OPERATION OF *TAKĀFUL* INSURANCE UNDER THE CONVENTIONAL REGULATOR: A SRI LANKAN EXPERIENCE

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ABSTRACT

Takāful insurance, an alternative for conventional insurance is a fast moving instrument in the insurance industry in the contemporary world. It has a significant impact in Muslim countries as well as in the countries where the Muslims live as minority. In general, regulatory supervision for insurance industry is very important to keep a healthy balance between insurance companies and insured. The *Takāful* insurance needs more consideration on this issue than the conventional insurance because of *Shari'ah* compliancy.

Takāful insurance is regulated by Central Bank by *Takāful* Act as in Malaysia or government authorised institutions as Securities and Exchange Commission of Pakistan (SECP), Capital Market Authority (CMA) of Oman. In contrast, in Sri Lanka as a non-Muslim majority country, conventional insurance including *Takāful* insurance is regulated by the Insurance Board of Sri Lanka (IBSL) by the Regulation of Insurance Industry Act No. 43 of 2000 which is legislated to supervise mainly conventional insurance industry. There is no *Takāful* Act or separate regulations in the Insurance Act for *Takāful* operation except some exemptions when contravene to *Shari'ah* principles. The Central Bank is a member of the IBSL and is represented on it by the Deputy Governor in charge of Financial System Stability.

This paper aims to explain how this hybrid system works and to examine the hindrances the *Takāful* operators face in practicing *Shari'ah* principles.

Keywords: *Takāful*, Insurance, Regulator, *Shari'ah* compliant, Insurance Board of Sri Lanka.

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1. INTRODUCTION

Today there are more than 200 registered *Takāful* companies worldwide, operating either through writing *Takāful* directly or placing it through windows of conventional insurers. According to the Ernst & Young World *Takāful* Report 2011, the *Takāful* market was worth US$ 12 billion in 2011, an increase of 31 per cent from the $9.15 billion figure posted the previous year.[2]

Between 2007 and 2010, global family *Takāful* gross contributions increased at a compound annual growth rate of 36 per cent. In fact in 2010, Southeast Asia's share of global family *Takāful* contributions was 73 per cent, followed by the Middle East with 25 per cent and South Asia with 2 per cent. In short, while most of the general *Takāful* market is centred in the Middle East and Gulf region, the family *Takāful* business is focussed in the Southeast Asia region, especially, in Malaysia, Indonesia and Bangladesh. Family *Takāful* in Malaysia was estimated to contribute 77 per cent of net *Takāful* contributions in the country in 2010.[3] The above phenomenon of development of *Takāful* shows that this financial segment can be further developed in recent future.

On the other hand, the Insurance Board of Sri Lanka (IBSL), the body responsible for the authorisation and regulation of all insurance services in Sri Lanka, apply conventional regulatory criteria and product definitions in authorising Islamic insurance institutions. Yet these institutions differentiate themselves from their conventional peers in that they house so-called *Shari'ah* Advisory Council (SAC). *Shari'ah* board's principle remit is to audit products and services for their compatibility with Islamic principles, which developed over the course of centuries of Islamic jurisprudence. Products that comply with such principles earn the 'Islamic' label, which crucial to their uptake by Muslim investors. Therefore, *Shari'ah* boards' direct responsibility for the religious interests of Muslim consumers creates a unique reputational risk in such institutions insofar as insurance companies to have contravened the *Shari'ah* may trigger a lack of confidence in them.

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[2] The world *Takāful* Report 2011, April 2011, Ernst & Young, Dubai, UAE: MEGA, p. 4
[3] Kazi Mohamed Mortuza Ali, 2013. Challenges of Takāful and Required Regulatory Framework, p. 1, accessed on 15 September 2013 through http://www.thefinancialexpressbd.com/index.php?ref=MjBfMDRfMjBfMTNfMF8xNjZfMTY2OTM0&feature=c3BlY2lhbHNOZXdz&na=RkVBVFVSRSAmIEFOQUxZU0VT

This paper examines the unique status and problems associated with *Takāful* Islamic insurance companies regulated by the conventional regulating system in Sri Lanka. And it proceeds in highlighting the issues by first addressing the importance of regulatory supervision for the insurance/*Takāful* industry after an outlook of the country's profile. Second, general outlook for development of insurance in Sri Lanka briefed. Third, regulatory authorities for insurance in Sri Lanka focussing to Central Bank of Sri Lanka and Insurance Board of Sri Lanka explained. Fourth, there will be a description on regulatory framework on *Takāful* in Sri Lanka. Fifth, regulatory issues of *Takāful* industry in Sri Lanka, the core issues discussed. Finally, the conclusion, with some final remarks and suggestions pointed out.

Sri Lanka now houses one full-fledged *Takāful* company namely, Amana *Takāful* PLC and a *Takāful* window in a conventional insurance company namely, HNB *Takāful* Assurance (It is started in July 2013) which claim to offer *Shari'ah*-compliant financial products and services. Another company called Ceylinco *Takāful* PLC was in practice and has been terminated by IBSL since 2009 until further notice due to its improper financial and accounting activities. Yet the history of Islamic insurance in Sri Lanka is fairly recent. Amanah *Takāful*, the first *Takāful* company launched its services in 1999.

2. A Brief Overview to Sri Lanka

The Democratic Socialist Republic of Sri Lanka (formerly known as Ceylon), an island in the Indian Ocean, is situated about 28 kilometres off the South Eastern coast of India. It is surrounded by the Indian Ocean, Gulf of Mannar, the Palk Strait, and lies in the vicinity of India and Maldives. The geography of Sri Lanka includes coastal plains and hills and mountains in the interior. Sri Lanka is famous for its golden beaches, gem stones, top quality tea, cricket, beautiful and dense forests. It has typically tropical climate with an average temperature of 27^{0}C fluctuates between 15^0 C in the highlands to 35^{0}C in certain areas of the lowlands. Sri Lanka is mainly an agricultural country. It is self-sufficient in its staple diet rice which is the largest cultivation. Tea, coconut and rubber are the main economic agricultural crops. Tea brings beauty as well as the foreign exchange to the country.

