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Research Article

Retakaful Pool Framework for Takaful Operators in Malaysia: Experts' Opinions

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Abstract: Malaysia is trying to position itself as a hub of Islamic finance and the government is promoting the Islamic finance industry. *Takaful* industry is rapidly increasing however, *Retakaful* industry is not catching up with the dynamic and complex needs of *Takaful* industry. In addition, the existence of the limited number of *Retakaful* operators causes *Takaful* operators not much bargaining power in negotiating the *Retakaful* agreement and *Takaful* operators have no option except to follow the requirements set by *Retakaful* operators. Thus, this study intends to propose framework for *Retakaful* pool mechanism by seeking the opinions of experts in Malaysia. By introducing *Retakaful* pool among the *Takaful* operators, it will create mutual and friendly business environment among them and reduce dependency on *Retakaful* operators. In addition, the experts believe that *Retakaful* pool will bring more benefit to the *Takaful* operators, compared to the traditional *Retakaful* method, i.e., engaging with *Retakaful* operators.

Keywords: Malaysia, pool, *retakaful*, *takaful*

INTRODUCTION

Insurance is known as a risk transfer mechanism and it is widely practiced all over the world. When the operational part of insurance is examined, the backbone of the insurance industry is reinsurance industry whose support will determine the success or failure of the insurance industry. The main reason is that unpredictable risks make insurance companies engage with reinsurance industry in order to cover any claims that the insurance industry is not able to pay (Kopf *et al*., 1929; Plantin, 2006). In the market, there are many reinsurance companies compared to the *Retakaful* companies since the later ones are relatively new industry. Similarly, *Takaful* industry is new compared to the insurance industry. *Takaful* companies usually follow the traditional way of ceding their risk, i.e., through *Retakaful*. Due to the limited number of *Retakaful* operators and over reliance of *Takaful* operators on *Retakaful* operators, *Takaful* operators do not have much bargaining power and they are at the sympathy of the *Retakaful* operators. Thus, the purpose of this study is to seek the experts' opinion towards the possibility of introducing *Retakaful* pool method and to propose the framework for *Retakaful* pool method. It is believed that this proposed method is able to bring the optimal benefit to the *Takaful* operators and participants.

LITERATURE REVIEW

Reinsurance is defined as insurance over effected by an insurer with a second insurer of the risks, wholly or partly, it has accepted and includes any similar arrangement by a branch of the insurer in Malaysia with its branch outside Malaysia (Financial Service Act, 2013). Reinsurance is a risk management device which enables an insurer to transfer its risk exposures that it cannot manage within its own resources (Kavita, 2013). In addition, it provides benefits to the insurance industry in both the micro and macro levels. At the micro level, reinsurance plays an instrumental role in the provision of 'capital' whereby the insurance company is able to leverage on the higher capital of the reinsurance company to write bigger and complex risks over and above its own financial and technical resources. Essentially, when a reinsurer takes over parts of risk/risks, he commits his own capital to cover these risks (Geonka, 2003).

It is standard practice that an insurance company based on prudential reasons, will only commit a small portion of its financial resources for a risk/risks which is commonly known as the retention policy. This represents the heart of a reinsurance programmed where, after its own net retention, the insurance company will reinsure (cede) the balance of the risk to the reinsurers. Another important role of reinsurance at the micro level to the insurer is by limiting the impact of catastrophe losses which will affect the capital of the

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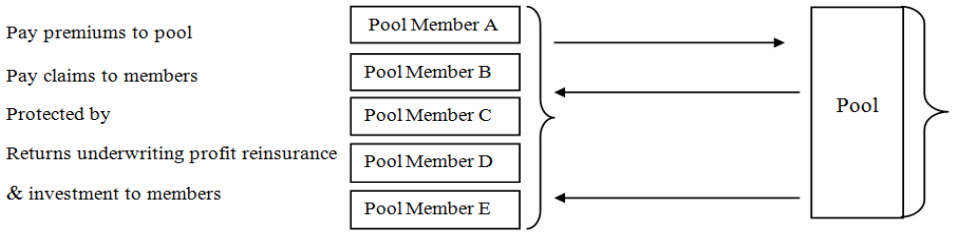


Fig. 1: Insurance pool mechanism

insurance company (Hoerger, 1990; Garven and Lamm-Tennant, 2003). Reinsurance also helps to stabilize the net operational result by reducing the potential fluctuation of actual result over a period of years where an unusually bad year in terms of claims experience can be balanced at some time by good years with satisfactory claims experience (Cummins *et al*., 2008).

