Balancing Regulation and Growth

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While the mainstream Islamic finance industry has witnessed healthy growth over the last ten years, takaful-dedicated funds are few and far between (with notable examples in Malaysia, Singapore and Bahrain). However, this does not properly reflect the emergence of takaful and its importance in the overall Islamic finance industry. The assets in global takaful operators have grown steadily, from an estimated $500m in 1998, to a projected $7bn by 2015. Simon Gray, director of supervision, asset management, at the Dubai Financial Services Authority (DFSA), outlines the challenges and opportunities affecting takaful.

Takaful is a youthful business, at least in its present form. Its models are new and not yet stress-tested. Takaful firms have yet to be seen to take on and retain large commercial risks, especially long tail liability clauses. Thankfully, there has not yet been a major insolvency, or any determined legal challenge to the segregation of funds that is inherent in most business models. Accordingly, both regulators and the regulated have only limited experience of what can go wrong. Like all aspects of Islamic finance, takaful faces a number of challenges — some generic and some specific.

A significant challenge is the lack of regulatory standards. In 2006, a key initiative was launched by the International Association of Insurance Supervisors (IAIS) and Islamic Financial Services Board (IFSB) which together established a Joint Working Group comparing the existing core principles of the IAIS with supervisory standards for takaful. The group concluded that while there was significant overlap between the two, four broad areas for future work could be identified, namely: corporate governance, financial and prudential regulation, transparency reporting and market conduct, and the supervisory review process. The IFSB used the report to establish the agenda for Working Groups on Governance and Solvency. It has also established other Working Groups covering Conduct of Business and Sharia Governance. These challenges are not exclusive to takaful but they certainly affect it as much as they do other areas of Islamic finance.

In terms of corporate governance, a commercial transaction will normally have two parties but in takaful there are three. The key task is to secure the interests of policyholders in a situation in which they could clearly become subordinated to those of shareholders. Takaful operations are generally hybrids between a conventional shareholder company and a mutual. One or more funds which in principle belong to contributors (policyholders) are embedded within a shareholder company. These shareholders expect to receive a return based on their management of the funds but also for having their own capital exposed to the risk that it may be called on to provide support for the funds via a loan (qard).

Three parties to a relationship seems a bit crowded and therefore it is imperative that the rights of each party are unambiguous. The key to the relationship between policyholders and shareholders lies in the use of Islamic contracts which define the basis on which shareholders will be rewarded. Perhaps the most popular structure currently is the combined waquala and mudaraba model where the underwriting of risk is made using the waquala contract while the actual management of the investments held uses the mudaraba contract. As with so many Islamic contracts, a lack of standardisation is an impediment to growth and future convergence on the terms of the waquala contract would be most welcome; and in particular on any performance fee.

Prudential regulation presupposes a firm having sufficient capital adequacy in place to cope when things go awry. In the context of insurance and takaful, this will be where claims exceed expectations, where investments make losses and where counter-parties default. In the last case, this may lead to aggrieved parties suing or seeking insolvency and it is vital that regulators preserve control and have the correct view on the relationship of the different money pools.

In its approach to prudential regulation, the Dubai Financial Services Authority (DFSA) deals explicitly with issues directly relevant to takaful companies (for example, in the treatment of the various Islamic contracts they may hold as investments).

However, when dealing with individual firms it can also use its extensive powers of waiver and modification to tailor the regime to the specific structure and contractual relationships of the firm. A good example of this in action involved the DFSA's authorisation of TakafulRe, which received modifications to the standard capital adequacy regime to recognise the structures of individual funds within it and to apply capital adequacy tests at the appropriate levels.

In the longer term, the industry will see the emergence of international capital standards for insurance generally. A good example is the much awaited Solvency II project from the European Union which is due for implementation in 2012 as well as the parallel work of the IAIS, whose standards follow the traditional three pillar model conceptual structure of Basel II. These two solutions will be fully risk-based, cover risks on both the asset and liability sides of the balance sheet and will also have the flexibility of allowing some use of the firm's own internal models. It is important to note that the Sharia is not a codified system but rather a set of core principles which are open to interpretation.

