Policies and Developments

- Policy Direction in 2005
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I. Policy Direction in 2005

The takaful industry continued to thrive buoyed by the increase in the public awareness of Islamic finance, the continued improvement of the nation's overall economy and the growing opportunities accorded following various efforts taken to strengthen Malaysia's position as an international Islamic financial centre. In this regard, the policy direction in 2005 centred on six key areas designed to enhance the resilience of the takaful industry in facing these challenging operating environment and to prepare the takaful players to reap the potential of global takaful business. These key areas are:

- Strengthening institutional infrastructure;
- Strengthening corporate governance and risk management;
- Enhancing operational efficiency;
- Strengthening the Shariah framework;
- Enhancing intellectual capital development; and
- Improving market conduct and consumer awareness.

Strengthening Institutional Infrastructure
Several major initiatives were taken in 2005 to further strengthen the institutional infrastructure of the takaful industry and reinforce takaful as one of the key components of the Malaysian Islamic financial system. The initiatives are aimed at adding to the number of strong and qualified players, including takaful brokers and adjusters, with sufficient resources and expertise to stimulate competition in the takaful industry and accelerate the pace of domestic and global expansion of the takaful business. Among the main initiatives are:

- Licensing of Four New Takaful Operators
  Bank Negara Malaysia approved the applications from four consortiums and joint ventures between domestic and foreign financial institutions to conduct takaful business in Malaysia. The new takaful operators were chosen based on their financial strength, expertise, competency and international network to contribute effectively to the development of the takaful industry in Malaysia and complement the efforts of establishing Malaysia as a premier international Islamic financial centre. The issuance of new licences is targeted at accelerating the pace of expansion of domestic and global takaful business by having strong and qualified takaful operators with sufficient resources, right expertise and international network to undertake the task. The participation of the new licensees will also strengthen the linkages with the international market and thereby increase the potential of the Malaysian financial institutions to reap the benefits of this growth sector globally;

- Licensing of Takaful Brokers and Adjusters
  In 2005, the Bank also took an important initiative towards strengthening the regulation and supervision of takaful brokers and adjusters through the issuance of 25 takaful broker and 32 adjuster licences to qualified insurance brokers and adjusters licensed under the Insurance Act 1996. Among the additional requirements imposed on the takaful brokers and adjusters in order to qualify for the relevant licences and be able to conduct business under both the Takaful Act 1984 and the Insurance Act 1996 were more stringent capital and professional indemnity requirements and achievement of a minimum volume of takaful business. In the effort to promote specialisation in takaful broking business, the Bank will additionally issue four specialised brokers licences that will solely be conducting takaful broking business. The issuance of such licences is

with the view of increasing the level of professionalism and competence among takaful intermediaries, as well as ensure an orderly growth of the takaful industry; and

- Designating Existing Associations as Mandatory Associations for Takaful Brokers and Adjusters
  Concomitant to the licensing of takaful brokers and adjusters under the Takaful Act 1984, the Minister of Finance has approved the Insurance Brokers Association of Malaysia (IBAM) and the Association of Malaysian Loss Adjusters (AMLA) as the mandatory associations for takaful brokers and adjusters, respectively. IBAM will later be known as the Malaysian Insurance and Takaful Brokers Association, reflecting the inclusion of takaful brokers as members of IBAM. Apart from complying with the statutory requirements under the Takaful Act 1984, IBAM and AMLA will serve as a platform to safeguard the interest of the takaful brokers and adjusters as well as become the central point to further promote higher level of professionalism among their members. The extension of the role of existing industry associations as associations for takaful brokers and adjusters is to leverage on the expertise and infrastructure already existing in the associations and facilitate cooperation and networking among the members of the associations.

Strengthening Corporate Governance and Risk Management

Strengthening the corporate governance and risk management practices of the takaful operators remained as one of the core agenda during the year in pursuit of a robust and stable takaful industry. Further improvements were made in the following areas to complement existing rules and practices on corporate governance and risk management:

- Transparent Criteria for Appointment of Auditors
  The Bank issued a circular setting out the qualifying criteria for the appointment of audit firm as the auditor of a takaful operator to enhance professionalism in the audit of takaful operators. With the transparent criteria, the onus is placed on the takaful operator to ensure that the proposed audit firm complies with all the criteria set by the Bank prior to seeking approval on the appointment of its auditor. Under the circular, takaful operators are required to submit their application for appointment of auditors at least two months prior to the date of their annual general meeting each year; and