At the macro level, reinsurance provides for the enhanced security and long-term stability of the insurance industry, making it feasible for insurance companies to write more complex risk beyond its financial and technical capacity, helps develop new products and tap on the reinsurer's specialized underwriting expertise, its vast knowledge and experience of the business because of the international nature of the reinsurance business. On the global scale, reinsurance helps spread risks across geographical boundaries thus reducing the impact of losses in any single company, market, or economy (International Association of Insurance Supervisors, 2012). Reinsurance may be arranged in a number of methods depending on the needs as well as the underwriting and reinsurance strategy or philosophy of each insurance company which are subject to review in tandem with the growth of the company.

One of the reinsurance methods, i.e., reinsurance pool is defined as an arrangement whereby a certain number of insurers agree to automatically cede a defined business to a common central association between themselves and to divide such business among them in certain agreed proportions (Golding, 1987). The pool may be activated in the form of a fixed share of the whole business, or as a surplus over and above a fixed retention, or of an agreed excess of loss. The premiums, claims and expenses, as well as profits or deficits of the pool are shared in agreed amounts as stipulated in the 'Pool' agreement among the pool members (Schwepcke, 2004). Pools are generally used as a means of exercising reciprocity among insurance companies especially for types of risks which are difficult or too expensive to be placed in the traditional reinsurance markets such as energy risks, nuclear risks, marine war risks, catastrophe risks, health risks, etc. For example, in Malaysia, the regulator has requested the local insurance companies to form the Malaysian Motor Insurance Pool (MMIP) as a high risk insurance pool for motor vehicle insurance for vehicle owners who have difficulty in obtaining motor insurance cover from the market. This pool is jointly owned by Malaysian insurance companies and managed by a third party. A pool is not an insurance company, but a jointly owned and managed insurance facility by the member insurance companies (A.M. Best Methodology Criteria-Reinsurance, 2013; Guideline to the Insurance Industry on Reinsurance Arrangments, 2013). A simple pool arrangement is described in the Fig. 1.

RESEARCH METHODOLOGY

This study uses both primary and secondary data. Primary data is collected by interviews using the Delphi technique. The secondary data is from the books, articles and internet resources relevant to our research. The interview questions focus on the general criteria for *Retakaful* pool, applicable contracts, financial projections for future and how *Retakaful* pool can replace traditional *Retakaful*. Nine experts in Takaful are identified and interviewed for three times to reach the findings.

RESULTS

The interviewees believe that it is possible to introduce *Retakaful* pool method in order to reduce dependency on the traditional *Retakaful* method.

Overview criteria for *retakaful* pool: For the sake of clarity and simplicity to initiate the establishment of the *Retakaful* Pool, the *Retakaful* contribution to be ceded to the Pool shall follow the same basis as a normal *Retakaful* arrangement which should be adequate to cover the actual *Retakaful* liabilities and cushion for adverse claims experience and provision for Wakalah fee to cover actual expenses for management of the *Retakaful* Pool fund.

Terms and conditions for the Pool can be benchmarked against the existing insurance and reinsurance pools structures and framework in the market as well as the Protection and Indemnity Club as shown by Kazlow and King (2001), Schwepcke (2004) and Iqbal (2005). Some of the suggested criteria are as follows:

- **Membership eligibility:** This sets out the criteria for membership. In this case, it is opened to all the licensed *Takaful* operators in the same country. This is to ensure that members admitted are subject to similar regulatory and corporate governance

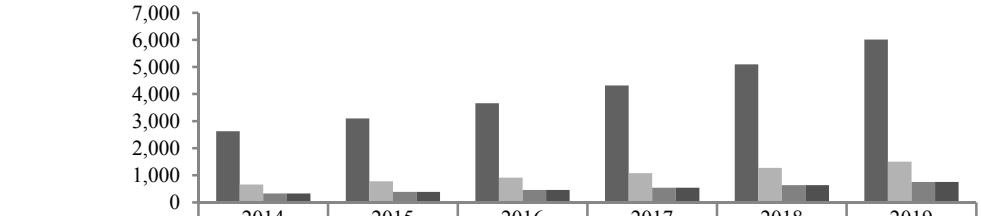
frameworks especially in writing the *Takaful* risks. At a later stage, subject to strict guidelines, *Takaful* operators from other jurisdictions may be admitted on a case by case basis. These guidelines are aimed at ensuring the Pool's resilience and long-term sustainability.

