profitability of the TO. Furthermore, the shareholders have to be in this market for the right reasons and with the right long term approach. They need to take a patient capital investment approach and be willing to substitute some of the expected financial return with social objectives. Additionally, proportionate pricing for *Microtakāful* products needs to take into consideration the need for the MPs to stay solvent and stable, at the same time remain competitive in the market. The TOs need to fully understand the type of risks that they are exposed to when offering products to the low-income segment of the population.
- *Sharī'ah* Board: the TOs need to ensure that the product offerings meet the requirements set forth by the SB. In addition, the intermediaries used to distribute the products and the mechanisms by which the products are sold should meet the basic *Sharī'ah* requirements whereby transparency and disclosure of information is key to transferring rightful information to the relevant parties. The SB may also play a role in ensuring that the *Microtakāful* products are truly inclusive and reaching the most vulnerable as propagated under the principles of *Takāful*.
- RSAs: The TOs need to ensure that the basic requirements pertaining to the product development process, fulfillment of regulatory requirements and monitoring of financial condition of the institution as required by the RSAs are followed strictly. Any cooperation done with entities non-regulated by RSAs of TOs (Example: Sri Lanka deregulating the insurance sector to allow for new providers such as the MFIs to provide *Microtakāful* products) should be monitored and not compromise the stability of the *Takāful* industry.
- Government and charitable agencies: Any kind of cooperation or partnership that is conducted between the TOs and the government or charitable agencies should be clearly spelled out and be informed to the RSAs that are in charge of supervising these TOs.

(ii) Board of Directors

77. The Central Bank of Malaysia has issued guidelines and standards pertaining to corporate governance of MPs. These guidelines and standards may be applicable to MPs however they may face some difficulty in applying those same requirements of directorship to their corporate governance structure especially if they are unregulated. RSAs may want to apply the proportionality approach to the directorship requirements discussed below.

78. As custodians of public funds, MPs are governed by an active and dedicated BODs which have been entrusted by their respective shareholders to protect the interests of *Microtakāful* stakeholders. IFSB 8 emphasizes on establishment of governance framework by the BOD for the BOD to oversee its implementation. Under the aforementioned governance framework, the BOD is expected to establish

various committees which include but not limited to the audit committee, nominating committee, remuneration committee, risk management committee, and a *Sharī'ah* Supervisory Board which is in tandem with the provisions stipulated by Central Bank of Malaysia in its Guidelines on Directorship for Takaful Operators¹⁷ (IFSB, 2009) (BNM, 2004). The BOD is able to resort to appointing a *Sharī'ah* Advisory firm to oversee the *Sharī'ah* aspects of the business (IFSB, 2009). In addition to the establishment of the aforementioned committees, IFSB 8 suggested that the BOD establish an additional committee namely the governance committee to primarily focus on protecting the interests of the Microtakaful participants (IFSB, 2009).

79. The *Sharī'ah* Governance Framework¹⁸ states that the BOD of MPs is responsible to establish a sound and robust *Sharī'ah* governance framework. Such framework specifies the following (BNM, 2010):

- BODs oversight of *Sharī'ah* compliance aspects of MPs' operations;
- Establishment of SB;
- Establishment of *Sharī'ah* governance functions which include *Sharī'ah* research and secretariat, *Sharī'ah* risk management, *Sharī'ah* review and *Sharī'ah* audit;
- Establishment of internal *Sharī'ah* risk management, review and audit processes;
- Issuance and dissemination of *Sharī'ah* resolutions to relevant stakeholders

80. The Islamic Financial Services Act 2013 emphasizes that the responsibility of overseeing the implementation of *Sharī'ah* governance does not only lie with the *Sharī'ah* Supervisory Board but also with the BOD. It further explicitly requires the BOD to have due regard to any decision of the *Sharī'ah* Supervisory Board pertaining to any *Sharī'ah* issue in respect of the execution of business, affairs or activities of MPs. *"The Board of directors shall have due regard to any decision of the Shariah committee on any Shariah issue relating to the carrying on of business, affairs or activities of the institution."* Additionally, a specific legal provision catered to the Takaful business states that in the event there is a conflict between the interests of the participants and the shareholders, the BOD must give priority to the interest of the participants. *"The board of directors of a licensed takaful operator shall, in the event of conflict between the interest of the takaful participants and the shareholders, give priority to the interest of the takaful participants"*

81. Another important role of the BOD is to approve all policies and procedures of MPs relating to *Sharī'ah* matters. Such approval would only be granted to the management upon consultation with the *Sharī'ah* Supervisory Board. On top of that, the BOD maintains its oversight on the performance of the senior management of the MPs in managing their affairs and business activities. The BOD also has the authority to decide reduction of surplus distribution, or retention of surplus in the MRF if it believes building up reserves is more beneficial (Archer, Karim, & Nienhaus, 2009). Such decision made by the BOD may need to be conveyed to the *Microtakaful* participants through proper channels to get them to be more engaged and also understand the value of *Takaful*.

82. Prior to the appointment of the members of the BOD. They are required to go through fit and proper assessments, and such assessments are practically conducted at least annually to ensure that the

¹⁷ Guidelines on Directorship for Takaful Operators applicable to all Takaful operators inclusive of Microtakaful operators

¹⁸ *Sharī'ah* Governance Framework is applicable to all Islamic financial institutions governed by Central Bank Malaysia inclusive of Microtakaful operators.

members remain fit and proper to oversee the MPs operations at all times. The fit and proper criteria encompass the following (Laws of Malaysia, 2013):

- Probity, personal integrity, and reputation
- Competence and capability
- Financial Integrity

83. Also, the Guidelines on Directorship for Takaful Operators issued by Central Bank of Malaysia states that BOD members' appointment do not threaten the interests of participants, *Microtakāful* claimants, customers or creditors of MPs. It stresses that the members of BOD should not behave in a manner that may cast doubt if their fitness to hold their respective positions in the BOD which may lead to decisions and actions that are detrimental to the interest of MPs and their participants (BNM, 2004).

84. The composition of BOD is pertinent to ensure that sufficient number of members is always present to give proper direction and guidance to the management of the MPs therefore Central Bank of Malaysia has limited it to five (5) directors. The Central Bank of Malaysia discourages having more than eight (8) directors, but allows up to ten (10) directors with the condition that the additional two (2) are independent non-executive directors (BNM, 2004). It is encouraged for the BOD to appoint that at least one (1) member of the *Sharī'ah* Supervisory Board as a member of the BOD. The purpose of such appointment is to create a tie between the BOD and the *Sharī'ah* Supervisory Body which consequently inculcate the understanding and appreciation of *Sharī'ah* amongst the members of BOD in its decisions and resolutions (BNM, 2010).

85. Diversity in qualification of BOD members is imperative in enabling MPs to achieve their corporate goals and fulfil their fiduciary responsibilities. Consequently, Central Bank of Malaysia in its Guidelines for Directorship for Takaful Operators specifies that at least two (2) members of the BOD are qualified in the field of finance at university degree level, or have had a minimum number of five (5) working experience at managerial level in the field of finance. In addition, a member of the BOD that sits in the audit committee must have a university degree or working experience in accounting, auditing, and financial reporting. Central Bank of Malaysia encourages that the members of the BOD be appointed from various relevant disciplines which include law, accounting, and investment management (BNM, 2004). Since the BOD is ultimately responsible to establish *Sharī'ah* governance framework of MPs, its members are expected to have reasonable understanding of *Sharī'ah* and its general application to Takaful. The management of MPs are responsible to provide the necessary training programs and seminars to the BOD on *Sharī'ah* (BNM, 2010).

(iii) Senior Management

86. From a pure corporate governance perspective, the senior management of MPs is responsible for the implementation of the medium and long-term strategies to create value for shareholders of MPs. It is also in charge of implementing policies approved by the BOD and also assist the BOD to perform BOD's duties by ensuring that the BOD fully understands matters pertaining to Takaful business activities and operations. To ensure that the smooth running of MPs' business activities and operations, the senior management has to ensure the application of proper technology and systems in conducting MPs' day to day activities. Also, as previously mentioned, the senior management needs to provide the BOD with

various training programs inclusive of *Sharī'ah* so that it remains abreast with current issues in Takaful. The same shall be provided to the SB and all relevant staff of the MPs (IFSB, 2009) (BNM, 2004).