Sri Lanka is ethnically, linguistically and religiously diverse. Of the country's population of about 20 million (20,283,723),[4] Sinhalese represent 74.9% and are concentrated in the southern and south western parts of the island. Tamils constitute about 11.2% of the population, whose South Indian ancestors have lived in the island for centuries, are living predominantly in Northern and Eastern Provinces. Plantation Tamils, a distinct ethnic group, represent about 4.2% of the population, were brought from South India by the colonial British to work in tea estates in the central hills. Other minorities, Muslims (both Moors and Malays) constitute about 9.4% of the population and negligible percentage of Burghers and the aboriginal Veddahs.[5]

Most Sinhalese are Buddhist (70.2%) and most Tamils are Hindus (12.6%). The majority of Sri Lanka's Muslims practice Sunni Islam (9.7%). Sizable minorities of both Sinhalese and Tamils are Christians, most of whom are Roman Catholic (6.1%).[6] The 1978 constitution - while assuring freedom of religion - grants primacy to Buddhism. Sinhala, an Indo-European language, is the native tongue of the Sinhalese. Tamils and most Muslims speak Tamil. Both Sinhala and Tamil are made as official languages. English is still commonly used in most government departments and spoken widely among the population.

Historically, Indo-Aryan emigration from India in the 5th century B.C. came to form the largest ethnic group on Sri Lanka today, the Sinhalese. Tamils, the second-largest ethnic group on the island, were originally from the Tamil region of India and emigrated between the 3rd century B.C. and A.D. 1200. Until colonial powers controlled Ceylon (the country's name until 1972), Sinhalese and Tamil rulers fought for dominance over the island. The Tamils, primarily Hindus, claimed the northern section of the island and the Sinhalese, who are predominantly Buddhist, controlled

[4] Department of Census and Statistics Sri Lanka, Population by religion according to district–2012, p.1
[5] ibid, p.1
[6] ibid, p.1

the south. In 1505 the Portuguese took possession of Ceylon until the Dutch India company usurped control (1658–1796). The British took over in 1796, and Ceylon became an English crown colony in 1802. The British developed coffee, tea, and rubber plantations. On February 4, 1948, after pressure from Ceylonese nationalist leaders (which briefly unified the Tamil and Sinhalese), Ceylon became a self-governing dominion of the Commonwealth of Nations.[7]

3. IMPORTANCE OF REGULATORY SUPERVISION FOR THE INSURANCE/*TAKĀFUL* INDUSTRY

The general purpose of insurance regulation is to protect the public against insolvency or unfair treatment by insurers. From the state's viewpoint, regulation is also important as a revenue producer through state taxes on insurance premiums.

The insurance business is among the types of private enterprise subject to much government regulation. It is generally classed as a business which is "affected with a public interest." This characteristic is the reason why many forms of government supervision of insurance are deemed necessary. Although competition is an effective regulator for some businesses, in insurance uncontrolled competition would work a hardship upon the buyers of insurance, most of whom do not understand insurance contracts. Much of the insurance written is to protect third parties who have not participated in making the contracts. The value of the contracts depends upon the ability of the insurers to fulfil their promises to the public, sometimes many years after the insurance of a policy. Ability to carry out the provisions of contracts depends upon many factors, including the efficient operation of the insurer, the selection of satisfactory risks, the determination of proper premium rates, and the wise investment of adequate reserves. Consequently, the needed integrity and long range financial stability of insurers place insurance in an area which has traditionally been considered appropriate for government regulation.[8]

Without interfering with the freedom of the individual, one of the state's obligations to its citizens is to protect the economy and maintain a balance between the state economy and the private market economy, such that private individuals and

[7] http://www.infoplease.com/country/sri-lanka.html accessed on 8th October 2013, p. 1

[8] David, L. Bickelhaupt, 1983 General Insurance, 11th Edition, Illonois (USA): Richard D. Irwin, INC., pp.857 and 858

companies enjoy the greatest possible freedom in their dealings. In an Islamic state where the majority are Muslims, government intervention varies from simple and unobtrusive control to a more paternalistic and close supervision of insurance business, coupled with power to impose regulations and restrictions considered appropriate by the government to guarantee a sound insurance sector.

As far as Islamic law is concerned, some argue that if insurance is undertaken by the state, it will be clear of all forbidden elements. But the role the state should play in economic activities has not been sufficiently defined by the classical Islamic authorities. It is, however, acknowledged by modern authorities (as expressed by *al-majma' al-fiqhi*) that 'Islamic economic doctrine' admits the principle of private initiative and enterprise in all economic fields and projects and that the state intervenes only to ensure the success of economic ventures and the soundness of their operations.[9]

It is worth to point out here that supervision of insurance by the governments and its agents can keep a healthy balance between insurance companies and insured, contributing to a steady economic environment and reducing the legal claims between insured and insurance companies. This in turn saves government's time and resources.

In view of state control, in order to have insurance schemes that are Islamically acceptable, the schemes must show fairness between the insurance companies and the insureds to avoid the advantages insurance companies have over their customers and policyholders.[10]

According to Aly Khorshid[11] that one of main purpose of state control has been to ensure that the insurer will be able to fulfil his obligations when the sum insured is due. Another concern is the possibility that insurers could dodge their legal obligations by drafting provisions in a way that small print (which is rarely read in full) or complicated wordings could be used to invalidate claims and avoid payments.

