asian-oceanian
standard-setters group

Appendix B

30 November 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG Islamic Finance Working Group comments on
IASB Exposure Draft ED/2010/8 *Insurance Contracts*

The Asian-Oceanian Standard-Setters Group ("AOSSG") is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2010/8 *Insurance Contracts*.

Introduction

The AOSSG's Islamic Finance Working Group ("AOSSG IF WG") was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS relati ng to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, Dubai, Indonesia, Korea, Malaysia, Pakistan, and Saudi Arabia.

The working group has mainly discussed ED/2010/8 in the context of Takaful undertakings. During discussions, it transpired that the accounting issues identified relate to not only the recognition and measurement of insurance assets and liabilities, but may fall under the purview of IASB's other projects, namely consolidation, financial instruments, and fair value measurement. Thus, the working group's comments are not limited to the contents of ED/2010/8, and include issues relating to other aspects of Takaful accounting. Due to the significant issues relating to consolidation, a copy of this letter is also extended to the IASB staff responsible for the consolidation project.

The comments are additional to the AOSSG Insurance Working Group's comments on IASB ED/2010/8 dated 30 November 2010. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and their views have been duly incorporated.

The working group's comments are accompanied by a brief overview of Takaful to assist in providing an appreciation of the related accounting issues.

What is Takaful?

Why is there a need for Takaful?

1 Many Shariah scholars believe that conventional insurance may not be entirely free of elements prohibited by Shariah such as *gharar*, *maisir*, and *riba*. Simplistically, *gharar* implies an unacceptable level of uncertainty or ambiguity; *maisir* denotes gambling, gaming or speculation; and *riba* which is often translated as 'usury', but taken by a majority of scholars to include any interest above a principal loan amount.

2 Firstly, the 'sale' of insurance is deemed to contain *gharar* because the subject of sale - 'protection' or 'safety' - is unclear. It is uncertain whether the insurer's liability will materialise, and if it does, it is uncertain how much the insurer would be liable for. Thus, insurance would fail to meet Shariah requirements for a valid sale contract, and a permissible contract other than 'sale' must characterise the relationship between an insurer and insured. Secondly, the way a conventional insurer invests funds may expose the policyholder to other Shariah prohibited elements. For example, investments in interest-bearing assets would result in *riba*, and there may be other impermissible elements, for example investments in alcohol businesses. Thirdly, a relatively smaller number of scholars also argue that a commercial insurance contract involves trading in risk and hence is contaminated by *maisir.*

3 To address these concerns, an alternative form of protection called 'Takaful' was developed. It is based in part on the risk-sharing practices of medieval Muslim merchant ships and caravans. Instead of a 'sale' of insurance from a company to an individual, Takaful is characterised by *ta'awun*, which denotes mutual assistance among participants contributing to a pool of funds; and by *tabarru'*, or 'donations' from that pool which would be used to compensate a participant upon a specified event befalling the participant. Another party - a 'Takaful operator' - may be appointed to safeguard and manage the participants' funds. In Shariah, the uncertainty (*gharar*) that inevitably arises in providing protection would be tolerated in a structure based on *tabarru'* because a donation is not a contract of exchange, and no return would be expected. Moreover, the funds will also be invested in ways which are Shariah compliant.

How does Takaful work?

4 Takaful is often described as a group of participants pooling their risks and funds to mutually indemnify each other should a specified event occur. These participants' funds are often likened to mutual insurance, in that a mutual insurance entity is owned entirely by policyholders and there are no shareholders.

5 However, in practice, it is rare to find a Takaful fund that behaves like a true mutual insurance entity. The reasons for this are two-fold. Firstly, unlike in medieval times, Takaful today is not driven by members of any trade or profession mutually indemnifying each other against the similar risks that they share. Instead, the modern Takaful industry was developed primarily to offer Shariah-compliant alternatives to commercial insurance products. Secondly, the initial capital needed to meet operating expenses as well as to meet adverse risk outcomes in the early years

is prohibitive and generally beyond the capabilities of individual participants. In most jurisdictions there would be regulatory minimum capital requirements, for the same reasons of consumer protection and systemic stability as in the case of conventional insurance.