87. From the *Sharī'ah* governance perspective, the senior management is expected to observe and implement resolutions and ruling made by the SB. Additionally, in order for the SB to come up with a sound ruling and decision, the senior management has to provide the SB with sufficient information and disclosure on the matter at hand. The senior management must also ensure that *Sharī'ah* policies and procedures are readily available to all that are involved in the implementation of *Sharī'ah* governance in the MPs. Another important aspect of *Sharī'ah* governance is reporting of *Sharī'ah* non-compliance. The senior management plays a major role in reporting of such events to both the BOD and SB, and if relevant the central bank that governs the MPs (BNM, 2010).

88. The RSA of Nigeria requires the same role spelled out in paragraph 29 be carried out by the senior management of MPs. It also imposes on the senior management to ensure that the SB is remunerated at an appropriate level whereby it commensurate with the duties of the SB (National Insurance Commission Nigeria, 2013)¹⁹.

(iv) Shareholders

89. In practice, the shareholders are represented by the BOD they have appointed to ensure the smooth running of the MPs they own. They get to voice their concerns and monitor the performance of the MPs through general meeting and annual reports respectively. There are instances whereby the SB is appointed by the shareholders upon recommendation by the BOD as seen in Sudan cooperative model (Odierno, 2009) (Suliman, 2014). The general assembly is also a platform where general policies and rules on the governance and management are set (Suliman, 2014). Such practice may not be suitable to other models that exist in the industry especially in jurisdictions such as Malaysia where the authority of SB appointment has been awarded and entrusted to the BOD as required by the RSA (BNM, 2010).

90. According to Archer, Karim, and Nienhaus, the shareholders have the ultimate authority to appoint all governance organs of MPs inclusive of the SB. They too have full control of the operations of MPs which entitles them to decide on matters such as distribution of surplus amongst participants, business strategy, amount of contribution paid by participants and more. More importantly, it is the responsibility of the shareholders to provide the MRF with Qard in the event of deficit. This is to ensure that the MRF remains solvent and is able to make payment of claims when necessary. The practice of providing Qard by shareholder to MRF is acceptable to RSAs of Malaysia, Nigeria, and even by the OIC Fiqh Academy. However, the practice of shareholders being the ultimate authority to appoint governance organ and make all decision concerning the operations of the MPs may be only suitable to those using the Mutual model where the participants are the shareholders.

(v) Participants

91. Participants of *Microtakāful* have needs that are different from *Takāful* participants due to their socioeconomic conditions. Their lack of knowledge and exposure in comprehending financial products of MPs, coupled with their economic limitations to have better access to information make them susceptible to various types of miscommunications. An obvious example would be the misunderstanding of product features. A 36 *Critical Illness Plan* that provides coverage for the listed illnesses may be understood by a

¹⁹ Operational Guidelines 2013 Takaful-Insurance Operators issued by the National Insurance Commission of Nigeria are applicable to all Takaful operators inclusive of Microtakaful operators.

participant to cover the various stages of illnesses when in actual fact it may not necessarily be. The fine print of the exclusion section of the certificate wordings may not be easily understood by the participants.

Apart from exclusion of *Microtakāful* products, there may be some confusion on the understanding of underwriting surplus sharing mechanism as it could be a little bit too technical for participants of *Microtakāful*. They should be able to understand that there is a possibility that the underwriting surplus may not be distributed to them in the event it is held back as reserves. This may lead to frustration on the part of participants when a claim arises and benefits are not paid by the MPs. The unfortunate consequence includes the decrease in confidence in the *Microtakāful* system, which was created to protect the low-income in the first place. In addition, the demographic spread of participants in areas that are not easily accessible by common means of communication and transportation may also pose difficulties when claims arise. Participants may find the cumbersome claims process not worth the trip to the nearest office of the MP.

92. Many jurisdictions which have initiated *Microtakāful* schemes find merit in simplifying the kind of documents provided to the participants. To bridge the gap of knowledge, Muslim Aid in Sri Lanka conducts Financial Literacy Training programme for its members who participate in *Microtakāful* plans of Amana *Takāful*. This programme is aimed at providing the members a thorough understanding about *Takāful*, since it is observed that many of its members lack trust in *Takāful* services and possess low understanding of the importance of *Takāful*. When the *Microtakāful* products were first launched, many of its members had the initial perception that *Takāful* is a savings option rather than a protection option. In addition, Amana *Takāful* also simplified its product literatures to enable the *Microtakāful* participants to comprehend the terms and conditions of the coverage straightforwardly. On July 9, 2014, Amana *Takāful* launched its new mobile application for iPhones and Android devices. This application which is made available at no cost provides Amana *Takāful* participants the avenue to access their account details online. In addition, the application also aims to facilitate easier claims process through supporting photos provided by the participants (ICMIF Takaful, 2014).

93. While easy access to *Microtakāful* is the aim of MPs, the type of distribution channels used to reach the participants, if not monitored by the RSAs or regulator of formal entities, may lead to miscommunication. Consumer protection is hence a feature that needs careful consideration when positioning for an appropriate communication tool to reach the low-income population.

(vi) Sharī'ah Board

94. The requirement to comply with *Sharī'ah* principles is as significant to *Microtakāful* the way it is to normal *Takāful* products. Many potential *Microtakāful* participants find Islamic financial products more welcoming and encouraging as compared to the conventional financial products, due to the absence of Riba, Gharar and Maysir elements especially in *Takāful*. There is hence the need to ensure that the *Sharī'ah* principles are adhered to in all aspects of *Microtakāful* operation. Such need can be addressed by establishing internal SB by individual MPs. Certain RSAs in jurisdictions such as Malaysia, Nigeria and Pakistan have their central *Sharī'ah* Advisory Boards to the ascertain Islamic law governing the business and operational activities of MPs. In addition to the central *Sharī'ah* Advisory Board, MPs operating in the aforementioned jurisdictions are required by their RSAs to establish an internal SB to oversee *Sharī'ah* matters related to their business activities and operations. In countries such as Sri Lanka and Kenya where the MPs operate under the absence of a central SB at the RSA level they rely solely on their internal SB. Consequently, the SB discussed in the following paragraphs refers to internal SB.

95. While it is the ideal scenario where MPs comply with *Sharī'ah* principles, the practicality of such requirement may not be easy to be carried out. In a jurisdiction where MPs are not regulated under the same RSAs as the TOs, or there is no requirement to have *Sharī'ah* governance framework in place, the challenge will be in satisfying oneself that the products of these MPs are indeed *Sharī'ah* compliant. If a monitoring mechanism is not in place, the sanctity of *Microtakāful* products will become easily questionable by the public at large.

96. For MPs regulated by the RSAs, the *Sharī'ah* Board often ascertains the *Sharī'ah* compliance of the *Microtakāful* products through similar screening process done on normal *Takāful* products. Central Bank of Malaysia's *Sharī'ah* Governance Framework for Islamic Financial Institutions requires all Islamic Financial Institutions to have "a robust *Sharī'ah* compliance function, comprising review and audit functions supported by risk management control process and internal research capacity" (BNM, 2010). This is complemented by the Central Bank's *Takāful* Operational Framework (TOF) which requires all *Takāful* Operators to have in place a comprehensive product development process which includes *Sharī'ah* Board's certification prior to offering any type of product to the market (BNM, 2013).

97. Consistency in the interpretation of *Sharī'ah* rules and principles based on the science of Islamic jurisprudence is pertinent to the growth of *Microtakāful* industry, as it gives the confidence *Microtakāful* participants. In arriving to a decision, members of SB should seek to reach a consensus, and if that cannot be achieved, then the members should resort to a decision of a simple majority. To achieve consistency, the members of SB should study and take into consideration the decisions of other SB before issuing a pronouncement. The SB should follow and adopt the pronouncements of a central SB wherever relevant. If a central SB is not established where the MPs are operating, then the SB should rely on pronouncements of internationally recognised bodies. Where there is absence of decision on a particular issue, and the SB has to come up with its own decision, then such decision should be documented and published so that it can be easily accessed by the industry's stakeholders.

98. Apart from approving *Microtakāful* products, the SB is expected to give binding opinions and decisions relating to the business and the operations of MPs and shall be responsible and accountable for the decisions made and opinions expressed. The SB plays the role of overseeing *Sharī'ah* matters pertaining to the business operations and activities of MPs via *Sharī'ah* review and *Sharī'ah* audit exercises conducted by internal units undertaking the *Sharī'ah* compliance functions. At the end of the financial year of MPs, the SB plays the important function of disclosing the state of *Sharī'ah* compliance of MPs in the respective financial statements (BNM, 2010).