Three basic methods of providing insurance regulation are available to government: (1) legislation, (2) administrative action, and (3) court action. Corresponding to the

[9] Sohail Jaffer, (Ed.), 2007 Islamic Insurance: Trends, Opportunities and the Future of Takaful, London (UK): Euromoney Institutional Investor PLC, p. 181
[10] Aly Khorshid, 2004 Islamic Insurance – A Modern Approach to Islamic Banking, London (UK): RoutledgeCurzon, pp.157 - 159
[11] ibid, p.159

three main branches of the government, each of these methods is significant in the supervision of insurance. Legislation is the foundation of insurance regulations, for it creates the insurance law. The insurance laws of each state are often combined in what is known as an insurance code, and these codes are of primary importance. Administrative action is also very important, as the application and enforcement of insurance laws are left in the hands of the insurance superintendent or commissioner in each state. Court action has great value in regulation because of its effect in providing detailed interpretations of troublesome parts of the law.[12]

According to Kazi Mohamed Mortuza Ali,[13] regulatory support is a key factor for the continued development and growth of *Takāful*. A good example is Malaysia which has become the biggest *Takāful* market worldwide. This is due to the comprehensive *Takāful* regulations and continuous support by the Regulator Bank Negara Malaysia. In Indonesia, the regulator allows conventional insurers to set up *Takāful* windows. Recently, Pakistan's regulator SECP issued new *Takāful* rules allowing conventional insurers to set up *Takāful* windows. In Bangladesh, Insurance Act 2010 allows conventional life insurance companies to open *Takāful* windows but non-life conventional companies are barred from opening *Takāful* windows.

The unique characteristics of *Takāful* make its success somewhat dependent on a supportive regulatory framework. Malaysia is a glaring example. Some of the important features of *Takāful* regulation in Malaysia are as follows:

a) An actuary is to certify pricing of *Takāful* products.
b) *Shari'ah* certification is required on the operation of *Takāful* companies.
c) A supreme *Shari'ah* Rules making body for *Takāful* has been formed by the regulator.
d) There are limitations on the commission to be paid to intermediaries.
e) There are specific regulations for the investment of *Takāful* assets.

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[12] David, L. Bickelhaupt, 1983 General Insurance, 11th Edition, Illionois (USA): Richard D. Irwin, INC., pp. 860 and 861

[13] Kazi Mohamed Mortuza Ali, 2013. Challenges of Takaful and Required Regulatory Framework, pp. 4, 5, accessed on 15 September 2013 through http://www.thefinancialexpressbd.com/index.php?ref=MjBfMDRfMjBfMTNfMF8xNjZfMTY2OTM0&feature=c3BlY2lhbHNOZXdz&na=RkVBVFVSRSAmIEFOQUxZU0VT

Enacting a modern legal framework and designating a special judicial authority to handle insurance related cases are key requirements to enable market development by protecting the rights of policyholders and regulating the activities of market participants. A modern legal framework should regulate all insurance market participants, including insurance companies, intermediaries, and professionals. The regulations covering insurance companies should address a number of areas, including, among others, licensing, product approval, financial reporting, investments, reinsurance, and solvency margins. In addition, and in line with IAIS principles, the regulations should stipulate the minimum internal capabilities of market players, such as governance and risk management. The regulations covering intermediaries and insurance professionals should entail, at a minimum, qualifications criteria, licensing requirements, and a code of conduct.[14]

4. DEVELOPMENT OF INSURANCE IN SRI LANKA

Insurance business in Sri Lanka commenced with the advent of coffee and tea industry during the period of British rule. The insurance industry at that time comprised well known foreign companies such as Sun Life Insurance Co., Royal Assurance Co., New India Assurance Co., who were with Edward Lumley underwriting business for Lloyds of London. After passing the Companies Act of 1938, the first Sri Lankan insurance company the "Ceylon Insurance Company Ltd" was established.

The insurance industry was nationalized in line with the prevailing economic policy of the government in 1961.The Sri Lanka Insurance Corporation was set up as the sole authorized insurer to transact life insurance business initially and from 1964 both life & general insurance.

In 1986, the amendment of the Control of Insurance Act No.25 of 1962 opened the doors for the private sector to venture into the field of insurance. In 2000, the Regulation of Insurance Industry Act No. 43 of 2000 was enacted by the Parliament of the Democratic Socialist Republic of Sri Lanka to provide for the establishment of an Insurance Board for the purpose of developing, supervising and regulating the

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[14] Peter Vayanos, (booz & co.) Promoting the growth and competitiveness of the insurance sector in the Arab world, p.11, accessed on 20 December 2012 through http://www.booz.com/media/uploads/Insurance_Sector_Arab_world.pdf

insurance industry, for the repeal of the control of Insurance Act, No. 25 of 1962, and for matters connected therewith or incidental there to be. Based on the above Act, the Insurance Board of Sri Lanka (IBSL) established to be responsible for the development, supervision and regulation of the insurance industry in Sri Lanka.[15]

As at the date 22 insurance companies, 54 insurance brokers and 36,801 insurance agents have been authorized to transact insurance business which includes the international players like Allianze and AIA Insurance Co.[16]

According to RAM Ratings Lanka, The Sri Lankan insurance sector has been gradually recovering from the economic slump in 2008/09. Premiums in the general segment, which had contracted in 2009, staged a strong rebound in the first half of 2010. Similarly, the life-insurance industry had picked up pace, recording a double-digit growth in premiums over the same period as opposed to the relative standstill a year earlier. Notably, the growth has been supported by the general improvement in macroeconomic conditions. Going forward, RAM Ratings Lanka envisages the industry to keep up this positive trend, supported by more robust economic growth and greater penetration in the northern and eastern regions of the country.[17]

The insurance sector accounted for a relatively small portion of the domestic financial industry, making up only 3.2% of the entire system's financial assets as at end-December 2009. Moreover, the insurance penetration rate is also lower than those of other Asian countries, with total premiums per capita coming up to a mere USD30.10 as of end-December 2009 (end-December 2008: USD29.40). We observe that several new players entered the insurance arena last year. At the same time, the more established players have shifted from price-based competition to focus more on service quality.[18]

With the industry poised for growth, the IBSL is in the process of enforcing a new regulatory framework. Mainly, composite insurance companies will be required to