6 Thus, in most contemporary arrangements, Takaful funds are usually initiated by a Takaful operator who would solicit participants to a fund. A Takaful operator is often an entity funded by shareholders, and would undertake many of the activities that a commercial insurer would, e.g. underwriting, risk management, claims processing. Nevertheless, a Takaful operator is deemed to be a 'manager' of participants' funds, and (to use Islamic classical terms) its relationship with participants can take the form of:

(i) *Wakalah*, or 'agency', where the Takaful operator would be entitled to a fee for managing a participants' fund; or

(ii) *Mudarabah*, or 'profit-sharing', where a Takaful operator would be entitled to a share of surpluses made by a participants' fund; or

(iii) a 'hybrid' model where a Takaful operator gets a management fee for managing the underwriting activity of the fund, as well as a share in any profits made by investing the assets of the fund.

The 'hybrid' model is the most commonly-used amongst Takaful operations being established today. Other models have been discussed (for example, one based on a trust structure) but these have not achieved widespread acceptance.

7 Takaful may be a pure protection product, as is commonly the case for general Takaful such as motor or household. However, some products – often referred to as 'family Takaful' - may also have an investment element. In family Takaful, it is common to divide the participants' contributions between a risk pool, used to cover mortality risk, and an investment pool. The economic structure thus becomes very like that of a conventional life insurance product, particularly a unit-linked product, in the sense that the sum payable at the end of the policy is directly linked to the performance of the investment pool.

8 Thus the structure of a typical modern Takaful undertaking[1] comprises a normal shareholder-owned company, embedded within which are funds which are considered to be the property of the participants, but which generally do not have separate legal personalities.

How is Takaful different from insurance?

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[1] In this letter, "Takaful funds" refer to participants' funds. Where we refer to the "Takaful operator", we mean the commercial operation which manages the Takaful funds, and the assets and liabilities attributable to that operation (and thus to the shareholders of the company). Where we refer to the "Takaful undertaking", we mean the entire legal entity within which these different pools are contained. Where we need to consider the investment pool within a Family Takaful undertaking, we refer to this as the "participants' investment fund".

Structure

9 The most important difference is the structural one explained above. Fundamentally this means that within the same legal entity there are pools of funds with different ownership. A parallel may be drawn with life insurers in Australia and in some parts of the EU where there are separate pools of funds to prevent cross-subsidisation and enhance policyholder protection.

10 A corollary of fund segregation is that, at least in Shariah terms, not all the assets of the undertaking are available to meet all the liabilities. For example, the Takaful fund cannot be used to pay the Takaful operator's rent. How far the principle of fund segregation would be respected in the event of insolvency may vary from country to country, and has not been tested in practical cases. Nevertheless, for financial reporting purposes, many Takaful undertakings would present separate financial statements for a Takaful operator and the funds it manages. This contrasts with the situation in Australia and the EU, where an insurance entity would generally consolidate these different pools of funds because all the funds are used to leverage a return for the insurer.

Contractual relationship

11 In a conventional insurance contract, there is a sale of insurance by an insurer to a policyholder for a premium, and there is often a direct risk transfer from a policyholder to an insurer. With Takaful, while there is risk-sharing among participants, the role of a Takaful operator to a participants' fund is primarily that of a manager. There is some debate as to whether there is a transfer of insurance risk from a participant (or the group of participants) to the Takaful operator. The answer to this may depend on practices relating to *Qard*, described below.

Nature of revenue

12 Due to the different relationships, the nature of revenue may also differ. An insurance entity may recognise premiums as income, while a Takaful operator may recognise revenue in the form of fees or profit-share. The premiums will, however, be income to the Takaful fund.

Treatment of policyholders' / participants' deficiencies

13 For most conventional general insurers, and in many life insurers, there is in principle no separation between policyholders' and shareholders' funds. Thus if underwriting or investment outcomes are poor, the effect is that shareholders' equity is eroded. If it is sufficiently eroded, below solvency or more probably below regulatory requirements, then the insurer may be forced to be closed to new business. However, with Takaful, the most common way to overcome a deficiency in the Takaful fund is through *Qard*, that is an interest-free loan, from the Takaful operator to the fund, given that the initial capital for the Takaful undertaking comes from the Takaful operator's shareholders. *Qard* has no fixed terms of repayment, but would generally be paid back once a sufficient surplus is generated.

Treatment of policyholders' / participants' surpluses

14 Because the Takaful fund is held to belong to the participants, if it achieves a surplus, that surplus may be distributed in whole or in part to the participants, and effectively becomes a rebate on premiums paid. The basis on which this will be done may be specified in the policy document. Part of any surplus may, for example, be retained to build up capital in the fund to cope with future adverse risk outcomes. The prospect that surplus may be distributed is seen as a significant selling point by some Takaful operators selling pure protection products.