Other pertinent responsibilities of the SB are as follows (BNM, 2010) (Billah, 2009):

- Endorse policies and procedures
- Endorse and validate documents including but not limited to *Microtakāful* certificates, proposal forms, Aqd forms, product disclosure sheets, and marketing collateral
- Assess reports and work executed by *Sharī'ah* review and *Sharī'ah* audit units
- Provide written *Sharī'ah* opinions in the event a central *Sharī'ah* Advisory Board requires more *Sharī'ah* justification on product approvals given to MPs.
- Examine and endorse Re*Takāful* arrangements and contracts
- Monitoring investment of MRF, and SHF

99. The composition of SB is crucial in ensuring that aforementioned roles and responsibilities are carried out efficiently and effectively. According to the Central Bank of Malaysia, the SB of every

individual MP shall consist of at least five (5) member whereby the majority of them hold at least a bachelor's degree in *Sharī'ah*. Diversity in the SB is recommended therefore the SB may comprise of experts from various disciplines other than *Sharī'ah* but shall not form its majority. In addition to this, the members of the SB shall be persons of acceptable reputation, character and integrity nominated by the nominating committee approved by the BOD (IFSB, 2009) (BNM, 2010).

100. The National Insurance Commission of Nigeria on the other hand requires the composition of SB to consist of at least three (3) members. MPs must appoint a minimum of one (1) insurance expert, and two (2) *Sharī'ah* qualified scholars (National Insurance Commission Nigeria, 2013). Pakistan has a slightly different approach to this. MPs within the Pakistani jurisdiction do not have to establish a SB as the appointment of at least one (1) *Sharī'ah* Advisor with expertise in *Sharī'ah* is sufficient to oversee the *Sharī'ah* aspects of the MPs' operational matters and business activities (Securities and Exchange Commission of Pakistan, 2012). Taking into account its limitations of MPs, a research study suggests that MPs appoint a minimum number of three (3) members to establish a SB (Mokhtar, Sulaiman, & Ismail, 2012). This is very much in consonance with the requirement imposed National Insurance Commission Nigeria.

101. MPs regulated by the Central Bank of Malaysia are required to establish four (4) key *Sharī'ah* governance functions namely *Sharī'ah* research and secretariat, *Sharī'ah* risk management, *Sharī'ah* review and *Sharī'ah* audit. All these functions report to the SBB ensuring end-to-end *Sharī'ah* compliance of MPs business operations and activities. The *Sharī'ah* research function undertakes review of product proposals, research on *Sharī'ah* issues, and secretarial matters pertaining to the SB. The role of *Sharī'ah* risk management function is to mitigate any possible *Sharī'ah* non-compliant events by systematically identifying, measuring, monitoring and controlling *Sharī'ah* non-compliance risks (BNM, 2010). Nigerian MPs on the other hand are not required to have their own internal *Sharī'ah* research function. In fact, the responsibility of carrying out this task is shouldered the SB rather than a unit established by the management of MPs. A *Sharī'ah* compliance unit which executes similar duties of *Sharī'ah* review in paragraph 92 could act as a secretariat to the SB (National Insurance Commission Nigeria, 2013).

102. The *Sharī'ah* review function is responsible to conduct regular evaluation on the *Sharī'ah* compliance of business activities and operations of MPs. Such evaluation will be reported to the SB for it to determine and confirm the *Sharī'ah* compliance status of a certain business activity or operational matter of MPs. Consequently, the *Sharī'ah* review function will be involved in the remedial rectification plan in the event a *Sharī'ah* breach has occurred. Such rectification plan must be approved by the SB. *Sharī'ah* audit function on the other hand carries out periodical assessments on the business activities and operations on MPs. A comprehensive internal *Sharī'ah* audit program is developed to provide independent assessment on the degree of *Sharī'ah* compliance employed by the MPs (BNM, 2010).

103. The Operational Guidelines 2013 Takaful-Insurance Operators spell out responsibilities of the *Sharī'ah* compliance unit in great detail. Its responsibilities include ensuring the segregation of Microtakāful funds, ensuring the management of MRF deficit complies with *Sharī'ah* principles, ensuring the payment of commission and expenses are made from the MRF and more. Unlike the *Sharī'ah* Governance Framework, members of SB of Nigerian MPs are expected to conduct *Sharī'ah* audit function with a condition that they are involved in product approval. Alternatively, the SB could appoint an audit firm to perform this task (National Insurance Commission Nigeria, 2013).

104. In the event the MPs is not capable of having its own internal SB and *Sharī'ah* governance functions, such functions must be outsourced to a third party namely *Sharī'ah* advisory firm. A *Sharī'ah* advisory firm should have sufficient expertise and resources to carry out its work (IFSB, 2009). In the

Malaysian context, outsourcing of *Sharī'ah* governance function is only limited to *Sharī'ah* audit which is also subject to the condition that the MPs are satisfied with comprehensiveness of the scope of audit.

105. For MPs regulated by entities other than the RSAs, where involvement of monetary assistance from Government or charitable entities come via subsidy or donation, the compliance to *Sharī'ah* principles may pose a challenge if there exists no formal *Sharī'ah* Board to oversee the compliance requirement. For *Takāful* Mikro Indonesia (Takmin), the partnership between Peramu and *Takāful* Indonesia obtains the involvement of Baytul Maal, which is an institution of trust fund, responsible for pooling funds and distributing them to the poor. Given the nature of Baytul Maal as a State Treasury in charge of managing the assets of the state in accordance with *Sharī'ah* principles, Takmin possesses its own *Sharī'ah* board and would use a screening mechanism when it comes to initial screening of eligible recipients. Baytul Maal needs to ensure that the money distributed for Zakat²⁰ or Sadaqah²¹ fulfill the appropriate *aĪnĒfs'* (categories)²² requirements. On the second layer of screening, *Takāful* Indonesia being the product developer of Takmin *Microtakāful* products has its own internal *Sharī'ah* Board for product development approval. The possible implication that may arise where there are state's *Sharī'ah* Board and MP's *Sharī'ah* Board involvement for arrangement of this type is when there is a conflict between the decision made by the *Sharī'ah* Board of Baytul Mal and the *Sharī'ah* Board of *Takāful* Indonesia. The issue may arise as to which *Sharī'ah* Board's decision is superior in *Sharī'ah* related matter.

106. For MFIs offering *Microtakāful* products under no formal supervision of the local RSAs, such as the example cited in Sri Lanka where deregulation of the insurance sector allows for new MPs, there will always be the recurring question on the sanctity of *Microtakāful* products' compliance to *Sharī'ah* principles. The MFIs may be offering the *Microtakāful* products under their own initiatives and limited understanding of *Sharī'ah* compliance requirements. It raises the question on whether *Sharī'ah* compliance should be compromised for the purpose of expansion of *Microtakāful* initiatives.

(c) Application of IAIS' Insurance Core Principles (ICPs)

107. The IAIS in its papers provides guidance on how its Insurance Core Principles (ICPs) may be implemented to enhance inclusivity of insurance markets. The proportionality principle has been taken to be the appropriate mechanism to apply ICPs to the microinsurance framework to reflect the nature, scale and complexity of the business framework. The proportionality principle aims to (a) justify simpler and less burdensome ways of meeting requirements for low risk activities; and (b) justify applying more sophisticated methods and techniques for more complex risk situations (IAIS, 2012).

108. For ICPs relating to corporate governance and interests of microinsurance stakeholders, the application of procedural proportionality requirements are found to be relevant in ICP 5 Suitability of

²⁰ Zakat is an obligatory act required by Islam to be performed by every adult and able bodied Muslim. It is an important pillar among the five pillars of Islam. Zakat is a part of the wealth and property that Muslims must pay annually, to help the poor of their community. One of the main purposes of Zakat is to keep those who are wealthy clean, monetarily, from sin. It is a form of charity which is obligatory on Muslims.

²¹ Sadaqah on the other hand means voluntary charity, the opposite of Zakat, which is obligatory

²² Under the obligatory payment of Zakat, only eight categories of the society are eligible to be the recipients of this fund. They are (a) those living without means of livelihood, (b) those who cannot meet their basic needs, (c) zakat collectors, (d) new Muslim converts, (e) those wishing to be freed from slavery or servitude, (f) those who have incurred overwhelming debts while attempting to satisfy their basic needs, (g) those fighting for a religious cause or a cause of God and (h) wayfarers, stranded travelers.

