June 20, 2011

Risk-based capital guidelines for Takaful operators in Malaysia

In an effort to improve the overall Takaful regulatory framework, Bank Negara Malaysia (BNM) issued new operational and valuation guidelines on 23 December 2010. These were followed by the long-awaited draft risk-based capital (RBC) guidelines for Takaful operators that were released for feedback in April 2011. The Malaysian Takaful Association is currently collecting responses from the industry.

Alignment with conventional business

At first glance, the proposed Takaful RBC framework appears to be similar to that imposed for conventional business in areas such as:

- The financial strength will be assessed at an operator level based on a capital adequacy ratio (CAR), with BNM imposing a minimum supervisory target capital level of 130%.
- The board of directors and senior management are held responsible for setting up an individual target capital level that reflects the Takaful operator's risk profile and risk management practices. Payment of dividends is prohibited if the individual target capital level is not met.
- The 'available capital' is separated into Tier 1 and Tier 2 categories depending on the degree of its permanence and the absence of encumbrances. Total Tier 2 capital must not exceed Tier 1 capital.
- Risk-based capital charges must be determined at a fund level and comprise of credit risk capital charges, market risk capital charges, liability risk capital charges (including expenses), and operational risk capital charges. The same methodology and assumptions as outlined in the RBC requirements for conventional business have been used to determine each of these capital charges.

Total risk charges determined for each fund will be subjected to a minimum of surrender value capital charges (SVCC), where the SVCC are defined to be the difference between the aggregate surrender value of the business in force less the liability provisions.

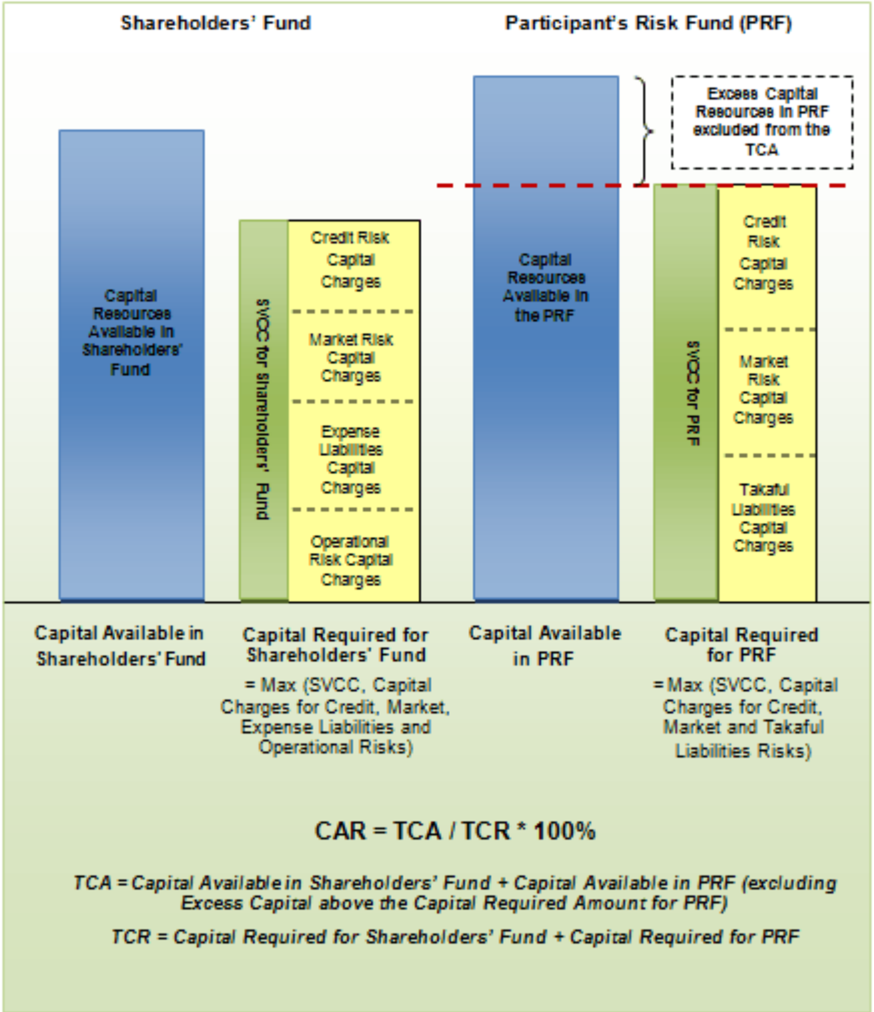
Key adjustments

To account for the difference in concepts between conventional and Takaful business, BNM has made adjustments to the Takaful RBC framework, with particular consideration made to align the new regime to Shariah-specific requirements. The main adjustments are summarised below:

- In the event of a deficit in the Takaful fund (i.e., the participant's risk fund or PRF), there is an explicit requirement for Takaful operators to provide Qard (the interest-free loan) from the shareholder's fund to the PRF. This is to enable the PRF to meet its Takaful benefit payout obligations.
- Any Qard from the shareholders' fund qualifies as Tier 2 capital. In determining the CAR, however, Qard will not form part of the capital available and will be treated as a deduction.
- Like conventional business, the CAR is set out to be the total capital available (TCA) over the total capital required (TCR). Adjustments have been made to each of these components as described below.
- The TCR under the draft RBC framework is the sum of the capital required for the shareholders' fund and for each of the Takaful funds (i.e., the PRFs):
    - Shareholders' fund: The capital required in the shareholders' fund is calculated as the sum of the capital charges for credit, market, expense and operational risks, or the SVCC in relation to the shareholders' fund if this amount is higher. It is noted that the capital charges for expense and operational risks for takaful business are fully held in the shareholders' fund to reflect that these risks are directly borne by the takaful operator. Hence, the capital required for operational risks is calculated by taking to account of all the assets in the shareholders' fund and takaful funds.
    - Each Takaful fund or PRF: The capital required in the PRF is calculated as the sum of the capital charges for credit, market, and Takaful liability risks, or the SVCC if this amount is higher.

- The TCA is the sum of the capital resources available in the shareholders' fund and in each of the Takaful funds. For each Takaful fund, the capital resources are subject to a maximum of the total required capital calculated for the PRF.

Illustrative risk and capital regime outlined in the draft RBC framework for takaful operators



Observations

One significant change within the new framework is the explicit mention and proposed treatment of Qard. The new rules require Takaful operators to have the legal obligation to provide for Qard to Takaful funds that are in deficit. The underlying formulae in determining the CAR have therefore been set such that there is a need for Takaful operators to hold sufficient capital in the shareholders' fund to meet any potential deficits in the Takaful funds.

Another key observation is the proposed formula for the TCA as set out above. While all the capital resources available in the shareholders' fund can be fully accounted for in the TCA, the capital resources that can be recognised in a particular Takaful fund are limited up to the amount of capital required for the fund. BNM has cited in the guidelines that such treatment is to reflect the limitations on capital support cross-subsidies between Takaful funds, or from the Takaful funds to the shareholders' fund, due to the segregated ownership of the different funds in accordance with Shariah requirements.

The adjustment may be appropriate if Takaful operators are only obligated to meet 100% of the required capital. However, the proposed regulations require operators to meet their Individual target capitals, which are subject to a minimum supervisory CAR of 130%. As such, based on the proposed formulae, any capital in excess of 100% will have to be met solely by the shareholders' fund. Such treatment may be viewed as penal, particularly for operators with strong Takaful funds where the excess capital requirements can readily be met by the surplus held within those funds. Equally, the likelihood for the shareholders' fund to provide a Qard facility to these funds in the future is expected to be negligible. Hence, the level of capital required in the shareholders' fund to provide for these potential Qard obligations should not be material.

With the new guidelines, BNM has certainly raised the bar for Takaful regulations globally by potentially being the first regulator in the world to implement a risk-based capital regime specifically designed for Takaful operators. The Malaysia Takaful Association (MTA) is currently gathering responses from the industry with formal feedback expected to be provided to BNM in August this year.

Contact details

If you have any questions about this e-Alert, please contact:

Safder Jaffer
Takaful Practice Leader
Grosvenor Business Tower
Suite 2010, Skeikh Zayed Road
P O Box 506784 Dubai
UAE
Office + 971 4 328 9828
Fax + 971 4 328 9838
Mobile + 971 50 557 7470
Email **safder.jaffer@milliman.com**

Or

Richard Holloway
Managing Director South East Asia & India Life
180 Cecil Street, #10-01 Bangkok Bank Building
Singapore 069546
Office +65 6327 2301
Fax +65 6221 0642
Mobile +65 9732 0150
Email **richard.holloway@milliman.com**

Disclaimer

This e-Alert is intended solely for educational purposes and presents information of a general nature. It is not intended to guide or determine any specific individual situation and persons should consult qualified professionals before taking specific actions. Neither the authors, nor the authors' employer, shall have any responsibility or liability to any person or entity with respect to damages alleged to have been caused directly or indirectly by the content of this e-Alert.