Shariah compliance

15 A Takaful undertaking would usually seek the counsel of a Shariah advisor or panel of advisors to ensure that various aspects of its operations are in compliance with Shariah. For example, Shariah advice would be sought as part of product development, and in making investment decisions.

Policy terms

16 Shariah requirements will also have an impact on policy terms. In conventional life insurance, the sum assured is distributed among the named beneficiaries. However, in family Takaful, payments for Muslim participants must be distributed in accordance with Islamic inheritance laws. Again, "new for old" policies are normally not written, because the prospect that a participant might effectively make a gain raises the issue of *maisir* even among scholars who have no objection to protection on a pure indemnity basis.

How is Takaful similar to insurance?

Activities

17 Although their contractual relationships with policyholders / participants differ, a Takaful operator and a conventional insurer carry out many of the same activities. For example, a Takaful operator usually carries out underwriting activities to determine whether to accept a participant and how much contribution he should pay; it would also carry out other activities like claims processing, loss adjustment, etc. just like a conventional insurer would.

Consumer perception

18 In a number of countries, Takaful operators and conventional insurers compete for the same pool of consumers. Other than Shariah compliance, the differences between many Takaful and conventional insurance products are indistinct to the consumer in terms of the protection offered. For example, religious beliefs aside, a consumer could choose to purchase either general insurance or general Takaful. Similarly, he could choose either a life insurance product or a family Takaful plan. Product pricing, too, is often comparable within the same market segments.

Regulatory requirements

19 Indeed, in part due to the economic similarities, regulators in many jurisdictions subject Takaful undertakings to similar requirements as insurance companies, indicating that regulators perceive similar risks to consumers and to the financial system. For example, a Takaful operator may need to meet similar capital requirements, and to submit similar reports and returns as conventional insurers.

Parity of consumers' risk

20 Some regulators may institute measures to ensure that Takaful participants' risks are more or less on par with conventional insurance policyholders. For example, if a Takaful operator was acting purely as a manager, then theoretically any deficiency in a participants' fund ought to be made up by further contributions from participants. However, pursuing such a puritanical model may (a) be detrimental to existing Takaful participants, and (b) deter future participants from entering the fund.

21 Thus, for consumer protection, regulators in some jurisdictions would require a Takaful operator to provide financial assistance, usually *Qard*, to a fund that is facing a deficiency. This would also prevent the moral hazard of a Takaful operator continuing to enjoy management fees regardless of the health of its participants' funds, whilst an insurance company in a similar situation would bear its' policyholders' deficiencies. In fact, this is why the capital requirements set by many regulators for Takaful operators are similar to those for insurance entities. The amount of capital required for a Takaful operator is generally far higher than would be expected for a management business.

Accounting issues relating to Takaful

Consolidation: Should the Takaful operator and the Takaful funds it manages be presented as a single entity?

View 1: The Takaful operator and the Takaful funds should have separate financial statements.

22 A Takaful operator is seen as an entity that is distinct from the participants' funds it manages. The ownership of the pools of money is held to be different, and not all the assets are available to meet all the liabilities. Thus, in some jurisdictions, there may be presentation and disclosure requirements to emphasise this separation, such as a requirement to prepare separate statements for the participants' funds. Some financial services regulators will apply capital requirements at the level of the participants' funds, again requiring a basis to evaluate the assets and liabilities of those funds.

View 2: The Takaful operator and the Takaful funds should have 'combined' financial statements.

23 Some jurisdictions do recognise that separate presentations may not adequately reflect the economic relationship between a Takaful operator and the funds it manages, and that there is some merit to a single entity presentation. In these jurisdictions,

regulation may require the presentation of a single set of 'combined' financial statements which would aggregate or 'combine' the Takaful operator and the participants' funds at the level of the legal entity, which is the Takaful undertaking. Some regulators may require presentations of both separate and combined financial statements.