Persons²³ and ICP 7 Corporate Governance²⁴. The former ICP requires that the Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer must have pertinent experience and maintain sufficient degree of knowledge whilst the latter provides a corporate governance structure through which an insurer is managed and controlled. It is worthy to highlight that proportionality from the perspective of IAIS does not translate to the introduction of automatic and systematic simplifications for insurers or intermediaries. The proportionality measure taken by the RSAs should at least be suitable, necessary and appropriate to attain the supervisory objectives of a jurisdiction. Most importantly the system must remain supervisable.

109. While this proportionality approach may similarly be applied by the MPs of *Microtakāful* on their governance framework, RSAs need to be aware of the existence of other MPs which are not regulated by them but rather other formal entities, as well as the MPs which may not be regulated at all. Where *Microtakāful* initiatives are subsidized by the government, the ideally supervised environment of the RSAs may in certain circumstances be jeopardized. This holds true if the MPs are required to participate in a national *Microtakāful* scheme where pricing is somewhat prescribed by the local authority rather than determined by prudent pricing as stipulated by the RSAs.

II. Financial & Prudential Regulation

(a) *Sharī'ah* -compliance requirements

110. *Microtakāful* is launched under the same premise as *Takāful*, which is to comply with *Sharī'ah* principles. It aims to rid from the existing insurance system three main elements which are Maysir (gambling), Gharar (uncertainty) and Riba (usury). While it may seem straightforward for MPs to simply follow the requirements set forth for TOs to ensure their operational activities are *Sharī'ah* compliant, the practical approach may not be as easy as it should be. This is since the stakeholders vary between MPs and TOs.

111. For MPs that are regulated by the RSAs, the licensing requirement may require them to have internal *Sharī'ah* Board or comply with RSA's *Sharī'ah* Board requirements prior to being offered a license. For MPs that are not regulated by the RSAs, the absence of licensing requirement may accord flexibility to these providers from ensuring strict compliance to *Sharī'ah* principles. This might lead to reputation risk when a breach of *Sharī'ah* principles is discovered.

112. The IFSB – 10: *Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services* provides guidance on the development of a *Sharī'ah* governance framework which may be made reference to by MPs wishing to have in place a *Sharī'ah* operational, screening and review framework. MPs that are not regulated by RSAs may opt to establish their own internal *Sharī'ah* Board for the purpose of having an internal *Sharī'ah* review mechanism for all their products, or they may opt to refer to local *Sharī'ah* Board which may provide guidance on *Sharī'ah* compliance issues relating to *Microtakāful* products. Whichever *Sharī'ah* Board that these MPs wish to put in place, there needs to be a clear terms of reference regarding the *Sharī'ah* Board's mandate and responsibility, well-defined operating procedures and line of reporting; and good understanding of, and familiarity with, professional

²³ ICP 5 states that "The supervisor requires Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer to be and remain suitable to fulfill their respective roles.

²⁴ ICP 7 states that "The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognizes and protects the interests of policyholders.

ethics and conduct. In addition, the individual mandated with overseeing the *Sharī'ah* governance systems must fulfill acceptable fit and proper criteria (IFSB, 2009).

113. In Pakistan, a focus group discussion conducted by the Securities and Exchange Commission of Pakistan (SECP) in 2012 with a group of low-income microfinance customers revealed that in the country where 96% of its population are Muslims, the preference for *Microtakāful* over microinsurance products is the main reason why penetration of microinsurance is low in that country (Amjad, 2013). Consequently, in February 2014, the SECP issued the Microinsurance Rule 2014 which is applicable to the *Microtakāful* industry. Prior the issuance of Microinsurance Rule 2014, the SECP had established a centralised *Sharī'ah* Advisory Board in year 2013. The *Sharī'ah* Advisory Board will oversee the application of Islamic Finance rules to instruments including mutual funds, pension funds and *Takāful*. In addition, the *Sharī'ah* Advisory Board will also be in charge of recommending accounting and investment guidelines apart from undertaking educational activities (Securities and Exchange Commission of Pakistan, 2013).

(b) Requirement on Separation of Funds

114. In the most commonly used model of *Takāful*, separation of funds between the Shareholders Fund (SHF) and Participants' Risk Fund (PRF) is key requirement in fulfilling the *Sharī'ah* principles. As stipulated in the IFSB-11 "*The distinctive rights and obligations between the TO and Takāful participants require a clear segregation of the PRF from the TO's shareholders' fund*" (IFSB, 2010). Similar argument is valid for *Microtakāful* operation since in the absence of misconduct or negligence, the MP is not contractually accountable for any deficit or loss arising from an MRF. This is also done on the precept that the SHF belongs to the shareholders and the PRF belongs to the Participants, in which claims and claims related expenses will be paid from. Under this principle, failure to separate the fund may render the *Takāful* operation non-*Sharī'ah* compliant. It is thus crucial for MPs to ensure this key requirement is understood comprehensively when choosing the type of *Microtakāful* model to be used for its operation.

(c) Solvency and Capital Adequacy Framework

115. The nature of *Microtakāful* market segment calls for the need to have a different regulatory requirement. This is intended to ease market participation by the low-income section of the population which under normal circumstances is excluded from the financial system.

116. The IFSB – 11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* issued by the IFSB in December 2010 listed seven key features to be observed by the TOs and RTOs. They are as follow (IFSB, 2010):

(i) **Key Feature 1:** The solvency requirements for *Takāful* undertakings must adopt a total balance sheet approach to ensure that risks are appropriately recognized and consistently valued and to identify the interdependence between assets, liabilities, regulatory solvency requirements for PRF and the shareholders' funds of the TO. However, the total balance sheet approach must address the clear separation of PRF and the shareholders' funds of the TO.

(ii) **Key Feature 2:** The solvency requirements should be established at a level such that the respective amounts of solvency resources in the *Takāful* and shareholders' funds are adequate to meet their respective financial obligations as they fall due, bearing in mind that part of the shareholders' funds may be 'earmarked' to cover a Qard facility.

(iii) **Key Feature 3:** The solvency requirements should establish solvency control levels at the respective *Takāful* and shareholders' funds, that trigger proper interventions by TO and the supervisory authority when the available solvency is less than the solvency control level.

- (iv) **Key Feature 4:** The solvency requirements should establish criteria for assessing the quality and suitability of solvency resources in the *Takāful* and shareholders' funds to absorb losses in different financial stages of the respective funds.
- (v) **Key Feature 5:** The solvency requirements for *Takāful* undertakings must have separate risk adjusted computation and assessment. The risk management framework must be comprehensive and cover all risks to which the PRFs and the shareholders' funds are exposed.
- (vi) **Key Feature 6:** The adequacy of regulatory solvency requirements for a *Takāful* undertaking depends on the maintenance of a sound risk management framework. An essential part of the supervisory review process is to assess for each undertaking that adequate risk management arrangements are in place through which the TO can, and does, monitor, measure, report and control the management of the assets and liabilities in a coherent and integrated manner.
- (vii) **Key Feature 7:** Information regarding the solvency requirements for a *Takāful* undertaking that is material and relevant to the market participants should be publicly disclosed to enhance market discipline and the accountability of the TO.

117. While it is ideal for RSAs to require MPs to observe each of the seven key features, the RSAs need to consider the size, complexity and nature of the risks absorbed by MPs into their institution. The issues that may be prevalent for normal TOs may not be so for MPs. An example would be the requirement to have two solvency control levels for each of the Risk Fund and the SHF. For MPs, for which some may not be under the regulation of *Takāful* RSAs, this requirement may be burdensome since a higher amount needs to be set aside to meet the various solvency control levels unless lower amounts are allowed from a perspective of proportionality as is shown in the next paragraph. The small amount received as contribution which has already been set at its lowest may not allow the MPs the excess to meet two levels of solvency requirements. Also, requiring MPs to meet these two (2) levels of solvency would increase the cost of providing the *Microtakāful* products. This is an area which requires careful thoughts by the RSAs. What is ideal under a secured financial system may not be so when it comes to a more or less risky group of participants.

118. In Philippines for example, microinsurance schemes which operate under mutual benefit associations (MBAs) are allowed by the Insurance Commission of Philippines to operate under lower minimum paid up capital. For example, for an existing local insurer to run business based on traditional insurance license, the minimum paid up capital required is USD1.7mill whereas for a new MBA to start offering microinsurance plan, the initial paid up capital required is only USD113,000. This amount however, is expected to increase annually by 5% of the MBA's total collected annual premiums with an ultimate aim to acquire 12.5% of the minimum paid up capital of a local insurer (Hafeman, 2009). The Insurance Commission is also the RSA that will determine the assumptions that will be used for the pricing of the microinsurance products. These include the maximum administrative expenses and investment yield, surrender rates, the minimum surrender benefit as well as the minimum amount that needs to go into the guarantee fund. Although the products and premium rates are pre-approved by the Insurance Commission prior to being offered to the market, there have been cases where the price offered to the microinsurance participants deviate from the price approved by the Insurance Commission.