This interpretive approach leads to some very divergent opinions among scholars, which we were alert to when engineering our DFSA Sharia Systems based regime. One of the biggest challenges, therefore, lies in the lack of formal precedent of scholarly opinions and these differing interpretations. However, from a regulatory point of view the most important starting point is to accept that the basic precepts of conventional financial regulation apply with equal force to Islamic finance. That proposition has to be tested because it will impact fundamentally on the approach that governments and regulators take as Islamic finance extends its influence and reach.

The main principles of Islamic finance are found in various prohibitions and these include the taking of interest (or riba) with Islamic finance being intolerant of the notion of a risk - free reward for return. The other banned principles cover uncertainty of contract (gharar); gambling (quimar) and games involving speculation (maysir), as well as unethical investments and unfairness or unjust gain at the expense of the other party.

The principles that underpin conventional market regulation are primarily designed to ensure that financial firms are able to deliver upon their promises. These may take the form of promises to indemnify policy holders against loss or to repay investors or depositors upon particular terms agreed at the time of contract formation. In the context of insurance, principles and standards have been developed by the IAIS to reflect the characteristics of insurance promises. Naturally, regulation also extends beyond the assurance of promises, but, in the main, financial services regulation has developed to mitigate the instability caused to a financial system when financial firms fail to honour their promises.

This should be the common starting point for all forms of financial services regulation, be they conventional insurance or takaful because, although the particular terms of promise may differ, reflecting the special structural features of Islamic products, the underlying character of those promises and the consequences of their failure, are the same. Accordingly, while regulatory rules will need some supplementation to accommodate areas of difference, the international standards already governing conventional finance should be adopted as the cornerstone for Islamic finance regulation. Organisations such as the IFSB and the Auditing & Accounting Organisation for Islamic Financial Institutions (AAOIFI) play an important role in dealing with issues of supplementation, but should avoid duplicating or altering existing standards that can apply equally across both conventional and Islamic sectors. To do otherwise will add to industry's compliance burden, constrain cross-border product flows, and hinder the acceptance of Islamic finance products as an integral part of the world's capital markets.

When considering how regulators might best adopt a practical approach to Islamic financial services regulation, we should start with the conventional market. If we identify the core issues in that market, we can then deal with any supplemental issues arising in the Islamic finance context.

This is the same approach adopted at the DFSA and it appears to work well. Of the prohibitions already mentioned, it is useful to spend a little time discussing the issue of certainty (which feeds neatly into the concept of gambling and speculation). The significance is obvious, given the pace of product innovation and the often divergent views held among Islamic scholars.

A contract lacking in certainty poses problems for a conventional contract of insurance which presupposes payment of compensation for an event that may happen, but which people rather hope will never happen. This will be contrary to the Sharia as the activating event to justify a payout is not guaranteed and indeed the actual amount of compensation payable bears no predictable relationship with the amount paid by way of a premium. However, insurance is of course a good thing and is actually a legal requirement in some cases and so the Sharia compliant solution is to use takaful, which means mutual or joint guarantee. Takaful is different from conventional insurance as it uses the concepts of solidarity and co-operation with both parties agreeing mutually to share losses, by making periodic donations, with the right to share in any surplus profits.

In terms of the investment pool used by takaful operators, the ban on unethical investments is actually very similar to investment restrictions imposed on conventional financial products either at a fund level or indeed demanded at an investor level. For example, the Sharia prohibits a number of activities including gambling, armaments, alcohol and pornography which are very similar to socially responsible investing. Islamic finance continues to evolve and the adaptation and innovation of both it and takaful will continue to drive the need for a practical response from regulators. I firmly believe that the DFSA's enabling infrastructure and our use of Islamic windows to bridge the gap between the conventional and the Islamic provides a helpful approach to the regulation of this growing industry.

However, some of the most effective work at bridging the divide has been carried out by the IFSB, AAOIFI and the IAIS. Long may this continue.

Simon Gray, director of supervision – asset management at the Dubai Financial Services Authority (DFSA). Gray writes that in its approach to prudential regulation, the Dubai Financial Services Authority (DFSA) deals explicitly with issues directly relevant to takaful companies (for example, in the treatment of the various Islamic contracts they may hold as investments). However, when dealing with individual firms it can also use its extensive powers of waiver and modification to tailor the regime to the specific structure and contractual relationships of the firm. A good example of this in action involved the DFSA's authorisation of TakafulRe, which received modifications to the standard capital adequacy regime to recognise the structures of individual funds within it and to apply capital adequacy tests at the appropriate levels.