24 'Combined' accounts are not synonymous with 'consolidated' accounts. One notable difference is that inter-fund transactions are not eliminated. In particular we note that an unusual presentation results from combining the separate statements of the Takaful operator and the participants' funds when *Qard* is treated as a receivable (financial asset). In the Takaful operator's financial statement, *Qard* disbursed by the Takaful operator to participants is recorded as:

DR Qard (receivable)

CR Cash

In the participants' financial statement, because the purpose of the *Qard* is to correct a deficiency in the participants' fund, it is usually recognised as a capital injection and not as a payable (financial liability), i.e.:

DR Cash

CR Participants' fund

Upon combining the Takaful operator's and participants' financial statements, the net effect would be:

DR Qard (receivable)

CR Participants' fund

It may seem anomalous for the combined entity to have a receivable due from itself, and an item of 'revenue' generated by itself. However, in jurisdictions where *Qard* is treated as a receivable, this is the customary presentation. [The classification of *Qard* is discussed in more detail in paragraphs 41-46.]

View 3: The Takaful operator and Takaful funds should have consolidated financial statements.

25 Outside of IFRS jurisdictions, such as the EU, it is less common to encounter financial statements that consolidate a Takaful operator and the funds it manages. From an accounting perspective, opponents of consolidation argue that since not all the assets of the legal entity are available to meet all the liabilities (e.g. the participants' funds are not available to pay the salaries of the Takaful operator's staff) it would be misleading simply to consolidate the various asset pools. In addition, there also seems to be a perception that the financial statement presentation must reflect the Shariah requirement for fund segregation, and that consolidation would be in conflict with this principle. Note also that in the case of family Takaful the arguments for consolidating (or not consolidating) the participants' investment fund are somewhat different from those relating to the participants' risk funds.

26 However, under IAS 27, the necessary criterion for consolidation – control – may be deemed to be present. A parallel may be drawn with the structure of life insurers in

Australia, where funds contributed by policyholders are isolated in Statutory Funds in accordance with prudential regulation. Despite the statutory segregation between policyholders' interests and shareholders' funds, Australian accounting standards require a life insurer to recognise in its financial statements the assets, liabilities, income, expenses and equity of the entity, whether they are designated as relating to policyholders or to shareholders. Paragraph 4.1.1 of AASB Standard 1038 *Life Insurance Contracts* explains:

> *"Life insurers may have both policyholders and shareholders with a financial interest in the entity. It is sometimes argued that the interests of policyholders and the interests of shareholders form the bases of separate entities that should prepare separate primary financial statements. However, the view adopted in this Standard is that the interests of policyholders and shareholders are intertwined and form the basis of a single entity. The boundaries of this entity are defined by control. The directors of the life insurer, in pursuing its objectives, govern the decision-making in relation to the financial and operating policies of the life insurer, which includes the assets of the entity, whether they are designated as relating to policyholders or to shareholders."*

Thus, in developing an accounting policy for the presentation of Takaful financial statement, giving due consideration to AASB's standards may be in line with IAS 8, paragraph 12 which states that:

> *"…management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards …"*

27 Others argue that although control may be present, beneficial ownership is not, and that the position of the Takaful operator is more analogous to that of a trustee. It would be misleading to consolidate the accounts of a trustee with those of the trusts it controls.

28 In the remainder of these comments, we assume that some jurisdictions will wish, at minimum, to be able to present separate financial statements for the Takaful funds and the Takaful operator, even if they also require financial statements at the level of the Takaful undertaking.

Scope: Does Takaful fall within IFRS 4* Insurance Contracts*? If not, should it?

29 As described in the preceding paragraphs, there are various similarities and differences between insurance and Takaful. Thus there is some debate as to whether IFRS 4 would apply to Takaful. The crux of the disagreement lies in the definition of insurance contracts given in Appendix A, which is:

> *"A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder"*

30 Additionally, there are other features of Takaful which some working group members

construe as indicating the presence of insurance risk, while others do not. In particular, these are:

(a) Qard

See paragraphs 41-46 for further explanation.

(b) Claims handling costs

A Takaful operator may bear claims handling costs. Staff of the Australian Accounting Standards Board ("AASB") believe that, in accordance with paragraph B27 of ED/2010/8, such costs may indicate significant insurance risk for a Takaful operator if there is a significant risk of the handling costs exceeding the fees charged.

However, other working members may see such costs as administrative in nature. For example, staff of the Dubai Financial Services Authority ("DFSA") cite the case of specialist claims administrators. These firms may not be remunerated through direct reimbursement of costs, and are exposed to financial risk if the cost of claims administration varies. They are not usually treated as insurers for regulatory or accounting purposes.