(d) **Risk Management Framework**

119. Another requirement to be considered by the MPs is the risk management framework. The IFSB – 14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* provides a general framework for TOs containing (IFSB, 2013):

- (i) Risk Policies and Strategies
- (ii) Risk Identification
- (iii) Risk Assessment, Response and Control
- (iv) Control Framework
- (v) Risk Monitoring
- (vi) Risk Reporting.

120. While putting in place a risk management framework specific to MPs is crucial in enabling the providers to ensure that all risks that are exclusive to *Microtakāful* participants are captured and recorded in the risk register based on the nature, scale and complexity of the business, it may not necessarily be easy to be implemented by MPs. MPs which are not regulated by the RSAs may not possess the required expertise to assess the risks and put in place an appropriate control framework. They may not be aware of the risks that are specific to *Microtakāful* such as the risk of *Sharī'ah* non-compliance and the risks arising from the separation of SHF and MRF funds (IFSB, 2013).

121. In addition, the various intermediaries involved in the chain of business and the types of possible moral hazard implicated in providing coverage to the *Microtakāful* participants may also not be captured into the risk management framework. These intermediaries may include small pawn shops and grocery stores which under normal circumstances are not licensed by any RSAs or regulator of formal entities. This is where the gap is, and mechanisms would need to be developed to capture the kind of risks that unregulated intermediaries bring into the financial system.

122. On the types of products offered to the *Microtakāful* participants, the risk weights carried by these participants needs to be reflected in the pricing of the products. This is normally taken care of if mortality tables that are approved by the RSAs are used in the pricing with appropriate expense assumptions loaded into the pricing mechanism. This is crucial in ensuring the funds are sufficient to meet all possible claims made by *Microtakāful* participants. However, for MPs that are not regulated by the RSAs, inappropriate pricing may lead to insufficient MRF which may eventually lead to insufficiency of the MRF to meet claims obligation.

(e) Investment Framework

123. Given the nature of MPs being created to provide coverage to *Microtakāful* participants, appropriate investment policies are crucial for all their product lines, taking account of the diverse characteristics of the liabilities of each category and the acceptable risk tolerance for each category and for the *Microtakāful* participants. The investment framework of MPs needs to provide for sufficient cash flow support for possible immediate need of the funds. In addition, the primary needs of MPs are on the support on its growth model. They need to know that the business has appropriate investment backing with technical skills to support downscaling while at the same time improving low income market focus.

124. While the investment policies are common in MPs regulated by RSAs, they may not exist in MPs that are not regulated by the RSAs. Some of these MPs may not be aware that the *Microtakāful* participants are the ones who will bear the investment risk and other associated risks. Since *Microtakāful* participants are not involved in the management of the *Microtakāful* funds, they cannot exercise their rights as owners of the funds. This is an important aspect which may be overlooked by the MPs. Another important aspect that requires careful consideration is the process of selecting or purifying assets to achieve *Sharī'ah* compliance. An MP that lacks knowledge on the requirements for *Sharī'ah* -compliant

investment return may not be able to assess if the income received is tainted by being derived from impermissible activities or questionable sources.

(f) Underwriting Requirements

125. The underwriting requirements for normal TOs usually involve various processes of understanding and classifying the types of risks absorbed by TOs. This process is to ensure that the risks taken in are risks that are not detrimental to the survival of the organization. This process normally involves mortality and morbidity tables in which statistics of survival and death of the insured from the past decades are compiled and made reference to in coming up with pricing of products. In addition, understanding risks include a thorough background check on the potential participants prior to accepting them into the pool of risks. This is normally done when selected high-risk participants are sent for thorough medical checkup by the TOs. Some of the key criteria in the underwriting process include health, build, cholesterol, blood pressure, cancer history, tobacco, alcohol or substance use, hazardous activities or occupations, driving history and family history. Individual's financial background as well as types of coverage required will also be key consideration in the underwriting process.

126. While it is common for RSAs to impose strict underwriting requirements on TOs, similar requirements may not be practical to be imposed on MPs. The demographic and education background differences between the low-income and the average income participants make the *Microtakāful* participants more prone to various kinds of hazardous occupations and sicknesses. At the same time, the limited exposure that they get with regards to maintenance of good health make them more susceptible to various health conditions that will lead to higher contributions if they were underwritten in the same way as the normal *Takāful* participants. In addition, these participants' irregular income makes financial underwriting a deterrent for them from being accepted. It is with this simple reason that the low-income has thus far being broadly excluded from the normal financial products offered by the existing TOs.

127. For *Microtakāful* initiatives to be expanded to include the low-income, the RSAs and other relevant authorities may have to encourage a more flexible financial environment in which these potential clients may go through simplified underwriting requirements while enabling them to be sufficiently assessed. To offset the risky downside of these participants, RSAs may instead limit the amount and type of coverage that may be provided to these participants, provided that it is not done at the expense of product innovation. The array of products to be offered should also be limited to simple-to-understand products in which these participants will not have difficulty in comprehending its coverage.

(g) Application of IAIS' Insurance Core Principles (ICPs)

128. While the expansion of *Microtakāful* industry has not reached the level of coverage similar to its conventional counterpart, i.e. microinsurance, there is advantage in knowing that the regulatory challenges and issues faced by the microinsurance sector are almost similar. It is with this knowledge that the IAIS proportionality principle serves as a good guidance especially in jurisdictions where regulations of microinsurance, if exists, may be referred to while ascertaining that the specificities of *Microtakāful* are taken into consideration.

129. Under the procedural proportionality of ICP 17 on Capital Adequacy and ICP 16 on Enterprise Risk Management, special consideration is given to inclusive insurance markets for the underserved, although exemption is not an option. However, this requires an approach that reflects the nature, scale

and complexity of the risks. The absolute minimum bound for the Minimum Capital Requirement (MCR) is allowed to be revised to a lower level reflecting its lower risk profile as well as more limited need for detailed governance and risk management. ICP 16 may also be applied by limiting the activities and prescribing specific requirements focused on the nature of risks undertaken and underwritten and capable of being economically implemented for small, low risk, less complex insurers so as to deliver the intent of ICP 16.

130. While the ICP on investment (ICP 15) is not specifically mentioned under the proportionality principle, its interconnection with ICP 17 makes the following factors worth considering in establishing the regulatory investment requirements for microinsurance: (a) quality of risk management and governance framework, (b) quality of capital resources, (c) comprehensiveness and transparency of disclosure frameworks, (d) development of relevant investment and capital markets, (e) cost of compliance, (f) competition with other financial services institutions and finally, (g) the level of prudence and risk-sensitivity of the regulatory solvency requirements.

131. Although these ICPs may be applied principally on *Microtakāful*, it is crucial for RSAs of MPs to consider the specificities of *Microtakāful* in formulating regulations and guidelines for *Microtakāful*. This is essential especially when it concerns the compliance with *Sharī'ah* principles, such as the requirement to ensure separation of SHF from the MRF as well as the *Sharī'ah* governance framework that is required in overseeing the operational activities of MPs.

132. The risk of *Sharī'ah* non-compliance is pervasive in the operations of an MP. An example is in the product cycle of an MP. Since all *Microtakāful* products need to be *Sharī'ah* compliant, the overall product development process therefore requires consideration of *Sharī'ah* compliance, including the stages where products are priced, underwritten, advertised, contracted and finally accepted by the participants. These require careful consideration on the part of the MPs and their RSAs.

III. Transparency, Reporting and Market Conduct

(a) Customer education and awareness

133. Educating the low-income on the importance of financial protection has always been a challenge to insurance companies and TOs. This is especially so when the income stream of the low-income is irregular. Some of the low-income may not even have a decent income for certain period of time during the year especially when they are directly involved in agricultural activities which are easily affected by weather condition. For *Microtakāful* initiatives to grow bigger in an attempt to widen the scope of financial inclusion, the RSAs and relevant authorities may wish to play a supportive role in encouraging the MPs to increase the education and awareness activities in areas saturated with the low-income.

