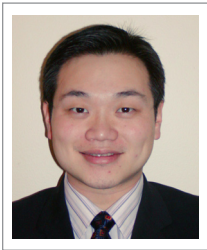




**Nick Bugler**  
Title: Partner  
Location: London



**Heng Loong Cheong**  
Title: Associate  
Location: Hong Kong



**Sheng Wu**  
Title: Associate  
Location: Hong Kong

The following article appeared in *Asia Insurance Review* | [www.asiainsurancereview.com](http://www.asiainsurancereview.com)  
December 2009

## The “dawn” of takaful corporate governance by Nick Bugler, Heng Loong Cheong and Sheng Wu

There is a need to introduce harmonised corporate governance standards for the takaful industry. Mr Nick Bugler, Partner, Mr Heng Loong Cheong, Senior Associate and Mr Sheng Wu, Associate, all from Dewey & LeBoeuf, tell us that while this goal faces key challenges, international standard setters and regulators are tackling this issue together with the industry.

The current global financial meltdown has taught us that existing corporate governance systems and controls (especially those of conventional financial institutions) should be improved to prevent future systemic failures.

### Growing consensus to reform and improve takaful and retakaful corporate governance

With takaful being increasingly viewed as a solid, if not more attractive, alternative to conventional insurance and the rapid growth of the takaful industry on a global scale, there is a growing consensus to reform and improve the corporate governance of takaful and retakaful operations to prevent future systemic failures, maintain takaful's competitive edge and enhance the industry's growth potential.

Currently there are international and regional initiatives that seek to introduce a set of generally accepted takaful and regional corporate governance standards which local regulators can adopt and adapt to local practice.<sup>1</sup>

A key aim of this focus on takaful corporate governance is to reduce the risk of systemic failures by introducing minimum harmonised corporate governance standards and hopefully win over the confidence of insureds, investors and reinsurers alike.

1. The Islamic Financial Services Board (“IFSB”) issued an exposure draft of Guiding Principles on Governance for Islamic Insurance (Takaful) Operations (“IFSB Guiding Principles”) in December 2008 (closed for comments on 15 May 2009). The Arab Forum of Insurance Regulatory Commissions (“AFIRC”) together with the Hawkamah Institute for Corporate Governance have also published a policy brief on corporate governance in the Middle East and North Africa (MENA) region in March 2009 which covers all insurers (including Takaful operations) in the MENA region.

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An issue caused by the current lack of harmonisation is Shariah ‘arbitrage’ where products and services may be approved by Shariah boards in one jurisdiction but not another (and even inconsistencies and arbitrage within the same jurisdiction due to differences in opinion between different Shariah boards or scholars).

### **Key challenges to harmonise corporate governance standards**

Whilst significant effort has been made to harmonise takaful corporate governance standards by looking to international standards for conventional insurers<sup>2</sup>, the progress may be slower than many expected due to certain unique challenges facing the takaful industry.

### **No universal takaful model**

There is no universal takaful business model. Takaful operations have sought to avoid the need for organic growth by developing various hybrid operating models<sup>3</sup> which require different governance structures. The different models also mean that it is difficult for the takaful industry to consistently define itself and promote the international growth of the sector as a whole.

Shariah compliance requirements necessarily impose an additional layer on top of governance standards for conventional insurers. A key issue is the treatment of the Shariah board within the context of conventional corporate governance structures, *i.e.*, whether it is viewed as equivalent to the board of directors or compliance department or auditor (or a combination of each) of a conventional insurer.

### **Regulatory approaches**

There are different regulatory approaches towards the regulation of takaful, such that local regulators will need flexibility in applying generally accepted takaful corporate governance standards within their respective regulatory framework.

In some jurisdictions, such as Singapore and the UK, where the regulatory framework applicable to conventional insurers applies equally to takaful operators, regulators could view the generally accepted takaful corporate governance standards as being consistent with and in compliance with the general insurance regulatory framework.<sup>4</sup>

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2. The International Association of Insurance Supervisors (“IAIS”) and the Organisation for Economic Cooperation and Development (“OECD”) have each published corporate governance guidelines for conventional insurers, and are working together (conducting joint surveys and jointly publishing issues papers) to improve these standards.
  3. Currently, there are three main models, the Mudharaban model (under which profits are shared between policyholders and shareholders), the Wakala model (under which surplus is owned by the policyholders and may be reduced by a performance fee incentive for the operator before distribution to the policyholders) and a model combining the above two models. [www.asiainsurancereview.com](http://www.asiainsurancereview.com) s December 2009 s 97 Spotlight on Takaful
  4. For example, in the UK all insurers (including takaful operators) have to meet the five basic requirements known as the “Threshold Conditions” (including the firm being “fit and proper” and having adequate resources (both financial and non-financial) for the activities it seeks to carry out). The Financial Services Authority, the UK regulator, would need to take into consideration certain unique features of Takaful operations (such as the existence of a Shariah board and the nature of profit sharing) in its application of these requirements.