31 There are varying views among working group members as to how IFRS 4 would apply to Takaful. Some believe that IFRS 4 would not apply to Takaful. Others believe it may; for example, staff of AASB have indicated that whether or not IFRS 4 would apply a particular Takaful contract would depend on the circumstances specific to that contract. The staff of the DFSA support applying IFRS 4 to either the Takaful fund or the Takaful operator if the Takaful arrangement falls within the insurance contract definition. The IASB may wish to note that the Malaysian Accounting Standards Board ("MASB") have not exempted Takaful entities from the scope of IFRS 4. We explain the three main views raised by working group members in the following paragraphs. Two of these views may not be mutually incompatible.

View 1: Takaful is not insurance. Hence IFRS 4 does not apply to Takaful.

32 Some working group members believe that the definition provided by Appendix A does not describe Takaful because Takaful is thought of as risk-sharing among participants, and not a risk-transfer from a participant to a Takaful operator. A Takaful operator acts only as a manager of the fund; it is not an insurer because it has not agreed to compensate the participant if a specified uncertain future event adversely affects the participant. Even where financial assistance such as *Qard* is lent by a Takaful operator to a participants' fund, some believe that it may only expose the Takaful operator to financial risk, and not insurance risk. Thus, because the definition is not met, Takaful should fall outside the scope of IFRS 4.

33 However, the staff of the Korean Accounting Standards Board ("KASB") have indicated that although Takaful may not always meet the definition of an insurance contract in IFRS 4, it may not necessarily mean that Takaful should be out of the scope of IFRS 4. They cite the example of a financial instrument with discretionary participation features which would be included in the scope of IFRS 4, although it may not necessarily meet the definition of an insurance contract. Thus, KASB staff believe that by analogy, the same would also apply to some Takaful contracts.

View 2: A Takaful participants' fund accepts an individual participant's insurance risk. Hence IFRS 4 applies to the Takaful participants' fund.

34 In practice, there is a contract entered into between a participant and a Takaful operator - acting on behalf of the participants' fund - for a group of participants to accept an individual participant's risk, and to compensate the participant should a specified adverse event befall the participant. Thus, at the very least the participants' funds would be subject to IFRS 4, and a parallel is drawn with a mutual insurer described in paragraph B17 of the Application Guidance:

> *"…In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract."*

View 3: The economic substance of a Takaful operator's role is similar to that of an insurer's. Hence IFRS 4 applies to a Takaful operator.

35 In jurisdictions where regulations or expectations compel a Takaful operator to provide *Qard* when there is a deficiency in a participants' fund, the Takaful operator's role may not be restricted to only that of investment manager. Since the amount (and recoverability) of the *Qard* depends on the performance of the participants' fund, the Takaful operator's exposure to the *Qard* could be seen as an acceptance of insurance risk (albeit, an indirect acceptance) and it could be argued that the Takaful operator is in essence an insurer, and would be subject to IFRS 4.

36 Interestingly, there are those who opine that whether or not a Takaful operator would be subject to IFRS 4 would depend on the accounting treatment for *Qard*. Currently, there are differing views on how *Qard* should be treated. [See paragraphs 41-46 for further explanation.] It has been opined that if a Takaful operator classifies *Qard* as a receivable from a participants' fund, then the definition of 'insurance contract' is not met. Paragraph B19 (b) of the Application Guidance is cited as the basis:

> *"The following are examples of items that are not insurance contracts: …*
>
> *(b) contracts that have the legal form of insurance , but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses …"*

Paragraph B20 further adds:

> *"If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9 or IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:*
>
> *(a) one party recognises the consideration received as a financial liability, rather than as revenue.*
>
> *(b) the other party recognises the consideration paid as a financial asset, rather than as an expense."*

The working group is uncertain whether this is an appropriate interpretation of the Application Guidance. It is further feared that such an interpretation may lead to accounting arbitrage, as well as a loss of comparability since Takaful transactions which are essentially similar may be treated differently depending on an entity's classification of *Qard*. Members also note that while there may be "mechanisms that adjust future payments" by participants generally, these may not operate at the level of individual participants (for example because they may choose to no longer participate in that Takaful undertaking and instead move their cover to another undertaking). Members are of the view that paragraphs B19 and B20 could be improved by more directly addressing 'deposit insurance', which involves a depositor entering an arrangement under which it expects to effectively receive interest. This would avoid the impression that *Qard* should be treated in accordance with those paragraphs, and that in doing so Takaful would not meet the definition of an insurance contract.