134. Information asymmetry is currently the predicament faced by both the MPs as well as the *Microtakāful* participants. The MPs are not certain of the types and behavior of risks that they absorb into their financial system due to the lack of mortality and morbidity statistics on the low income. Whereas on the part of *Microtakāful* participants, there is lack of awareness and understanding on the importance of *Takāful* protection. This information asymmetry on both sides of supply and demand has created a gap which to date deters both sides from successfully bridging the gap. Various types of initiatives may be conducted and supervised by the RSAs and relevant government agencies to increase awareness among the low income population.

135. In Indonesia, the awareness program for *Microtakāful* is conducted by Islamic Economic Society (MES) in their 2014 initiative to integrate the efforts done by MPs and Baittul Maal wa Tamwil (BMT)²⁵. Islamic Micro Insurance Business Matching Event is a series of roadshow events which started in 2013 until April 2014, and held in six cities in Indonesia, namely Batam, Padang, Banjarmasin, Palangkaraya, Medan and Cirebon. The objective of the roadshow is to increase the awareness among the BMTs on the importance of risk mitigation through *Microtakāful* products. MES felt the need to first educate the BMTs on the importance of *Microtakāful* so that the information may be transferred to the recipients of BMT funds throughout Indonesia. From this awareness programme held by the MES, a total of 20 BMTs in Malang, 4 BMTs in Batam and 41 BMTs in Padang started to increase the awareness program for the use of *Microtakāful* products among the recipients of funds from BMTs (Hamzah, Rusby, & Hamzah, 2013).

(b) Consumer protection

136. The lack of education on financial services and *Takāful* literacy makes *Microtakāful* participants susceptible to various types of possible misselling and misinformation on the part of the MPs. The product literature, contract wordings, sales illustration and various other means of information sharing provided by the current TOs are usually lengthy and worded in illegible format, in a language that usually requires careful comprehension on the part of the *Takāful* participant. A potential participant needs to know for certain the types of coverage and exclusion that comes with it prior to agreeing to participate in the product plan. Furthermore, potential participants must have some understanding of the structure of the product in order for them to be aware of mechanism of underwriting surplus sharing. This however may be a challenge for the low income since they may not have the necessary background to understand the intended meaning of product literature.

137. It is important that the RSAs and relevant authorities to ensure that the *Microtakāful* participants are protected from their own inability to comprehend the product literature. There should be a requirement to ensure that product literatures of MPs are simplified in language(s) that are easily comprehensible by the low income. The intermediaries appointed by the MPs should also comply with certain code of conduct to prevent possible types of inappropriate misconduct.

138. *Amana Takāful* of Sri Lanka in collaboration with Muslim Aid conducts monthly Centre Meetings to discuss *Microtakāful* among its participants. In these meetings, five to ten minutes are allocated for the *Microtakāful* participants to share their experiences in the application and claims process. This is to provide ease of understanding to other participants who may not be aware of the processes to apply and to claim from the MP. It has been reported that during these meetings, key roles are played by village leaders for effective and efficient transfer of information to *Microtakāful* participants since trust seems to be the main concern of *Microtakāful* participants.

(c) Consumer recourse and complaints

139. Many jurisdictions already have in place a dedicated complaint channel for *Takāful* participants. There are dedicated websites, customer services centres, toll-free telephone lines and various other channels that make TOs easily accessible by the participants. However, many of these are not user-

²⁵ Baitul Maal Wat Tamwil (BMT) is a financial institution in Indonesia that provides financing facility to small entrepreneurs to finance their business operations. These small entrepreneurs usually do not have access to the larger banking sector due to their financial background. BMT which started its operation in year 1992 has since been a source of financing for small business institutions and rid them the need to go for illegal money lenders.

friendly for *Microtakāful* participants since the latest technology for average income citizen is still a luxury for the low income section of the population.

140. RSAs and the relevant authorities may wish to consider dedicating a complain channel for *Microtakāful* participants to direct their grievances over *Microtakāful*-related issues. This channel should be easily accessible by the participants at minimal or no cost to ensure that their welfare is taken care of at all times.

141. In India, Uplift Mutuals²⁶ provides a 24/7 helpline to its policyholders. This helpline is managed by medical doctors so as to allow the microinsurance policyholders easy access to medical advices just over the phone. Uplift Mutuals also sets up branch offices in rural areas which provide referral and guidance services so that the microinsurance policyholders can collect referral letter to the nearest health service provider. Apart from providing this helpline, Uplift Mutuals also organize health camps on a monthly basis where the microinsurance policyholders receive preventive check up on a systematic basis. This is an example of how consumer recourse and complaints can be easily handled by MPs. The 24/7 helpline, the frequent meetings, the easy access to service providers, the monthly health camps provide avenues to the microinsurance policyholders to channel their concerns easily (Microinsurance Learning and Knowledge, 2013).

(d) Reporting to RSAs

142. It is common for some MPs to offer only *Microtakāful* products with the intention to purely assist the low-income. This reason has been used to justify why these MPs do not require strict supervision from the RSAs or relevant authorities. However, lack of supervision or reporting is a loophole that can be abused to misuse the pool created to assist the low-income. It is hence equivalently relevant for MPs to be required to adhere to the type of reporting that normal TOs are required to follow strictly.

143. Instead of requiring the MPs to provide an elaborated reporting (in which some jurisdictions may involve monthly or quarterly reporting) the way it is required of the TOs, the RSAs and the relevant authorities may request for simplified but consequential reporting. This simplified reporting should contain minimum information enough for the RSAs and relevant authorities to gage the financial strength of the MPs. This is necessary to ensure that the MPs have the capacity to undertake their duty and obligation towards the participants. It is also necessary for the RSAs and relevant authorities to ensure that financial assistance (Islamic Financial Services Board, 2010) is available to assist the *Microtakāful* risk fund when the fund faces difficulty to meet its obligations. Reporting should be done with the intention to protect the interests of *Microtakāful* participants.

²⁶ “Uplift Mutuals is the flagship programme of Uplift India Association that brings micro insurance solutions to low income families on the twin principles of mutuality- solidarity and collective responsibility. Born out of the health protection needs of self-help group women in 2003, the mutual model designed by Uplift model has over 200,000 lives covered in India. It is one of a kind of a programme where low income families share and manage their own health risk in a systematic way similar to how insurance works.” –upliftmutuals.org

(e) Application of IAIS' Insurance Core Principles

144. Under the IAIS' proportionality principle, the microinsurance providers need to still comply with the requirements set forth under ICP 18: Intermediaries, ICP 19: Conduct of Business as well as ICP 20: Public Disclosure, subject to the requirements being made consistent with the focus of the microinsurance providers. This means that these microinsurance providers should at least have the incentives to service the low-income and sufficiently be effective in carrying out their tasks. They need to be aware that microinsurance policyholders have different needs in terms of consumer protection than normal insurance policyholders. Their good conduct is pertinent to promote confidence in insurance markets. It is also essential that the type of information shared with the microinsurance policyholders commensurate with their financial and general literacy.

145. From the perspective of supervisory reporting as indicated in ICP 9, there may be a need for additional guidance to be provided by the supervisors with regards to minimum reporting. This is to ascertain minimum understanding by the potential diverse entities that are involved in the inclusive insurance market innovations.

146. While transparency, reporting and market conduct of MPs differ marginally from that of the microinsurers', the RSAs of MPs should be mindful of these requirements from the perspective of *Sharī'ah* principles. IFSB-9: Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services provides guidelines on the type of information provided to the clients, the concept of conflict of interest and the concept of duty, and on honesty and fairness from the perspective of *Sharī'ah*. As quoted in paragraph 4 of IFSB – 9, "One of the most common unethical practices in modern business is to exploit one's ignorance of market conditions." This holds true for *Microtakāful* participants, who may not possess the background knowledge of *Takāful* protection and their rights as participants (IFSB, 2009).

IV. Supervisory Review Process

(a) Licensing requirements

147. Licensing is a tool used by RSAs to control entities which are allowed to conduct *Takāful* business. It is a mechanism to ensure that unauthorized *Takāful* transactions do not take place. Through licensing, TOs will be fully aware of the need to have sound governance framework for ease of effective supervision by RSAs of all their *Takāful* activities.