- The classes of business to be covered under this Pool can be any type of general *Takaful* products such as fire *Takaful*, Accident *Takaful*, Marine *Takaful* and Motor *Takaful.* Later on, using different *Retakaful* Pools can ensure homogeneity of the risks to be covered by such Pools.
- Details of risks ceded such as type, class, size, volume, value, pricing must meet the minimum criteria to ensure homogeneity of risks ceded as a measure of ensuring the Pool's viability and security in meeting its liabilities. The Pool should not be treated as 'dumping ground' for badly underwritten or inferior priced risks.
- Method of *Retakaful* arrangement can be based on the proportional *Retakaful* arrangement, either on quota share or surplus basis.
- Exclusions can be normally applied in *Retakaful* contracts but may be tailored to members' needs.
- *Retrotakaful* can be linked with the appropriate *Retrotakaful* to protect the *Retakaful* pool fund against adverse claims as well as catastrophic losses.
- Claims management should be simplified to cater for the needs of members.
- Regarding capital and operational expenses, the initial seed capital may be required to set-up the pooling fund collected from the founding members. When the new members join, they should contribute accordingly and an appropriate Wakalah fee will be charged to cover the actual operational expenses.
- *Retakaful* pool surplus from the Pool including the investment income will be shared proportionately with pool members. Deficit of the Pool will be charged to members in the form of levy.
- Management of the *Retakaful* pool can be jointly managed or outsourced to third party with adequate oversight from members especially on the technical and *Shari'ah* issues through special committees appointed from the pool members. Close monitoring of the pool's operations by the various committees as well as the main board of the pool comprising of all the registered pool members will ensure adequate oversight and successful implementation of the pool's objectives.
- Prudent manner for the security and sustainability of the pool fund is important and hence, timely report on the management of its risk exposures due to accumulations, adverse claims experience and catastrophic losses and exposures should be provided.

Applicable contracts for *retakaful* pool: The *Retakaful* Pool may be established by applying the following contracts:

- *Musharakah* contract between the various *Takaful* operators where each operator shall contribute to the capital of the pool.
- *Wakalah* contract between the *Takaful* operators and the appointed pool manager to manage the *Retakaful* pool.
- *Tabarru*' contract between the Takaful operators who agree to jointly contribute a portion of the original *Takaful* contributions to the *Retakaful* pool fund for the purpose of joint guarantee against specified *Takaful* liabilities, including the necessary Retrotakaful placements.
- *Mudharabah* contract between the *Takaful* operators and the pool manager for the investment of the *Retakaful* pool fund.
- *Juala'* contract between the *Takaful* operators and the pool manager as incentive from the surplus of the *Retakaful* pool fund.

Sample financial projection for *retakaful* pool: The Fig. 2 will provide an illustration of the proposed *Retakaful* pool fund. It shall be based on the projected



	2014	2015	2016	2017	2018	2019
Gross Contribution	2,627	3100	3658	4316	5093	6010
Retakaful	657	775	915	1079	1273	1503
Recoveries	328	388	458	540	637	751
Surplus	328	388	458	540	637	751

Fig. 2: Projection for 2014-2019 (RM'000)

Table 1: Projected profit and loss of the proposed surplus fire *retakaful* pool (RM'000)