In other jurisdictions where takaful operations are subject to a separate and bespoke set of laws and regulations, such as Pakistan and Malaysia, such bespoke takaful laws and regulations could be tailored to incorporate and reflect the generally accepted takaful corporate governance standards either as a code of best practice (similar to the UK's Combined Code) or as a strict legal requirement.

Additionally, the scarcity of trained Shariah scholars brings certain corporate governance challenges. For example, conflicts or independence issues may arise if a particular Shariah scholar is serving on the Shariah boards of different takaful operators or on the boards of both a takaful operator and its retakaful provider.

### **The “dawn” of takaful corporate governance**

The Islamic Financial Services Board (IFSB) Guiding Principles aim to address many of the above challenges by targeting such issues as independence and integrity of each organ of governance, management of conflicts of interest, model terms of reference and operational guidelines for Shariah boards and the Shariah governance system (*i.e.*, Shariah board, compliance and audit functions).

The AFIRC-Hawkamah policy brief on corporate governance in the MENA region addresses issues faced locally by the takaful industry in the region, such as dominance of family-owned, majority-owned and state-owned businesses and the shortage of qualified board members and management in the region, by emphasising the importance of having competent and independent board members and senior management, and recommending that takaful operators adopt and maintain minimum levels of transparency and disclosure.

Both the IFSB Guidelines and the AFIRC-Hawkamah policy brief are meant to complement other existing internationally recognised frameworks for conventional insurers.

### **Malaysia setting Shariah Parameters**

Compared with international and regional initiatives, actions taken by local regulators could have a more immediate impact on local takaful corporate governance.

For instance, Bank Negara Malaysia (BNM), Malaysia's central bank and insurance regulator, has recently issued Shariah Parameter Reference 1 (Murabahah Parameter) — guiding principles and illustrations that help identify and explain the Shariah components of a Murabahah contract<sup>5</sup>.

Together with further planned series of Shariah Parameters (which will hopefully cover takaful contracts), BNM aims to facilitate the design and development of Shariah compliant financial products and services and to harmonise the interpretation and application of Shariah views and opinions, especially among Shariah board members.<sup>6</sup>

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5. A Murabahah contract is an Islamic sale contract which provides a Shariah compliant alternative to interest-based finance contracts — the purchase price is set on a cost plus mark-up basis which can be paid on a deferred basis.

6. The parameters are offered as a key reference tool to assist Shariah board members in making Shariah compliance related decisions relating to the relevant Islamic financial institutions, products and services.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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8408 REV01 12-04-2009

These Parameters are endorsed by Malaysia's Syariah Advisory Council (SAC), which under Malaysian law is the highest authority for definitive interpretation of Shariah law in Malaysia.<sup>7</sup> One would therefore expect Shariah boards in Malaysia to eventually adopt a consistent interpretation of Islamic finance contracts including takaful contracts.

With Malaysia being one of the world's leading takaful markets, its success stories may serve as a persuasive model for regional and, perhaps eventually, even international takaful corporate governance convergence.<sup>8</sup>

### **Need for "think global, act local" approach**

The global "dawn" of takaful corporate governance has arrived. Nonetheless, a common understanding of challenges in takaful corporate governance requires an understanding of the local insurance regulatory framework and practices, as much as the Shariah specific 'overlays' and local takaful market context.

There will need to be a "think global, act local" approach by all takaful participants and stakeholders, when they engage with each other, as well as with local regulators, international standard setters and participants and stakeholders in the conventional insurance space.

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7. Malaysian Civil Courts having jurisdiction to hear a particular dispute involving Takaful operators / insureds will nevertheless have to refer questions of Shariah law interpretation to the SAC.

8. For example, some jurisdictions are considering the Malaysian model to establish a domestic central Shariah Council as the ultimate decision making body on Shariah matters, which helps ensure the consistent application of Shariah in Islamic financial transactions, products and services (including Takaful) within its jurisdiction.