148. Although MPs should ideally be required to have license prior to being allowed to offer products to the market, it is not always necessarily easy to impose such requirement since some MPs are not regulated under the RSAs of the *Takāful* sector. For TOs who offer *Microtakāful* products, this poses no issue. However, concerns arise when there are entities which are created exclusively for *Microtakāful* purposes in which they may not be regulated by the RSAs or any other regulator of formal entities. Concerns over the sanctity of these unlicensed entities include the effectiveness of their governance framework, and the validity of their business model. All entities providing *Microtakāful* plans should meet minimum requirements of having a proper business plan and evidence of sufficient financial resources to back the business plan. Where the entity does not have the capacity to absorb the risks of *Microtakāful* participants, prove of *ReTakāful* backing should be provided.

149. The distribution system of MPs should meet the minimum requirement for conduct of business in which code of ethics should be observed strictly. The licensing requirement for intermediaries should be considered to be imposed on intermediaries of MPs other than TOs. They should be required to possess appropriate levels of *Takāful* knowledge and expertise, integrity and competence. However, it is worthy to note that a requirement that is too stringent will pose a challenge since many of the *Microtakāful* intermediaries do not enjoy high remuneration package the way that normal intermediaries do. On the other hand, a requirement that is too flexible may render the participants of *Microtakāful* to be at risk of not being protected since the intermediaries are not required to follow strict licensing rules of the RSAs.

150. In Sri Lanka for example, the Regulation of Insurance Industry (RII) Act requires all MPs to operate under the supervision of a regulatory authority. There are no special regulatory provisions for microinsurance / *Microtakāful* in the jurisdiction. This, in addition to the high administrative costs to register insurance / *Takāful* business in the jurisdiction has led to unwillingness of MPs to acquire license to offer just microinsurance/*Microtakāful* products. However, the realization that the vision of microinsurance / *Microtakāful* extends beyond mere coverage of loan protections has led to the implicit deregulation on the part of the RSA. The RSA has taken into consideration the various characteristics of MPs in Sri Lanka, the environment under which they operate, and the target population to whom the microinsurance/*Microtakāful* products are offered to. With these in mind, a circular was issued by the Insurance Board of Sri Lanka (IBSL) which allows the microinsurers/*Microtakāful* Operators to appoint MFIs as their institutional agents. Consequently, many MFIs in Sri Lanka have started to be involved in distributing microinsurance/*Microtakāful* products even though they are not permitted by law to conduct insurance/*Takāful* business.

(b) Application of IAIS' Insurance Core Principles (ICPs)

151. According to IAIS' *Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets*, the overall objective is that informal insurance is undesirable. Insurance activities should be conducted by licensed entities. Jurisdictions may decide that some limited activities are not included in the definition of regulated insurance activities subject to licensing requirements. When defining regulated insurance activities and exclusions from the licensing requirements consideration should be given to the need for appropriate alternative safeguards to protect policyholders. Alternative arrangements for microinsurance providers could be as simple as registering the institution (be it pilot or informal institution with transitional arrangements²⁷) whereby only identification of the institution and its form is registered with the supervisor. These informal institutions will hence report to the supervisor (IAIS, 2012).

152. While it may seem practical and simplified, MPs for *Microtakāful* may need to go through a more thorough process due to the need to ensure *Shari'ah* compliance of MPs' operational activities. This translates to the need for MPs to possess adequate resources with sufficient knowledge so as to facilitate effective and efficient expansion of *Microtakāful* products and knowledge to the participants.

²⁷ These are institution that require time to transition to formal entities which will be regulated by the RSAs of insurance companies

D. PROPOSAL FOR FUTURE WORK

153. *Microtakāful* is a segment of the financial industry that is rapidly gaining acceptance by the financial institutions and especially RSAs and government agencies. The realization that the low income should not be excluded from the financial system is gaining ground since their contribution to the economic system of every jurisdiction, no matter how minimal; warrant them the chance to enjoy similar kind of financial services. In India for example, the RSA requires that a minimum target of gross written premium should be written by the microinsurance providers to ensure that the insurance industry contributes to the national initiative on financial inclusion. This is reflected in its “*Obligations of Insurers to Rural or Social Sectors*” which took effect on 16th October 2002 stipulates that insurers which started their operations after year 1999 must sell a fixed percentage of their policies to the social sector and rural areas. Progress has shown that as many as 25.7% of new policies of life insurance were unwritten and sold in 2012 and 2013. According to Insurance Regulatory and Development Authority’s 2012 and 2013 annual reports, all 23 private sector life insurance companies had fulfilled their rural sector obligations. (Insurance Regulatory and Development Authority of India, 2002) (Business Standard, 2014). Another example is Jordan, whereby the government is planning to revise its Insurance Law 2002 in order to promote microinsurance / *Microtakāful*, specifically in the licensing conditions for intermediaries (GTZ, 2004).

154. However, the abrupt change to the current system in an attempt to make it inclusive requires careful consideration since it will not only have an impact to the current structure and framework, it will also have impact on the way the financial industry is regulated, the way products are developed and sold, the way distribution channels are utilized, and most of all, the way these initiatives are perceived by the public.

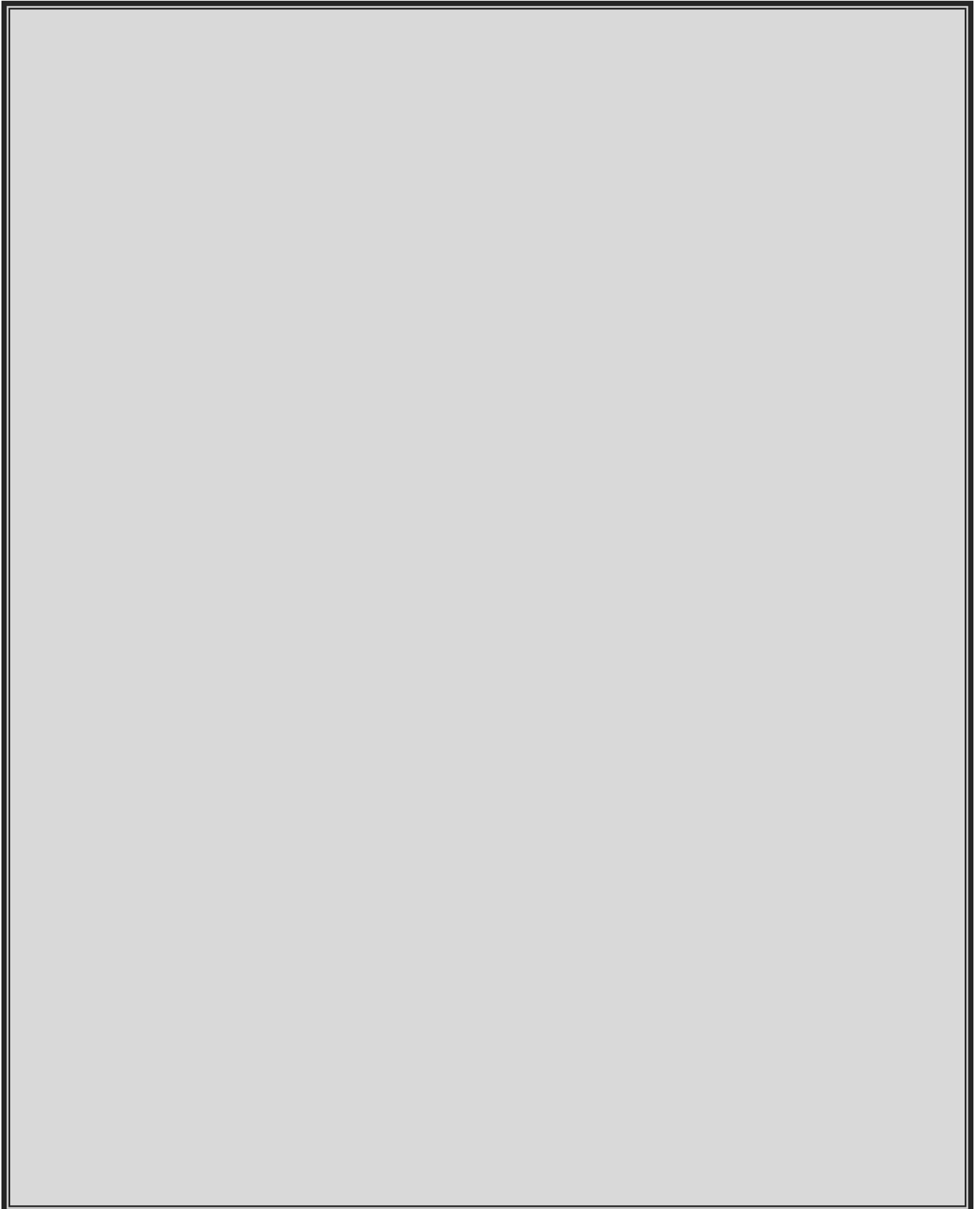
155. *Takāful* is known for its Islamic features which are free from Shariah non-compliant elements. The products and services offered by the TOs carry with them not only the financial but also the religious obligation to be fulfilled. This is similarly the scenario with *Microtakāful*. Only difference is the need to ensure that the objective of *Microtakāful* is clarified clearly to participants which have different demographic and educational background.