- Sound Information Systems Governance
  Bank Negara Malaysia continued to take steps to enhance the overall information systems (IS) governance and to promote IS best practices among the takaful operators. Key to these efforts is to ensure good governance at various levels of management of the takaful operators, complemented by the Bank's on-site and off-site monitoring. In this regard, takaful operators are required to observe the guidelines on the management of the information technology (IT) environment that outline the minimum responsibilities and requirements for planning, managing and establishing preventive and detective measures to mitigate the risks relating to their IT environment. The Bank continued to conduct regular IS supervision and further improve the standards of IS supervision by benchmarking against other proven IS auditing standards. The Bank also conducted a due diligence review on a new takaful operator to ensure that its IS governance was in place before the takaful company commences operations. The review includes an assessment of the adequacy of application and network security, system support and recovery strategy as well as business functional requirement.

These measures were complemented by the Bank's continued focus on assessment of the institutions' risk profiles, as well as effectiveness of their operational management and risk management systems under the Risk-Based Supervisory Framework. This assessment substantially focused on evaluating the effectiveness of the board of directors and senior management in performing their roles towards enhancing the takaful operator's capacities and capabilities to face future challenges. The assessment would contribute to an overall evaluation of the takaful operator's safety and soundness, with timely and appropriate measures taken to mitigate the risks.

Improving Operational Efficiency

Policies have also been targeted at facilitating the takaful operators in attaining optimum efficiency in their operations. The measures taken include facilitating outsourcing arrangements by takaful operators, enhancing bancatakaful as an effective distribution channel and improving the product approval process. Specific policies introduced in 2005 in this area are as follows:

- Issuance of the Guidelines on Outsourcing Arrangements
  The guidelines set out the minimum expectations of the Bank for takaful operators that outsource, or plan to outsource, any of their business activities, functions or processes. The guidelines contain international best practices in outsourcing arrangements that emphasise on governance of risk management practices. Operating on the premise that takaful operators retain ultimate responsibility for all outsourced activities, the guidelines require takaful operators to have in place a comprehensive outsourcing policy to guide strategic outsourcing decisions and establish a comprehensive outsourcing risk management programme that includes the conduct of appropriate due diligence in selecting service providers. Greater flexibility accorded under the guidelines is complemented by an enhanced reporting requirement that will strengthen the Bank's ability to monitor any risks associated with material outsourcing arrangements at the institutional and industry levels. This is further strengthened by the requirements for takaful operators to incorporate provisions in service agreements to allow supervisory access by the Bank;

- Implementation of Regulatory Requirements for Bancatakaful
  New regulatory requirements of bancatakaful were introduced during the year with the primary aim of ensuring that consumers benefit directly from the efficient cost structures of bancatakaful arrangements, hence further promoting bancatakaful as an effective alternative distribution channel. The introduction of new requirements on commission disclosures on savings products marketed via bancatakaful arrangements will facilitate comparisons of bancatakaful products with other savings and investment instruments. With the development of bancatakaful, consumers will have access to integrated financial services from banking institutions in a cost effective manner; and

- Enhancement of Takaful Product Approval Process
  The enhancement of product approval process was aimed at ensuring that all pertinent aspects such as risk management and Shariah compliance have been carefully considered by the takaful operators before the product is submitted to the Bank. The new requirements include the certification from relevant department or division of the takaful operators on their ability to manage the risk arising from the introduction of the new products, the readiness of the IT system to monitor and manage the new products, the adequacy of the security features and controls and compliance with the law, rules and guidelines issued by the Bank. Takaful operators are also required to provide the endorsement of the Shariah Committee with regard to the Shariah compliance on the concept and mechanism of the new product by furnishing the relevant *fiqh* literature, supporting evidence and reasoning.

Strengthening the Shariah Framework

Bank Negara Malaysia continued to monitor the implementation of the Shariah governance framework to ensure compliance with the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions. Following the issuance of the guidelines, there was an increase in the number of Shariah advisers in the Shariah Committees of takaful operators and this development would serve as a base for increasing the number of competent Shariah experts in the country. The diversity of composition of the Shariah Committees was also enhanced with the inclusion of a former judge and legal practitioner as a member of the Shariah Committees. The diverse background and expertise will enhance the quality of Shariah deliberations which would add value and contribute to the further development of the takaful industry.