37 Because Views 2 and 3 are operating at different levels (one on the participants' fund and the other on the Takaful operator) they are not mutually exclusive. The treatment of the contract between a participant and the fund may be different from the treatment of that same contract at the level of the Takaful operator considered as a manager of the fund, and different again at the level of the Takaful undertaking as a whole.

IFRS 4 by analogy

38 Notwithstanding the preceding paragraphs, the application of IFRS 4 to Takaful would be in line with paragraphs 10 and 11 of IAS 8, where in the absence of a Standard that specifically applies to a transaction, management is required to use its judgement by considering the applicability of the requirements in Standards dealing with similar and related issues. In the whole corpus of IFRSs, IFRS 4 is the Standard that most closely relates to Takaful transactions. Moreover, in many jurisdictions, Takaful and insurance are perceived by consumers to be similar, and indeed similar regulatory standards often apply to both industries such that both should be subject to the same IFRS.

Unbundling: Possible non-accounting implications

39 In family Takaful, a participant's contribution would be apportioned into at least two funds. Some part of the contribution would be deemed *tabarru'*, or a 'donation' to the participants' risk fund. The remainder of the contribution would be placed in a participants' investment fund. Under the ED, the former would be treated as insurance, and the latter as an investment contract. Acquisition costs would be apportioned between the two. Thus the participant would see an immediate, and very substantial, reduction in his investment which, under a normal Takaful contract, would be paid to his beneficiary on death. We have not analysed in detail how this would impact on the economics of Takaful, though we note that there may be similar impacts on conventional unit-linked policies. There would, however, be more serious contractual problems in Takaful, since payments into the participants' investment fund are normally managed under a Mudarabah contract, which does not permit the deduction of an initial fee corresponding to the acquisition costs. Unbundling may therefore impact on business and contractual models as well as accounting.

Valuation of contracts

40 In a typical Takaful undertaking, certain expenses (e.g. claims) are met from the participants' fund and others (e.g. claims handling costs) by the Takaful operator. The application of the rules for contract valuation therefore needs to take account of this. At the level of the fund this is relatively straightforward to do by analysing the cash flows, since certain payments (for example a management fee) are made to the operator as recompense for conducting those activities. It does, however, mean that valuation of a contract at the level of the fund may not be identical with the valuation that would follow if it were considered at the level of the Takaful undertaking as a whole. This may pose issues for consolidation.

Classification of Qard: Is it an item of expense, asset, or "equity"?

41 As mentioned, Takaful operates as pools of participants' funds managed by a Takaful operator. The participants' funds may represent those of general Takaful, such as motor vehicle, shipping, and construction; as well as family Takaful, such as education, health and annuity plans. (Whether a Takaful operator chooses to segregate participants' funds by line of business varies from case to case.) In some product lines, it may be many years before a fund begins to generate a surplus. To 'top-up' a fund which is in deficiency, a Takaful operator may extend to the fund an interest-free loan, *Qard*. In classical texts, *Qard* would normally be provided out of benevolence and the provider would generally not expect repayment. However, because many modern Takaful operations are run as businesses, it is expected that a fund would repay *Qard* to the Takaful operator when there is a sufficient surplus even though the tenure may be unspecified, and *Qard* is deemed to be 'payable when able'.

42 There is some discussion as to how *Qard* from a Takaful operator to a participants' fund ought to be treated. The question needs to be answered both for the operator and for the fund, on the basis that accounts may be required at both levels. Currently, there are three main views on the matter:

(a) *It is an expense of the Takaful operator and income for the fund.*

In a Takaful undertaking, it is common for participants' funds to, at some point, incur a deficiency. Thus, *Qard* extended to a fund may be viewed as an operational cost of engaging in Takaful, and should be an item of expense. Any subsequent recovery may be deemed other income. This view is also in line with classical views on *Qard* in that although repayment would be welcomed by the lender, it is not expected.

(b) *It is the 'equity' of the Takaful operator in the fund.*

Some have likened Q*ard* to 'an investment in a subsidiary' because the Takaful operator has control over the fund, and consequently, *Qard* could be measured at cost under paragraph 38 of IAS 27. On this basis, repayment of the *Qard* would need to be treated as redemption of equity. It has, however, the unfortunate effect that consolidation treatment would potentially depend on the level of the *Qard* outstanding at any time.