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[15] Regulation of Insurance Industry Act No. 43 of 2000, no. 1 and 2, p.1
[16] Insurance Board of Sri Lanka, Annual Report 2012, p. 6
[17] RAM, 2011. Insurance Sector Update – Bright Prospects Despite Regulatory Changes, p. 2, Colombo: RAM Ratings Lanka, accessed on 2nd June 2013 through http://www.ram.com.lk/other_pdf/Insurance-Sector-Update-11.pdf
[18] ibid, p. 2

split their existing general and life businesses into separate legal entities. Listing on the local stock exchange will also be made mandatory, with the incumbents and new entrants given a respective 5 years and 3 years to comply. Meanwhile, the rules on solvency margins have been revamped, with a view to broadening the classification of assets recognised as admissible.[19]

Through these initiatives, the regulator intends to bring the local insurance sector more in line with international norms; they would also support a more vibrant investment market. RAM Ratings Lanka envisages the changes in classification to improve the existing players' solvency margins, as many of them presently exclude these investments. Meanwhile, the IBSL has also permitted foreign-currency investments. These moves will provide insurers more avenues for investment. Over the medium term, the regulator intends to implement risk-based capital supervision - currently practiced by banks. While these changes are viewed positively, we note that the new regulations will expose insurers to operational and foreign exchange risks.[20]

Meanwhile, the industry's general insurance claims have remained relatively stable, hovering at around 62% for the general segment. Additionally, the combined ratio for this segment has been kept above 100%, signifying that general insurance companies have been incurring underwriting losses. Consequently, they have been relying on investment returns for profits. Nonetheless, RAM Ratings Lanka notes that most general insurance companies in other South Asian markets are also reporting underwriting losses. Going forward, claims in the general segment are expected to increase due to the heavy floods in 2010 and early this year. At the same time, we note that its impact on insurers' bottom lines may be offset by an expansion in premiums, supported by the more conducive economic climate.[21]

Conversely, the life segment has experienced an increase in claims among RAM Ratings' rated companies as well as listed companies. This has been mainly due to policy lapses brought on by the harsh economic landscape. Unlike the general segment, most life insurers are currently earning underwriting profits as the life

[19] ibid, p. 2
[20] ibid, p. 2
[21] ibid, p. 2

market has yet to mature and claims will only arise over the long-term. Given the low penetration rate in the life insurance market, we believe that there is still room for growth. We expect claims in this segment to ease over the medium term, as the sector expands against the backdrop of the improving economic conditions while replenishing maturing contracts.[22]

In terms of financial performance, insurance companies have been shifting their investments to the booming equity market to maintain their investment income as interest rates taper. Traditionally, investment income has mainly stemmed from fixed-income securities, buoyed by the previously high interest rates. As such, insurance companies have been able to maintain their financial performance. With regulations permitting a wider range of investments, investment appraisal and monitoring will play a greater role within each company. In the medium term, overheads may experience upward pressure as insurance companies seek to expand their branch networks into the northern and eastern provinces of Sri Lanka.[23]

5. REGULATORY AUTHORITIES FOR INSURANCE IN SRI LANKA

There are two regulatory bodies in Sri Lanka to regulate and monitor financial institutions operating in Sri Lanka. The Central Bank of Sri Lanka holds major regulatory authority and the Insurance Board of Sri Lanka is government authorized body to handle the insurance industry in Sri Lanka.

5.1 Central Bank of Sri Lanka (CBSL)

Central Bank of Sri Lanka (CBSL) Established in 1950 under the Monetary Law Act No.58 of 1949 (MLA), the CBSL is the apex institution in the financial sector in Sri Lanka. It is a semi-autonomous body and, following the amendments to the MLA in December 2002, is governed by a five member monetary board, comprising the governor of the CBSL as chairman, the secretary to the Ministry of Finance and Planning and three members appointed by the President of Sri Lanka, on the recommendation of the Minister of Finance, with the concurrence of the constitutional council.

[22] ibid, p. 3
[23] ibid, p. 3

With a view to encouraging and promoting the development of the productive resources of Sri Lanka, the CBSL is responsible for securing its core objectives of economic and price stability and financial system stability. The CBSL is also responsible for currency issue and management. In addition, the CBSL is the advisor on economic affairs as well as the banker to the government of Sri Lanka (GOSL). On behalf of GOSL, the CBSL, as its agent, is responsible for four agency functions of management of the Employees Provident Fund; management of the public debt of Sri Lanka; administration of the provisions of the Exchange Control Act; and administration of foreign and government funded credit schemes for regional development.[24]

The Central Bank of Ceylon was set up by the post-independence government in recognition of the importance of an active monetary policy regime and a dynamic financial sector to support and promote economic growth.

Prior to the establishment of the Central Bank, functions relating to central banking were conducted by the Currency Board System that was set up under the Paper Currency Ordinance No.32 of 1884.

After gaining political independence, the Currency Board System was considered inadequate and unsuitable for meeting the needs of a developing country and an independent nation. Therefore, 1949 the Central Bank of Ceylon was established by the Monetary Law Act (MLA) No.58 of 1949 and commenced operations on August 28, 1950. It was renamed the Central Bank of Sri Lanka in 1985.

The Central Bank was given wide powers to administer and regulate the entire money, banking and credit system of the country. The CBSL was also given the sole right and authority to issue currency and it also became the custodian of the international reserves of the country. The objectives of the Central Bank as specified in the MLA in 1949 were;

a) The stabilization of domestic monetary values (maintenance of price stability)

[24] http://www.cbsl.gov.lk/htm/english/03_about/a_1.html accessed on 3 June 2013

b) The preservation of the par value or the stability of the exchange rate of the Sri Lankan Rupee (maintenance of exchange rate stability)

c) The promotion and maintenance of a high level of production, employment and real income in Sri Lanka.

d) The encouragement and promotion of the full development of the productive resources of Sri Lanka.[25]

Even though, the Central Bank of Sri Lanka acts as regulator and authority for whole financial activities of financial institutions in Sri Lanka, it is not given sole powers to control and regulate the insurance industry. This industry is regulated and monitored by Insurance Board of Sri Lanka (IBSL). But Central Bank has some connection with the IBSL as a member of the IBSL and is represented on it by the deputy governor in charge of financial system stability.