Bank Negara Malaysia undertook the following two important initiatives in 2005 towards developing and promoting Shariah dynamism and convergence on the international front:

- The first initiative was the **Shariah Scholars Dialogue** held on 22 - 23 June 2005 in Kuala Lumpur in conjunction with the 30th Annual Meeting of the Board of Governors of the Islamic Development Bank (IDB). The main objective of the Dialogue was to promote convergence and harmonisation of Shariah interpretations and appreciation among the Shariah scholars in the development of Islamic banking and finance at the global front. The Dialogue brought together more than 40 eminent Shariah scholars from several countries such as Saudi Arabia, Tunisia, Iran, Bahrain, Pakistan, Bangladesh, Indonesia, Brunei Darussalam and Malaysia. The Dialogue provided a good networking platform to foster the understanding and appreciation amongst Shariah scholars of the Shariah implementation in various jurisdictions and to facilitate the integration of the domestic Islamic financial system with the global Islamic financial system; and

- The second initiative undertaken by Bank Negara Malaysia was the establishment of a RM200 million **Fund for Shariah Scholars in Islamic Finance**. The Shariah Fund will provide the resources to finance Shariah research activities, scholarships for Shariah studies as well as organise the annual international Shariah scholars dialogue. The Shariah Fund will facilitate the creation and development of competent Shariah scholars equipped with sound knowledge and expertise in both Islamic laws and *Fiqh Muamalat* to deal with the ever-changing and dynamic environment of the Islamic financial industry.

During the year, the Shariah Advisory Council (SAC) of Bank Negara Malaysia deliberated on a number of issues pertaining to Islamic finance and among the main decisions made by the SAC were as follows:

- **Permissibility of Compensation Charges for Late Payment of Judgment Debt**
  The Court may grant compensation charges for late payment of judgment debt in Islamic finance cases based on the average Islamic money market rate or 8% whichever is lower, which will not be compounded;

- **Permissibility of Takaful Coverage for Conventional Loan**
  Takaful operators may provide takaful coverage to conventional loan customers on the basis that the takaful and conventional loan contracts are distinct contracts and the coverage is to provide financial protection for the dependants of the participants. This decision was also made on the basis that it is necessary for the public, including conventional banking customers, to be given equal opportunity to have access to takaful products as part of the efforts to promote Islamic finance; and

- **Permissibility of Forward Foreign Exchange Mechanism**
  The SAC approved a mechanism for forward foreign exchange transaction based on a binding unilateral promise that does not tantamount to a contract before the settlement date. In the event of default of the binding promise, the compensation charge is allowed to be imposed on the defaulter.

Enhancing Intellectual Capital Development

The Bank undertook a major initiative during the year in promoting human capital development with the establishment of the International Centre for Education in Islamic Finance (INCEIF) that will commence operations in 2006. The establishment of INCEIF serves as a catalyst in creating a large pool of world-class experts and high calibre professionals in Islamic banking, takaful and finance, in meeting the talent requirements of the industry both domestically and internationally.

The International Centre for Education in Islamic Finance

Building skills talent is one of the key pre-requisites in supporting the progressive developments of Islamic finance. Human intellectual capital is a critical asset that is much needed to drive innovation and sustain market competitiveness to meet challenges in the Islamic financial industry. With the rapid growth of the Islamic financial system, Bank Negara Malaysia took a strategic move in establishing an international education centre in Islamic finance to produce the needed pool of professionals and specialists in Islamic finance for the domestic and global markets. The establishment of the International Centre for Education in Islamic Finance (INCEIF) will promote greater linkages between the domestic and international Islamic financial system and make Malaysia a leading centre of education in Islamic finance.

The establishment of INCEIF was announced by the Prime Minister of Malaysia at the 3rd ASEAN Business and Investment Summit in December 2005. Extensive pre-operating work is underway for INCEIF to commence operations in the second quarter of 2006. Bank Negara Malaysia has set up an endowment fund of RM500 million to support this initiative.

INCEIF is to be a leading international centre for educational excellence in Islamic finance with the objectives of:

- facilitating the coordination, planning and implementation of human capital initiatives for the global Islamic financial industry;
- developing superior talents for the global Islamic financial system;
- offering internationally recognised professional certification and postgraduate programmes; and
- supplying talented researchers and educators in Islamic finance.

Programmes

INCEIF programmes are designed to provide the latest onsite and online teaching techniques with unique value elements. INCEIF will also form strategic alliances with renowned local and international institutions of higher learning to provide joint education programme through visiting professor and scholar-in-residence schemes.

INCEIF programmes are categorised into three main areas:

1. Professional certification programme
   INCEIF will award professional certification, namely, Certified Islamic Finance Professional, to qualified Islamic finance practitioners. The certification programme, which will commence in June 2006, consists of three parts:

   - *Part I: Building knowledge*
     Candidates will acquire the necessary knowledge in Islamic finance from theories and ethics to wealth planning and management. Validations are done through examinations, written case studies and project papers before candidates are conferred as Associate Members.

