Implementing IFRS 17 for Takaful companies

As insurance companies prepare themselves for the new accounting standard IFRS 17, Takaful companies (i.e., companies selling Islamic or Shariah-compliant insurance products) are facing significant uncertainty in how to interpret and apply IFRS 17 to their business. IFRS 17 is intended to be the first international and comprehensive accounting standard for insurance contracts and has largely been developed based on conventional insurance structures. Takaful companies typically adopt a different operating model, and as a consequence, interpreting IFRS 17 for Takaful business is not a straightforward process.

How is Takaful different to insurance companies?

Takaful companies often have various funds to meet their liabilities. In insurance companies, it is common for all liabilities including claims, expenses, and commissions to be paid from the insurance fund, and surplus declared from the insurance fund is transferred as profit to the shareholders’ fund. In a typical Takaful company, only claims liabilities are paid from the insurance fund or risk fund, whereas expenses and commissions are met by the shareholders’ fund. The key difference is that there is no co-mingling of funds used to meet expenses and claims as observed in a typical insurance structure. Premiums or contributions are segregated at outset, such that a portion of the contributions is allocated to the shareholders’ fund to meet expenses and commissions, along with an allowance for profit margin.

Using Malaysia as an example, a summary of a typical operating model for a Takaful company is outlined below:

Key takeaways:
- Interpreting IFRS 17 for Takaful business is often not straightforward.
- Key issues in implementing IFRS 17 for Takaful business include:
  - Selection of measurement models
  - Treatment of various funds in Takaful
  - Fulfilment cashflows and CSM
  - Treatment of surplus sharing
  - Disclosure requirements
- To date, there has been limited discussion and direction on the implementation of IFRS 17 for Takaful business.

Note: Wakalah fee is a fee payable to the Takaful operator for acting as an ‘agent’ in managing the Takaful contracts (i.e., agency fee)
Challenges of implementing IFRS 17 for Takaful companies

The interpretation and implementation of IFRS 17 for insurance companies is already challenging, and this is even more so for Takaful companies. On one extreme, we note that there are market players who argue that IFRS 17 may not be applicable to Takaful companies, given that Takaful does not represent a transfer of risk from the policyholder to the company, but instead a pooling of risk shared by the participants. However, as IFRS 17 is applicable to mutuals and there is significant insurance risk borne by the risk fund, it is likely that IFRS 17 will be applicable to Takaful companies.

Several areas where there are additional uncertainties for Takaful companies under IFRS 17 include:

- **Selection of measurement model**
  It is common for Takaful contracts to have a participant’s account and a risk fund, similar to an investment-linked product structure, even for protection-focused products such as mortgage reducing term Takaful (MRTT). Hence, when selecting the measurement model under IFRS 17, there is a natural tendency to steer towards the Variable Fee Approach (VFA) given the similarities with the investment-linked product structure.

  To qualify for the VFA, a contract must be considered to have Direct Participation Features (DPF) and meet three conditions:
  1. The policyholder participates in a share of a clearly identified pool of underlying items.
  2. The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items.
  3. The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

  In many aspects, Takaful contracts with a participant’s account appear to meet the DPF qualification requirements outlined above. However, whilst the first condition is easily met for most Takaful contracts, meeting the second and third conditions is less clear. For example, MRTT contracts are significantly protection-focused and, despite having a participant’s account, the amount paid from the participant’s account is likely to be small compared to the protection payout or the sum assured. Such contracts may not meet the conditions of DPF if we consider:

  - IFRS 17 describes DPF contracts as insurance contracts that are substantially investment-related service contracts. For protection-oriented contracts it is not clear that this is the case.
  - On a probability-weighted basis, a substantial proportion of the amounts paid to policyholders may not vary with the fair value of the underlying items (given the high protection component).

Takaful companies thus need to assess each product independently to determine whether they qualify for VFA, and the determination of the suitable measurement model is not necessarily straightforward.

- **Disclosure requirements given multiple funds within Takaful**
  Given that there are multiple funds underlying the Takaful contract (i.e., participant’s account, risk fund, Takaful operator’s fund), in certain jurisdictions such as Malaysia, Takaful companies are currently required to provide separate disclosures by fund under the current accounting basis (i.e., IFRS 4). For Malaysia, this is mandated by the Malaysian Accounting Standards Board (MASB) rather than a specific requirement under IFRS 4. However, it is unclear whether there would still be similar requirements for separate disclosure by fund under IFRS 17 in countries such as Malaysia. We note that under IFRS 17, there is no such requirement for disclosures at a fund level. Companies preparing for IFRS 17 may need to prepare for the continued granular disclosures (i.e., by fund level) given that there is no clear direction or guidelines issued by the local accounting standards board as yet.

- **Fulfilment cashflows and CSM**
  There is also uncertainty whether companies should calculate fulfilment cashflows and CSMs at a fund level (i.e., separate for risk fund and Takaful operator fund). This issue ties up closely with the uncertainty on disclosure requirements as outlined above.

  Most Takaful contracts have an element of surplus sharing from the risk fund between the Takaful company and participants. When there is a shortfall in the risk fund, Takaful companies are obliged to provide qard (i.e., interest-free loan) to the risk fund. Correspondingly, there is uncertainty as to whether surplus sharing and qard should be included in the fulfilment cashflows.
In the most recent second quantitative testing (QT2) by Bank Negara Malaysia in August 2018, the measurement of liabilities for Takaful was not carried out according to sub-funds; it was instead carried out from a contract perspective regardless of whether they were managed in the risk fund or Takaful operator’s fund. The fulfilment cashflows in QT2 makes an allowance for surplus sharing but ignores qard. However, no formal guidance has been issued by the local accounting standards board in Malaysia.

- **Treatment of surplus sharing**

  In Malaysia, currently surplus sharing from the risk fund between the participants and Takaful operator is subject to minimum regulatory requirements. In summary, surplus distributions need to be in line with the company’s surplus management policy and take into account statutory reserves. It is unclear whether treatment of surplus sharing under IFRS 17 should reflect statutory reserving and capital requirements or accounting requirements. However, ignoring reserving and capital requirements is likely to accelerate the emergence of surplus allocated to the shareholders’ fund, which may not necessarily reflect the timing of expected future cashflows.

  The issues outlined above are not exhaustive and the most appropriate approach for Takaful companies remains highly debatable. Although there continue to be regular discussions on IFRS 17 within companies and industry associations for conventional insurance business, discussions on the most suitable approach and interpretation for Takaful companies have been more limited to date. This is not surprising as Takaful business is significantly smaller than conventional insurance business for most multinationals. Although Takaful companies within multinationals can leverage some of the IFRS 17 work conducted on their conventional insurance business, companies should not underestimate the issues and challenges in developing appropriate IFRS 17 methodology for Takaful business.

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