5.2 Insurance Board of Sri Lanka (IBSL)

The Insurance Board of Sri Lanka (IBSL) regulates and supervises the insurance industry - insurance companies and their agents and insurance brokers, under the Regulation of Insurance Industry Act No.43 of 2000 to safeguard the interests of policy-holders. Prior to the promulgation of the Act the insurance industry was regulated by the Controller of Insurance acting under the powers vested by the Control of Insurance Act, No. 25 of 1962. Subsequently, this Act was repealed with the introduction of the Act.[26] The Central Bank is a member of the IBSL and is represented on it by the deputy governor in charge of financial system stability.

The Insurance Board of Sri Lanka (IBSL) has been established under the Act for the purpose of development, supervision and regulation of the insurance industry and to ensure that insurance business in Sri Lanka is carried out with integrity and in a professional and prudent manner, with a view to safeguarding the interests of policyholders and potential policyholders.

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[25] http://www.cbsl.gov.lk/htm/english/03_about/a_1.html accessed on 3 June 2013

[26] Insurance Board of Sri Lanka, Annual Report, 2011. p.16, accessed through http://www.ibsl.gov.lk/publications/IBSL_Annual_Report_2011.pdf

From time to time several amendments have been incorporated into the principal enactment of the Act and subordinate legislation made to strengthen the insurance industry.[27]

Twenty two insurance companies were registered under the Board at the end of the year 2012. Twenty one companies are in operation and the suspension of registration of Ceylinco *Takāful* Limited still continues from 2009. Out of the twenty two companies, 12 companies are registered as composite insurance companies carrying on both long term insurance business and general insurance business, 3 companies are registered to carry on long term insurance business and 7 companies are registered to carry on general insurance business.

In terms of section 80 of the Act, a company interested in engaging in insurance brokering business in Sri Lanka should incorporate a company under the Companies Act, No. 7 of 2007, and obtain registration as an insurance broker under the Act after having fulfilled all statutory requirements under the Act. At the end of 2012, there were 54 companies engaged in insurance brokering business in Sri Lanka.

As per section 34 of the Act insurance agents are one of the important distribution channels through which insurance companies and insurance brokering companies procure insurance business. Total number of insurance agents representing insurance companies as at 31st December 2012 was around 36,801.[28]

6. REGULATORY FRAMEWORK OF *TAKĀFUL* IN SRI LANKA

Muslims wherever they live, they have to formulate their day to day life according to *Shari'ah* principles. Islam as a complete code of life, it has shown guidance and regulation for every segment of the life. In this juncture, The Muslims have to discover alternative systems for the financial institutions which evolved in the west with the western ideology. These institutions commonly developed with association of interest, gambling and getting the money on improper ways which are completely prohibited in Islamic *Shari'ah*. Unfortunately, these institutions influenced immensely

[27] ibid, p.16.

[28] Insurance Board of Sri Lanka, Annual Report, 2012. P. 6, accessed through http://www.ibsl.gov.lk/publications/IBSL_Annual_Report_2012.pdf

in all Muslim countries and other countries where Muslims were living as minorities. The *Shari'ah* scholars and economists worked hard to come up alternative system for the interest-based institutions. In this way, they developed systems for banking, insurance, mortgage, leasing and other transactions.

Sri Lankan Muslims even though they live as minority community, they like to organize their lives on the basis of Islamic Devine rules and regulations. Therefore, they started some of financial institutions themselves in their motherland. For instance, Amana *Takāful* Ltd. emerged in 1999. With the vast demand for the Islamic products in the financial market, the conventional operators have begun to involve in this business. For instance, The Ceylinco consolidated which includes over 500 subsidiary companies has started Ceylinco *Takāful* Ltd in 2006. The HNB Assurance commenced HNB *Takāful* Assurance as a window operation last July 2013. Some other conventional insurers also are planning to start *Takāful* windows under their conventional companies.

In countries where there is a rapidly growing demand for *Takāful* insurance, the legal framework should also promulgate adequate legislation to address this form of insurance. There are three main challenges in *Takāful* regulation: capital requirements, corporate governance, and consumer protection from misinterpretation. Although the underlying risk is the same, the risk profiles of conventional and *Takāful* insurers are different because the latter has higher operational risk. It is uncertain whether this leads to increased capital requirements for *Takāful* insurance, especially in the *Al-Wakālah* structure that is predominant in the Middle East. A sound governance system, including risk management and internal control processes, is crucial for meeting these capital requirements. Furthermore, the regulation has to ensure that the *Shari'ah* compliance claim of a *Takāful* insurer is valid. To do so, the operations of the *Shari'ah* board have to be scrutinized by the regulator. There are two different approaches for the regulation of *Takāful* insurance. While some countries have established a special *Takāful* law, others have modified their existing regulatory frameworks and adjusted them to the specific needs of Islamic insurance. Whether or not there needs to be a separate *Takāful* regulation should depend on the definition of the term insurance in the conventional regulation. Separate *Takāful* -

specific regulation is not required where *Takāful* can be interpreted as a subset of conventional insurance.[29]

In countries where there is a rapidly growing demand for *Takāful* insurance, regulators should identify, develop, and disseminate risk-management best practices that take into account the contractual relationships of Islamic insurance products[30] and the regulators need to ensure the availability of training programs to educate the market on these relatively new products.[31]

Anyway, in Sri Lanka all insurance companies including *Takāful* companies are regulated by Insurance Board of Sri Lanka (IBSL) under the terms of the regulation of Insurance Industry Act, No. 43 of 2000 and the circulars issued by IBSL from time to time on various specific issues.