   - *Part II: Building skills*
     Candidates will obtain the required skills in handling operational issues and Islamic financial transactions such as structuring corporate financing and issuing Islamic securities. Candidates have the option of specialising in specific areas of Islamic banking and/or takaful. To be conferred as Certified Members, candidates have to pass examinations, undertake project papers, develop new products and prepare transactional documentations.

   - *Part III: Building competency and experience*
     This final part is designed to provide articleship programmes where various activities will be designed to provide candidates with practical experience in the Islamic financial services industry. The activities include a mentor-mentee programme at pre-approved participating Islamic financial institutions and running a simulation bank via a financial laboratory. Candidates will have to go through validation processes such as solving problems, restructuring exercises, simulation and management games, product conversion exercises, Shariah and audit compliance, and interviews in order to be conferred as Practising Members.

2. Postgraduate programmes
   INCEIF will embark on its own Masters and Ph.D. programmes to produce graduates with strong foundation in Islamic finance, coupled with strong research and development capabilities. The Masters programme of INCEIF will be on a highly specialised field of Islamic finance such as Islamic Wealth Management. Candidates will also participate in internship programmes. The programme will commence latest by end-2006.

3. Research and publication programmes
   INCEIF will set up a world-class resource centre that will intensively engage in research and

development projects in Islamic finance as well as publication of books, journals and working paper series. The certification and postgraduate programmes will facilitate and enhance this programme by supplying the relevant research materials and publications for academic references. INCEIF Educational Colloquium, which will be held in April 2006, will also serve as a platform for INCEIF to assess research materials relevant for its research programmes. INCEIF will also develop a comprehensive domestic and international financial database.

Governance

INCEIF is headed by a Chief Executive Officer who reports to the Board of Directors (BOD). The INCEIF Governing Council, comprising prominent local and international personalities, has been established to set the strategic directions and provide visionary global insights on the learning needs of the Islamic financial services industry. The Professional Development Panel was also set up as the highest authority in academic matters that is responsible for reviewing and approving the certification and postgraduate module programmes and to ensure INCEIF offers the highest quality of module content and standards for all its programmes.

The establishment of INCEIF completes the talent development infrastructure in Malaysia's Islamic financial industry. The industry-owned Islamic Banking and Finance Institute of Malaysia (IBFIM) and the Securities Industry Development Centre (SIDC) focus their training programmes to meet the industry needs at the technical level whilst INCEIF will provide intermediate and advanced knowledge and skills in Islamic finance. The International Centre for Leadership in Finance (ICLIF) provides leadership programmes to top management that include those from the Islamic financial institutions. This allows Malaysia to offer a full range of Islamic finance talent development programme for the global needs of the Islamic financial services industry.

INCEIF reflects Malaysia's continuous effort and commitment towards the development of a progressive Islamic financial industry by developing and enhancing human intellectual capital in Islamic finance. It is envisaged that the establishment of INCEIF would contribute towards supporting the growth and development of the global Islamic financial system.

Improving Market Conduct and Consumer Awareness

Concerted efforts continued to be accorded to further strengthen consumer education and awareness in takaful concepts, products and services. The Bank continued to participate actively in the Islamic Banking and Takaful Roadshows (IBTR) organised by the Association of Islamic Banking Institutions Malaysia in collaboration with the Malaysian Takaful Association, which were conducted nationwide at six locations which managed to gather an average of 20,000 visitors. Bank Negara Malaysia participated in the OIC Trade Exhibition organised by the Malaysian External Trade Development Corporation (MATRADE) and an exhibition in conjunction with the Investors Conference both held in June 2005. The Bank was also involved for the second consecutive year in the Malaysian International Halal Showcase, organised by the Islamic Da'awah Foundation.