156. For *Microtakāful* to achieve its target of inclusivity, concerted efforts need to put together by all the stakeholders. This paper identifies a set of important areas as a direction for future work on *Microtakāful*:

(a) To identify a successful cooperation mechanism between stakeholders (especially between the RSAs, government agencies, TOs, RTOs and *Shari’ah* Board), and to understand the roles and responsibilities of each of the stakeholders.

(b) To delineate the specific areas to be looked into by RSAs and relevant authorities when regulating the MPs. These significant areas include MPs’ corporate governance strategy and structure, underwriting requirements, licencing provisions, their fund management framework and regulatory reporting.

E. APPENDIX





F. DEFINITIONS

Corporate governance	<p>A defined set of relationships between a company's management, its board of directors, shareholders and other stakeholders that provides the structure through which:</p> <ul style="list-style-type: none"> (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined. <p>In the context of <i>Takāful</i> and <i>ReTakāful</i> Operators, good corporate governance should encompass:</p> <ul style="list-style-type: none"> (i) a set of organisational arrangements whereby the actions of the management of <i>Takāful</i> and <i>ReTakāful</i> undertakings are aligned, as far as possible, with the interests of its stakeholders; (ii) provision of proper incentives for the organs of governance such as the board of directors, the <i>Sharī'ah</i> Board and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging TUs and RTUs to use resources more efficiently; and (iii) compliance with <i>Sharī'ah</i> rules and principles.
Liabilities	<p>The financial obligations of both the Shareholders' Fund (SHF) and the Participants' Risk Funds/Participants' Investment Funds (PRFs/PIFs) or TORFs. Detailed descriptions are set out below:</p> <ul style="list-style-type: none"> (i) Liabilities of the SHF are all financial obligations of those funds, and do not include technical provisions which are liabilities of the PRFs/PIFs or TORFs. (ii) Liabilities for PRFs/PIFs and TORF include financial obligations owed by the funds, particularly amounts payable to participants in respect of valid expected benefits. In addition, PRFs' and TORFs' liabilities include technical provisions in respect of potential liabilities from business already written.
<i>Muḍārabah</i>	<p>A contract between the capital provider and a skilled operator whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the operator as the <i>Muḍārib</i> (or labour provider). Profits generated by the enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib's</i> misconduct, negligence or breach of contracted terms.</p>
Operational risk	<p>Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For <i>Takāful</i> or <i>ReTakāful</i> undertakings, this also includes risk of loss resulting from <i>Sharī'ah</i> non-compliance and failure in a <i>Takāful</i> or <i>ReTakāful</i> Operator's fiduciary responsibilities.</p>
Participants' Risk Fund (PRF)	<p>A fund to which a portion of contributions paid by <i>Takāful</i> participants is allocated for the purpose of meeting claims by <i>Takāful</i> participants on the basis of mutual assistance or protection.</p>

Provisions	<p>(i) The amounts set aside on the balance sheet to meet liabilities arising out of <i>Takāful</i> or <i>ReTakāful</i> contracts, including claims provision (whether reported or not), provision for unearned contribution, provision for unexpired risks, <i>Takāful</i> or <i>ReTakāful</i> provision, and other liabilities related to <i>Takāful</i> or <i>ReTakāful</i> contracts (e.g. contributions, deposits and savings accumulated over the term of <i>Takāful</i> or <i>ReTakāful</i> contracts).</p> <p>(ii) Terms, conditions or requirements of a contract, agreement, item of regulation or standard.</p>
<i>Qard</i>	A loan without remuneration intended to allow the borrower to use the funds for a period with the understanding that it would be repaid at the end of the period.
<i>ReTakāful</i>	An arrangement whereby a TU, as representative of participants under <i>Takāful</i> contracts contributes a sum of money as <i>Tabarru'</i> commitment into a common fund maintained by an RTU on a <i>Takāful</i> basis, i.e. covering participants of that and other TUs against specified loss or damage.
<i>ReTakāful</i> Operator	Any establishment or entity that manages a <i>ReTakāful</i> business, usually though not necessarily a part of the legal entity in which the participants' interests are held.
Risk management	The process whereby the <i>Takāful</i> or <i>ReTakāful</i> undertaking's management takes action to assess and control the impact of past and potential future events that could be detrimental to the undertaking. These events can impact both the asset and liability sides of the undertaking's balance sheet, as well as its cash flow.
Shareholders' Fund	The part of the assets and liabilities of a <i>Takāful</i> or <i>ReTakāful</i> undertaking that is not attributable to participants in the form of a PRF, PIF or TORF.
Solvency requirements	The financial requirements that are set as part of the solvency regime and relate to the determination of amounts of solvency resources that a <i>Takāful</i> or <i>ReTakāful</i> undertaking must have in addition to the assets covering its technical provisions and other liabilities.
Stakeholders	<p>Those with a vested interest in the well-being of <i>Takāful</i> or <i>ReTakāful</i> or <i>Microtakāful</i> undertakings, including:</p> <p>(i) employees;</p> <p>(ii) <i>Takāful</i> participants or cedants under <i>ReTakāful</i> arrangements;</p> <p>(iii) suppliers;</p> <p>(iv) the community (particularly the Muslim ummah); and</p> <p>(v) supervisors and governments, based on the unique role of TUs and RTUs in national and local economies and financial systems.</p>
<i>Tabarru'</i> commitment	The amount of contribution to be relinquished by the <i>Takāful</i> / <i>ReTakāful</i> participant as a commitment for fulfilling the obligation of mutual help and to be used to pay claims submitted by eligible claimants.
<i>Takāful</i>	The term <i>Takāful</i> is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as <i>Tabarru'</i> commitment into a common fund, which will be used for mutual assistance of the members against specified loss or damage.

<i>Takāful</i> Operator	Any establishment or entity that manages a <i>Takāful</i> business.
<i>Takāful</i> participant	A party that participates in the <i>Takāful</i> product with the <i>Takāful</i> undertaking and has the right to benefit under a <i>Takāful</i> contract (similar to ‘policyholder’ in conventional insurance).
Technical provisions	The value set aside to cover expected obligations arising on <i>Takāful</i> or <i>ReTakāful</i> contracts. For solvency purposes, technical provisions comprise two components: the current central best estimate of the costs of meeting the <i>Takāful</i> or <i>ReTakāful</i> underwriting obligations, discounted to the net present value (current estimate); and a margin for risk over the current estimate.
Underwriting	The process of evaluating new applications, carried out by a <i>Takāful</i> or <i>ReTakāful</i> Operator on behalf of the <i>Takāful</i> or <i>ReTakāful</i> participants based on an established set of guidelines to determine the risk associated with an applicant. The <i>Takāful</i> or <i>ReTakāful</i> Operator could accept the application, or assign the appropriate rating class, or decline the application.
Underwriting risk	Underwriting risk is the risk of loss due to underwriting activities relating to the PRF or TORF. Sources of this risk include assumptions used in pricing or assessment that are subsequently shown to be incorrect by experience of, for example, claims.
Underwriting surplus or deficit	The PRF’s or TORF’s financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contributions income and adding the investment returns (income and gains on investment assets).
<i>Wakālah</i>	An agency contract where the <i>Takāful</i> or <i>ReTakāful</i> participants (as principal) appoint the <i>Takāful</i> or <i>ReTakāful</i> Operator (as agent) to carry out the underwriting and investment activities of the <i>Takāful</i> or <i>ReTakāful</i> funds on their behalf.
<i>Waqf</i>	<i>Waqf</i> is a voluntary, permanent, irrevocable dedication of a portion of one’s wealth – in cash or kind – to Allah Almighty. Once a <i>Waqf</i> is established, it can never be gifted, inherited, or sold. It belongs to Allah Almighty and the corpus of the <i>waqf</i> always remains intact. The yield and/or usufruct of the <i>Waqf</i> may be utilised for any <i>Shari’ah</i> compliant purpose as determined by the <i>Waqf</i> deed.

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