Every company should be registered at IBSL to carry on insurance business. According to the insurance industry act,

(1) No person shall be registered to carry on, either one or both classes of insurance business in Sri Lanka, unless such person-

- (a) is a public company incorporated in Sri Lanka and registered under the Companies Act, No 17 of 1982 ;
- (b) has paid up share capital of not less than the prescribed amount ; (The minimum capital requirement for a company to seek registration is Rs. 500 million per class of insurance business.)[32]
- (c) pays as deposit to the Treasury such amount as may be determined by the Board, by rules made in that behalf ;
- (d) pay the prescribed fee (a sum of one hundred thousand rupees, in respect of each class of insurance business; or one twentieth of one per cent (0.05%) of the gross written premium of long term insurance business of the preceding

[29] Peter Vayanos, (booz & co.) Promoting the growth and competitiveness of the insurance sector in the Arab world, p.12, accessed on 20 December 2012 through http://www.booz.com/media/uploads/Insurance_Sector_Arab_world.pdf
[30] ibid, p. 14
[31] Ibid, p. 16
[32] Insurance Board of Sri Lanka, Annual Report 2011, p. 17

year; and one twentieth of one per cent (0.05%) of the gross written premium of general insurance business of the preceding year)[33]; and

(e) fulfil such other requirements as may be laid down by the Board by rules made in that behalf, for the purpose of ensuring the proper conduct of insurers to safeguard the interests of the insured public and for the development of the insurance industry.

(2) For the purpose of paragraphs (b), (c) and (d) of subsection (1), different amounts may be prescribed for different classes of insurance business.[34]

Amana *Takāful* Ltd, the first *Takāful* company in Sri Lanka which was started in 1999, was in the beginning not regulated by the regulator and was under the special category. The IBSL annual report reveals that Amana *Takāful* Ltd, a non-conventional insurance company, carrying on both long term insurance business and general insurance business according to Islamic principles, was not regulated by the Controller of Insurance as it was exempted by the Minister of Finance under the powers vested in the Minister by the Control of Insurance Act No.25 of 1962. As the Regulation of Insurance Industry Act No.43 of 2000 did not confer any power on the Minister of Finance to exempt any insurance company from the provisions of the Act and since there were no transitional provisions permitting the continuation of this company as a licensed insurer, the Board requested Amana *Takāful* Ltd. to obtain registration after satisfying all the conditions required under the Act. The Company submitted the application for registration with the request that it be permitted to invest in bullion[35] as in terms of Islamic principles the company is prohibited from investing in interest bearing investments. The Board agreed to take steps to amend section 25 of the Act which deals with the investments of long term insurance fund and technical reserves of general insurance business to accommodate the request made by Amana *Takāful* Ltd. This company was registered under the Act in February 2002.[36] The point is to be noted here, that the government authorities or relevant personals to *Takāful* industry have not taken initiatives or steps to form a separate regulatory

[33] The Gazette of Democratic Socialist Republic of Sri Lanka, No. 1414/19, October 12, 2005, Government Notifications, Regulation of Insurance Industry Act, No. 43 of 2000, p. 2

[34] Regulation of Insurance Industry Act No. 43 of 2000, Part II – Registration of Insurers, section 13 (1), (2)

[35] Bullion Exchange is a firm which occupies the position of being one of the largest and longest standing jeweller manufacturing in Sri Lanka.

[36] Insurance Board of Sri Lanka, Annual Report 2001, p.06

system in Sri Lanka as in Malaysia or regulatory provisions referring alternative financial instruments in the existing regulatory system as in United Kingdom.

According to the same source, - this was happened during the period of the regulation amendments - it declares “the insurance industry is regulated and supervised in terms of the provisions of the Regulation of Insurance Industry Act No. 43 of 2000 (hereinafter referred to as the Act) which was enacted by the Parliament in August 2000 and came into operation with effect from 1 March 2001. The Insurance Board of Sri Lanka (hereinafter referred to as the Board) was established under the Act and the Board took over the regulatory function of the insurance industry from the Controller of Insurance of the Ministry of Finance who regulated the insurance industry in terms of the Control of Insurance Act No. 25 of 1962 which was repealed with the enforcement of the new legislation.”[37]

Furthermore, there is no any clause on *Shari’ah* supervisory board mentioned in any documents of IBSL. But the *Takāful* companies and *Takāful* windows may have *Shari’ah* advisory council to monitor the transactions and investments in accordance to the *Shari’ah* principles. Based on that, every *Takāful* company has a *Shari’ah* advisory council. But this council has been not appointed according to a criteria or guidelines approved by the regulator. For instance, in Pakistan, Securities and Exchange Commission of Pakistan (SECP), the regulator passed the following rules regarding to *Shari’ah* Board.

(1) The Commission may establish a *Shari’ah* Advisory Board consisting of such number of members as may be decided by the Commission.

(2) The *Shari’ah* Advisory Board will be responsible to formulate policies and guidelines for operation and management of *Takāful* business in line with *Shari’ah* principles:

(3) If in the opinion of the Commission different treatment for a similar operational issue is adopted by various operators, with the approval of their *Shari’ah* advisor, the matter shall be resolved by the *Shari’ah* Advisory Board and the findings of the *Shari’ah* Advisory Board shall be final.

[37] ibid, p. 05

(4) The Commission may assign any other responsibility to the *Shari'ah* Advisory Board from time to time.[38]

In addition to that the rules provide qualifications and responsibilities of a *Shari'ah* Advisor.

(1) Each operator shall appoint a *Shari'ah* Advisor who shall be responsible for:

(a) the approval of products including all related documentation;

(b) approval of Participant *Takāful* Fund policy;

(c) approval of investment policy;

(d) approval of Re- *Takāful* arrangements; and

(e) approval for the distribution of surplus to participants.

(2) Each operator shall obtain prior approval from the Commission for appointment of its *Shari'ah* Advisor at the time of commencing *Takāful* business and at later dates if there is a change.

(3) The Commission may within thirty days of such submission, based on reasonable grounds, require an operator to change its *Shari'ah* Advisor.