The Bank continued to further increase public acceptance of takaful products through improvements in the market conduct and practices to further safeguard the interest of consumers. Measures introduced are as follows:

- Issuance of Circular on Replacement of Takaful Certificates

  To improve the practices relating to marketing of takaful products and ensure that the interest of certificate owners are continuously safeguarded, the Bank laid down minimum requirements and standards of conduct to reduce the incidence of replacements of takaful certificates. Measures introduced through the issuance of the circular on replacement of certificates include the requirement to establish an effective control mechanism to detect replacement of policies and to include relevant questions in the proposal forms on replacement of certificates. Takaful operators were required to appoint designated officers within the company to conduct follow-ups and advise certificate owners on the disadvantages of replacing a takaful certificate and the alternative options available. Takaful operators are also required to conduct regular internal audits to ensure proper enforcement of the control procedures on the replacement of takaful certificates; and

- Issuance of Revised Guidelines on Claims Settlement Practices
  The Guidelines are aimed at improving the transparency and objectivity of the claims estimation process. The guidelines direct takaful operators to electronically approve "own-damage" claims via the Motordata Research Consortium Sdn. Bhd. (MRC) database system, itemise claims approval according to each part used and its price as well as labour time required for repair and not subject the final repair estimate derived from the MRC database system to any further reduction.

II. International Developments

Building Greater Linkages with International Islamic Financial Markets

A vital aspect in developing a progressive global takaful industry is the need for greater international linkages and strategic alliances among the Islamic financial institutions, regulators and relevant international standard setting organisations. Towards this end, the takaful operators and the Bank intensified efforts to promote takaful through strategic alliances and international collaboration to achieve global business expansion and convergence in takaful regulation and practices. Among the notable developments are:

- Participation in Joint Working Group of the Islamic Financial Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS)
  The Bank participated actively in the IFSB-IAIS Joint Working Group (JWG), which is an important platform to support the IFSB in achieving its mandate in developing internationally accepted prudential standards for the regulation and supervision of the takaful industry. The JWG made significant progress through the issuance of an Issues Paper on "Issues in Regulation and Supervision of Takaful", which was presented before the Technical Committee of the IAIS in October 2005 and approved by the IFSB Council in December 2005. The Issues Paper provides a preliminary examination on the applicability of the insurance core principles (ICPs) of the IAIS to the regulatory and supervisory standards to be developed by the IFSB for the takaful industry, which led to the identification of four major themes of issues. They are corporate governance, financial and prudential regulation, transparency, reporting and market conduct as well as supervisory review process. These areas when addressed by the IFSB, are expected to lead to adaptation of the IAIS ICPs for the takaful industry, and may also lead to issuance of specific guidance papers or standards. The Issues Paper also identified corporate governance as the area of priority for future work by the IFSB;

- Takaful Development Initiatives under the Memorandum of Understanding with the Islamic Development Bank (IDB)
  Further progress was achieved in the implementation of the Memorandum of Understanding (MoU) between Malaysia and the IDB with strong commitment shown by both parties to ensure smooth implementation of the existing areas of cooperation within the specified timeframe. In the area of promoting the development of takaful and retakaful, a 12-member Committee on Takaful and Retakaful (Committee) was established in June 2005 comprising regulators and takaful practitioners from Malaysia and other member countries of the Organisation of the Islamic Conference (OIC). The inaugural meeting of the Committee was hosted by Bank Negara Malaysia and held in November 2005 to discuss the current position of takaful development in the OIC member countries and deliberate on the proposed action plans to address the gaps identified in the development of takaful and retakaful. The action plans were divided into eight main areas as follows:

  i. Provide customised support to establish takaful company in targeted jurisdictions;

  ii. Promote human capital support;

  iii. Enhance promotion and awareness;

  iv. Increase capacity and support for retakaful;

  v. Promote development of basic and full range of products;

  vi. Promote development of market and investment avenues;

vii. Optimise existing framework of dispute resolution; and

viii. Foster development of sound legal, regulatory and Shariah framework.

- Equity Participation in Pakistan
  In line with the Government's vision for Malaysian financial institutions to expand overseas, a Malaysian takaful operator has entered into a joint venture agreement with Pakistan Kuwait Investment Corporation to hold 25% equity in the first takaful company established in Pakistan which recently commenced operations. Another takaful operator is also undergoing negotiations with prospective partners with a view of expanding into the takaful market in Pakistan; and

- Foreign Equity Participation in Retakaful Operator
  Efforts continued to be taken to reinforce the position of ASEAN Retakaful International (L) Ltd (ARIL) as the premier retakaful operator. During the year, the IDB finalised its participation in the equity of ARIL, through its subsidiary, Islamic Corporation for the Development of Private Sector amounting to 2.2 million shares or 15.7% of ARIL's paid-up capital. This is part of ARIL's overall plan to attract new shareholders especially among the OIC member countries to further increase its capital to USD60 million by 2008. ARIL has also conducted regular roadshows especially to countries in the middle-east in search of business support and this has been an important factor contributing to the increase in ARIL's foreign business, to account for nearly one-fourth of its total business.