(c) *It is a financial asset of the Takaful operator.*

A Takaful operator, which is often a business entity, would generally expect that a *Qard* it has extended would be repaid from a fund's eventual surplus irrespective of the tenure of the *Qard*. Moreover, purists insist that participants should ultimately bear the risks of Takaful, and therefore participants have a liability to repay the *Qard*. Thus, it ought to be recognised as a financial instrument.

43 If *Qard* is viewed as a financial instrument, paragraph 43 of IAS 39 requires that it be measured at fair value on initial recognition:

> *"When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."*

With regards to interest-free loans, paragraph AG64 of the Application Guidance to IAS 39 further provides that:

> *"…the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating…."*

44 There are two views about how to discount the future cash receipts of *Qard*:

(a) *The discount rate should be nil.*

The majority of Shariah jurists rule that a return cannot be imposed on *Qard* because it must not be commercial in nature. Thus, no Takaful operator charges interest on *Qard*. Therefore, some argue that the discount rate for the future cash receipts from *Qard* should be nil because this is "the prevailing market rate(s) of interest for a similar instrument"; or

(b) *The discount rate should be either an internal rate, or a commercial rate, or at the very least, the risk-free rate.*

Although the 'market rate' for *Qard* may be nil, providing *Qard* over an indeterminate period carries an opportunity cost for the Takaful operator, since those funds might otherwise be invested. Thus, it would be more useful to apply a discount rate that reflected the entity's cost of funds, or a commercial loan similar as to currency, term, type and other factors. The use of these other rates would provide information on the opportunity costs forgone.

45 If *Qard* is treated as a financial instrument, there is a question whether it can ever be treated as impaired. For example, the position of the participants' fund may be such that no repayment can be expected for a long time. In this case, should the loan be shown as impaired in the accounts of the Takaful operator, and if so how should consolidation be handled?

46 There may be a stand ready obligation to provide *Qard*, in that some financial services regulators will insist as part of their regulatory regimes that the operator be willing to do so under certain specified circumstances, or to maintain a specified level of solvency in the participants' risk fund. Such a stand ready obligation would probably be accounted for as a contingent liability under the existing IAS 37, but as a liability under the IASB's 2005 proposed revisions to IAS 37.

Disclosures

47 Certain additional disclosures may enhance the usefulness of Takaful financial statements. For example, paragraph 39 of AAOIFI FAS 12 *General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies* requires that:

> *"Disclosure should be made on the face of the statement of financial position of the following assets, with separate disclosures in the notes to the financial statements, of assets jointly financed by the owners' equity and policyholders' equity, and those exclusively financed by each of them wherever possible ..."*

Paragraph 40 requires similar disclosures for the various items of liabilities, and paragraph 2 of AAOIFI FAS 12 considers separate statements for participants' revenues and expenses to be part of "the complete set of financial statements that should be prepared by the company". Such disclosure and presentation are not required by current IFRS; and indeed are absent in the financial statements of many conventional insurance companies. However, some believe that without them, the formal structure of a Takaful set-up would be obscured, and the presentation of the accounts would mislead since not all assets are available to meet all liabilities.

Need for clarification

48 It is apparent to the working group that ED/2010/8 had not been drafted with alternative types of protection, namely Takaful, in mind. Given the accounting issues relating to Takaful that have been described in this comment letter, members of the working group would like the IASB to consider the matters herein, and especially to give consideration to the following questions:

(a) Under what circumstances (if any) would the financial assistance given by a Takaful operator to meet a fund's deficiency constitute, in substance, an acceptance of insurance risk?

(b) What would be the most appropriate classification for the financial assistance, which is usually in the form of an interest-free loan, given by a Takaful operator to a participants' fund?

(c) Should a Takaful operator and the funds it manages be presented as a single consolidated entity, or would some other presentation be more appropriate?

49 The Working Group will be deliberating on the answers to these questions in its forthcoming discussions, and it is probable that these would continue well after IASB's intended completion date for IFRS 4 in 2011. Accordingly, working group members would like to see a longer transition period for IFRS 4 (for example, 1 January 2014) so that the working group might assist the IASB in addressing the issues during that transition period.

We thank you for this opportunity to express our concerns, and hope that you would give due consideration to our comments. If you have any queries regarding this submission, please feel free to contact us.

Yours sincerely,

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c.c. Ms Sue Lloyd
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