(4) The *Shari'ah* Advisor, in discharging his responsibilities under sub-rule (1), shall ensure adherence to conditions specified by the Commission upon the advice of the *Shari'ah* Advisory Board on all matters.

(5) Where an operator is required to file a document with the Commission which requires prior approval of the *Shari'ah* Advisor, the operator shall along with the requisite document annex the approval of the *Shari'ah* Advisor.

(6) the minimum qualification and experience of the *Shari'ah* Advisor of the *Takāful* operators / window *Takāful* operators shall be as follows:

(a) Educational Qualification:

Shahādat ul Aalmia Degree (*Dars e Nizāmi*) from *Madāris* recognized by the Higher Education Commission of Pakistan with a certificate in *Takhaṣuṣ fil Iftā / Takhaṣuṣ fil Fiqh* and adequate knowledge of Islamic finance and *Takāful*.

[38] Securities and Exchange Commission of Pakistan (SECP), *Takaful* Rules 2012, Part V Compliance with Principles Of Shari'ah, p. 15

(b) Experience and Exposure:

Must have at least 4 year experience of giving *Shari'ah* rulings including the period of *Takhaṣuṣ fil Iftā* or *Takhaṣuṣ fil fiqh* and must also have sufficient command over English language and applicable Pakistani laws.

(7) A person cannot work as *Shari'ah* Advisor at a time for more than three operators in Pakistan.[39]

7. REGULATORY ISSUES FOR *TAKĀFUL* INDUSTRY IN SRI LANKA

Based on the information mentioned earlier, there is no regulatory establishment separately for *Takāful* insurance in Sri Lanka. Currently the Insurance Board of Sri Lanka (IBSL) under the terms of the regulation of Insurance Industry Act, No. 43 of 2000, deals with *Takāful* insurance in the same conventional manner by using the same monitory policies and regulations. In this juncture, is Islamic insurance in Sri Lanka capable to operate *Takāful* business under the *Shari'ah* rulings completely?

The *Takāful* industry in Sri Lanka faces some adversities to operate the Islamic insurance with accordance to Islamic *Shari'ah* due to absence of regulatory supervision for *Takāful* insurance. The core issues discussed as follow:

7.1 Operations of *Takāful*:

The operations of *Takāful* are guided by the choice of model and the contract between the *Takāful* operator and the participant (Policy holder). These operations must be transparent, clear and free of any tenet that may render the *Takāful* contract null as per laws of contracts in Islamic jurisprudence. Particularly for *Takāful*, these laws include ensuring that interest (*Ribā*) either in investment or operations, uncertainty and gambling is freed from the process.

It is worthy to note that the wisdom of conventional insurance to pay for claims or keep the proceeds is interpreted as transfer of risk and akin to gambling from *Shari'ah* definitions.

[39] Securities and Exchange Commission of Pakistan (SECP), Takaful Rules 2012, Part V Compliance with Principles Of Shari'ah, pp. 15, 16

Hence operationally, to achieve/ ensure proper regulation of *Takāful*, the regulators need proper infrastructure that can enable them supervise the operations of *Takāful* in a clear and precise manner while adhering to the founding principles of the concept? Such enhanced regulation needs hands-on understanding of these operations to elevate the fears that "*Takāful* operators are just *Shari'ah* compliant on paper".[40]

7.2 Investment of Funds

Takāful operators can only invest in *Shari'ah* compliant instruments. The regulators to ensure the compliancy of *Shari'ah* by adapting reporting frameworks developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) or the Islamic Financial Service Board (IFSB) or other institutions.

In this matter, there is no any Islamic investment regulation or framework included either in the Insurance Act or in the circulars issued by IBSL from time to time except some exceptions. But the *Shari'ah* Advisory Council does this job in Sri Lanka with assistance of some institutions. For instance, Amana Global Ltd, IGL Lanka Limited, two subsidiary companies of Amana *Takāful* PLC.

According to a member of *Shari'ah* advisory council, Amana *Takāful* PLC invests the contributions collected from the participants in five major avenues. First, Treasury Bills, according to the Act No. 23 of 2000, not less than twenty *per centum* of the assets of the technical reserve being maintained for a general insurance business under section 24 and not less than thirty *per centum* of the assets for the Long Term Insurance Fund being maintained under subsection (1) of section 38, shall be in the form of Government Securities. The balance assets shall be in the form of such other investments as shall be determined by the Board.[41] It is a mandatory requirement for all insurance companies. Second, in equity (share market), which are white listed companies approved by *Shari'ah* board. Third, a portion of funds invested in bullion exchange, with the guidelines of *Shari'ah* council. Fourth, another portion invested as fixed deposits in Islamic fully fledged banks or Islamic Banking windows under the

[40] Abbas Mohamed, 2012. Takaful Regulation in a conventional set-up, Takaful Articles, No: 24, ICMIF Takaful, p. 2

[41] Regulation of Insurance Industry Act No. 43 of 2000, Part II – Registration of Insurers, section 25(1)

conventional banks with the limitations of the government. Finally, some of the money is engaged in real estates.

All are fully aware that the Treasury Bills are interest based instruments. Investment in those instruments has two impacts: affect the revenue of the operator because interest income cannot be recognized and at the same time reputational or image-risk to the operator with public perception that it is indulged in non-Islamic transactions.

According to IBSL annual report 2005 and 2006, 15% of the shares of Amana *Takāful* were held by *Takāful* Malaysia.[42] But we could not see the above clause in the latest issues of the annual reports of IBSL.

7.3 Reporting and Segregation of Funds

This refers to ensuring the shareholder and risk fund resources are not mixed in the operations of *Takāful*. Segregation of funds ensures transparency and ownership of the funds collectively by pool members. Through segregation of funds, investment income, *Wakālah* fees, surplus/deficit can all be analysed properly. Hence, without proper segregation of funds, the *Takāful* concept is akin to the conventional principle and the entire program will be compromised.

