IFRS 17 and the Takaful Model

Rais Kazmi and *Omer Mehmood* delve into the specificity of IFRS 17 implementation for takaful.

Takaful, also referred to as Shari'ah Insurance, is compliant with Islamic principles and is quite popular within the Middle East and South-East Asia region. Global Takaful business has a market capitalisation of around USD24[1] billion at present which is expected to further increase in the foreseeable future.

Owing to the very different operating model embedded within Takaful business, IFRS 17 implementation poses several challenges. In what follows, we have tried to shed light on some of these areas signposted below and share our interpretation of the standard in addressing the following issues:

» Definition of an insurance contract
» Wakalah fee
» Liability measurement and reporting
» VFA eligibility

DEFINITION OF AN INSURANCE CONTRACT

The scoping requirements of IFRS 17 set out the definition of an insurance contract as a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the other party given the possibility of being adversely affected in a specified uncertain future event. This is further supplemented by Paragraph B16 which states that an entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder.

While the application of this principle is very straight-forward for a conventional

insurer, it might not be so for the Takaful business. The operating model in Takaful comprises of policyholders or participants pooling together their contributions in a risk fund that is then used to pay any claims that arise. Since the participants are pooling their own funds, the question that then arises is whether there is something to the effect of risk transfer, as defined above, taking place.

For this matter the standard does give some clear guidance again in Paragraph B16 when it says that mutual insurers will also have to apply the IFRS 17 standard. The rationale given there is that although policyholders may be pooling their risks collectively in a mutual entity, the mutual entity is still considered to be a separate entity that has accepted the risk.

The provisions above can be extrapolated to the case of a Takaful business since by design, the Takaful model can be looked upon through the same lens as a mutual insurer.

WAKALAH FEE

The scoping requirements of the standard in Paragraph 12 require an entity to separate from the host insurance contracts any cashflows that relate to the provision of distinct goods or services other than insurance contract services and report these under IFRS 15.

This becomes relevant to Takaful business in the context of 'Wakalah Fees'. This is the portion of premium that the takaful operator charges for managing the risk and any individual investment funds. However, the intra fund flows within different takaful models and across different regions for this element vary. This variation both in the underlying models and general practice makes the classification of these flows towards the shareholder funds difficult to isolate to be accounted for under other accounting standards. Therefore, the question that arises is that whether Wakalah fee is a non-insurance service?

Keeping in mind the theoretical Takaful operating model, Wakalah fee is not strictly related to insurance since claims liabilities are paid from the separate risk fund. However, in the context of IFRS 17 we need to see whether the Wakalah fee has any link with the underlying risks. In other words, the question that arises is whether the determination of Wakalah fee requires an assessment of the risk associated with the participant.

Wakalah fee is determined by apportioning the written premium upfront. The written premium already includes the assessment of the underlying risk based on insurance principles. Thus, the determination of Wakalah fee does indeed involve an assessment of the risk being written and according to our interpretation is an IFRS 17 measurable item.

LIABILITY MEASUREMENT & REPORTING

As per the prevalent regional financial reporting regulations, Takaful businesses report their liabilities at the fund levels. Such disclosure requirements if not applicable under all jurisdictions are true for some. This issue closely ties up with the question of what level should the IFRS 17 liabilities be computed. Should the fulfilment cashflows and contractual service margin be computed at the fund level i.e. separately for the risk fund, participant fund and the shareholder funds and then aggregated to arrive to at the entity-wide results?

Computing liabilities at fund level may bring in additional operational complexity and challenges as it will require setting assumptions at a more granular level among other things. Also, there is the chance that the entity level liability computed using this bottom-up approach does not reconcile with that computed at the contract level itself across all reporting periods.

The standard itself does not provide any guidance in relation to takaful business let alone the issues highlighted above. Therefore, it is safe to assume that the principles mentioned apply equally to takaful business and compute liabilities at the entity level which can then be allocated to the fund level. Disclosures at fund level may still be required by the regulator as in takaful business they lead to a better representation of results.

Since the standard does not stipulate liability measurement at such a level of aggregation, the simple and more efficient method to allow for such disclosure requirements is to allocate the entity level results to the constituent funds.

Furthermore, the distinct fund mechanics and values at each projection period at valuations are intrinsically intertwined. The shareholder fund is expected to cover losses in the risk fund, while the risk fund projections are impacted by the projected investment fund balances. In this respect, an argument can be made that these sub fund valuations although explicitly separate

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are interrelated to the degree that one cannot be valued without providing due considerations for the others. This principle in IFRS 17 is also applied in the separation or identification of non-insurance elements from within a contract.

VFA ELIGIBILITY

IFRS 17 broadly categorises insurance contracts into those with Direct Participation Features (DPF) and into those without DPF. An insurance contract with DPF is defined as a contract that meets the following three conditions:

» the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

» the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

» 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.

The first condition is readily satisfied by takaful products by virtue of presence of the risk fund within the takaful model. This is true even for those products where there is no savings component such as a pure property and casualty product. However, the standard states that contracts with DPF are those that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items.

Therefore, a question that comes up within Takaful is in relation to non-investment related contracts as to whether they can be classified as contracts with DPF. This aspect is important since the selection of a measurement model is dependent on these categorisations since an insurance contracts with DPF must be measured using the variable fee approach.

The second and third conditions above give some further guidance in this respect. The claims payout in case of a non-investment related takaful product is dependent on the nature of claim, sum insured and any policy terms and conditions. The fair value returns on the underlying items i.e the risk fund is definitely not commensurate with the claims outgo since the takaful operator is not obliged to return the contributions received from the participants as is the case in a contract with a savings component. Therefore, such contracts do not fulfil the requirements of contracts with DPF.

CONCLUSION

As if IFRS 17 on its own was not complicated enough, some of the issues highlighted above appear to make the IFRS 17 transition even more daunting for Takaful operators. The working groups established in different parts of the world, including the one constituted by the CBUAE, are still involved in many discussions. There may be better clarity due to these deliberations. In navigating these conundrums it would be best to look at things from basic principles i.e. the conceptual framework around which IASB issues reporting standards.

The ultimate objective of the reporting of a takaful entity should be comparable to that of a conventional insurer given that for the most part Takaful products are simply conventional contracts structured to conform to basic Islamic principles of finance. In this respect, interpretating the standard from a purist viewpoint may lead us to an extremely divergent path. Such situations should always be determined on the anvil of comparability with a conventional product, in which case the application of the standard is relatively less complicated. ℗

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1. *https://www.imarcgroup.com/takaful-market*

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