The segregation depends on characteristics of the investment instruments and purposes of the investments. Accounting treatments and disclosures that Islamic financial institutions have to carry out are to be based on this segregation. Similarly, the new accounting guidance note on First Time Adoption of AAOIFI Accounting Standards provides Islamic financial institutions with the starting point for preparing financial accounting records and reports based on AAOIFI standards.

Thus separation of shareholder and participant funds, ensuring proper accounting and reporting of such funds segregation and providing for clear frameworks is a fundamental in *Takāful* operation. The key question is again “under conventional reporting and supervision can such segregation and separation of funds be achieved?

[42] Insurance Board of Sri Lanka, Annual Report 2005, p. 16 and 2006, p. 12.

Will a mix and unclear reporting be condoned? If such separation cannot be achieved and enforced clinically, can *Takāful* provide optimal value?[43]

7.4 Treatment of Surplus/Deficit

Surplus distribution and declaration is a significant feature in *Takāful* insurance. Through surplus declaration elements of uncertainty and gambling are eliminated from operation and complete equity and mutual solidarity is achieved. It is prudent that the distribution framework is also regulated at supervisory levels as this also has a further capacity to either tilt the playing field in favour of *Takāful* or just act as an empty promise. Indeed, there should be a clear regulatory guideline to manage this issue. Otherwise, every *Takāful* company or window takes the decisions on their own perception or idea as in operation in Sri Lanka. This is merely the results of the absence of *Takāful* regulatory system.

7.5 Retakāful Arrangements

It is an arrangement or a mechanism either by an agreement covering a class of *Takāful* product or a risk by risk basis that enables a direct *Takāful* operator, called the 'cedant', to transfer or cede the whole or a part of the risk that it has accepted, to another *Takāful* or retakāful operator.[44]

Retakāful as well as *Takāful* should be *Shari'ah* compliant as indicated in the resolution of the *Fiqh* Academy (Resolution No: 9, December 1985). "… commercial insurance contract commonly used by commercial insurance companies is a contract which contains major elements of risks which is prohibited according to *Shari'ah*. The alternative for both insurance and reinsurance should be based on the principles of corporative insurance…"[45] Nasser Yassin and Jamil Ramly[46] point out that *Shari'ah* principles applying to *Takāful* also apply to retakāful. In principle, retakāful does not differ from *Takāful* operations; the main difference is that in the retakāful operations, the participants are *Takāful* operators instead of individual participants.

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[43] Abbas Mohamed, 2012. Takaful Regulation in a conventional set-up, Takaful Articles, No: 24, ICMIF Takaful, p. 2

[44] Mohd Fadzli Yusof, Wan Zamri Wan Ismail and Abdul Khudus Mohd Naaim, 2011. Fundamentals of Takaful, Kuala Lumpur, Malaysia:IBFIM, p. 517.

[45] Majma' al Fiqh al Islami al Duwali, Resolution No: 9 (9/2) on Insurance and Reinsurance, Jeddah, KSA, December 1985.

[46] Nasser Yassin and Jamil Ramly, 2011. Takaful: A Study Guide, Kuala Lumpur, Malaysia: IBFIM, p. 250

Based on the above quotations, Sri Lankan *Takāful* industry also should seek retakāful companies which operate *Shari'ah* compliantly. In practice, all the reinsurance companies are not *Shari'ah* compliant. For instance, Amana *Takāful* PLC listed its reinsurance companies. According to that its reinsurers are BEST Re, Hannover Re, Labuan Re, Tokio Marine, Catlin, Malaysian Re, Trust International, ACR Retakāful and MNRB.[47] There may be Justifications for this practice. Whatever they are, mainly it is due to the lack of regulatory framework for *Takāful* insurance in Sri Lanka.

8. CONCLUSION AND FINAL REMARKS

After analysing the above particulars, we can come to the following conclusions:

- As Sri Lanka a Muslim minority country, we cannot treat it as other Arab countries or Muslim majority countries. This community has unique problems, circumstances, pressures which are not available to the Muslim communities live in other countries.
- Sri Lankan Insurance Regulator (Insurance Board of Sri Lanka) considers *Takāful* companies as similar as conventional insurance companies with some relaxations of rules.
- Even though, the first *Takāful* company commenced its operation before 13 years (1999), the market penetration of *Takāful* industry is very low comparatively to the conventional insurance industry.
- Due to absence of *Takāful* Act or special regulatory provisions for *Takāful* industry in Sri Lanka, it is hard to operate the *Takāful* insurance 100% on *Shari'ah* compliance. There are some hindrances justified by two legal maxims. One is "Necessities permit prohibitions". Other one is "Necessities estimated with their limitations".
- The rich and abled people should take measures to create huge *Shari'ah* compliant projects. Then, they can be investment avenues for Islamic financial institutions.
- The *Shari'ah* advisory council plays a significant role in the *Takāful* industry in Sri Lanka. They are responsible to formulate policies and guidelines for operation and management of *Takāful* business in line with *Shari'ah* principles

[47] Amana Takaful PLC, Annual Report 2012, pp. 137, 138

as well as *Shari'ah* monitoring and auditing. Indeed, they act as *Shari'ah* regulatory body of Islamic insurance in Sri Lanka.

- The *Takāful* operators should plan to do several programmes to make *Takāful* insurance for all irrespectively religion, race and ethnicity and to make it aware among the common mass. There should be huge propaganda to make the *Takāful* for all by friendly approaches among non-Muslims.
- The Muslim political leaders, *Shari'ah* scholars, *Takāful* operators, University academics have a huge responsibility to take steps to establish a regulatory framework for *Takāful* insurance in Sri Lanka introducing a stand-alone *Takāful* Act or at least a supplementary for *Takāful* to the existing Insurance Act.
- The Bank Negara Malaysia recently introduced an Act called Islamic Financial Service Act 2013 (IFSA) to regulate Islamic banking and *Takāful* operations under one law. The relevant authorities may think to adapt the IFSA for the Sri Lankan context.

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