	2014	2015	2016	2017	2018	2019
Retakaful contribution revenue *(note 1)	51.58	68.100	89.81	118.60	156.60	206.71
Less wakalah fee *(2%) (note 2)	(1.03)	(1.360)	(1.79)	(2.37)	(3.13)	(4.13)
Net retakaful contribution *(note 3)	50.55	66.740	88.02	116.23	153.47	202.58
Add investment income *(5%) (note 4)	2.53	3.3400	4.40	5.81	7.67	10.13
Total income *(note 5)	53.08	70.080	92.42	122.04	161.14	212.71
Less claims reserves, retrotakaful *(50%) (note 6)	(26.54)	(35.040)	(46.21)	(61.02)	(80.57)	(106.35)
Surplus *(50%) (note 7)	26.54	35.040	46.21	61.02	80.57	106.35

growth of general *Takaful* contributions for the *Takaful* market in Malaysia (based on average growth of 18% annually), *Retakaful* outgo (based on average 25% of *Takaful* contributions annually) and *Retakaful* recoveries (based on higher average of 50% of *Retakaful* outgo annually, instead of the annual average of 36%) for period 2014-2019.

Figure 2 shows the projected gross contribution from the General *Takaful* and its respective *Retakaful* outgo, recoveries and surplus from year 2014 until 2019.

Table 1 shows a sample projected profit and loss for the fire *Retakaful* pool:

Note 1: Revenue for the Pool refers to *Retakaful* contribution made by *Takaful* operators as Pool members either on monthly or quarterly basis to the *Retakaful* Pool Fund subject to the terms and conditions of the Pool arrangement.

Note 2: *Wakalah* Fee refers to the amount payable to the Pool manager for its management expenses which is a deduction from the *Retakaful* contribution.

Note 3: Net *Retakaful* Contribution refers to amount available to cover the *Retakaful* liabilities and investment of the *Retakaful* Pool Fund.

Note 4: Investment Income refers to the return on investment of the *Retakaful* Pool Fund which is credited back to the *Retakaful* Pool Fund.

Note 5: Total Income refers to the balance of the *Retakaful* Pool Fund plus the investment income.

Note 6: Refers to the outgo from the *Retakaful* Pool Fund in meeting its *Retakaful* liabilities to its members.

Note 7: Refers to the Distributable Surplus/Deficit of the *Retakaful* Pool Fund after meeting all the *Retakaful* liabilities of members on a proportionate basis.

From the projection shown above, the pool members can immediately note that the surplus from the *Retakaful* pool fund belongs to them as members of the Pool, which otherwise, will be enjoyed by the *Retakaful* operators should the *Retakaful* be placed on normal *Retakaful* practices. This surplus may be utilized by the *Takaful* operators for the benefit of the participants and the industry as a whole such as through price reductions, to strengthen the reserves and resilience of the *Takaful* risk fund to cater for future

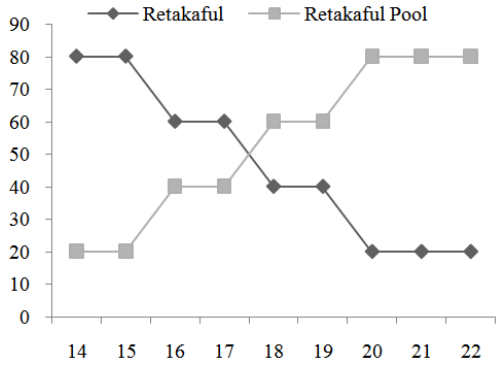


Fig. 3: Proposed incremental growth of the retakaful pool

adverse claims experience. In addition this surplus can be utilized to enhance further research and educational/public awareness activities on *Takaful.*

In culmination of the successful launch of the *Retakaful* Pool described above, the industry should prepare a business plan and timelines to include other classes of business in order of priority into the pool as well as slowly increasing the pool's limits in tandem with its growth and experience. Likewise, risks ceded to *Retakaful* operators shall be reduced incrementally over the years as proposed below.

Figure 3 indicates that should *Retakaful* business ceded to the *Retakaful* pool be increased incrementally (2014-2022) every two years, starting with a ratio of 80:20 (*Retakaful* against *Retakaful* pool), the ratio will reversed to 80:20 (*Retakaful* pool against *Retakaful*), representing the optimal amount of *Retakaful* to be placed to the Pool, thus reaping the benefits as mentioned earlier. The 20% ratio to *Retakaful* is the residual *Retakaful* needs of the *Retakaful* operators especially for catastrophe covers as well as for large risk exposures.

CONCLUSION

Malaysia positioning as one of the leading countries in Islamic finance, it promotes Takaful industry. However, the number of *Retakaful* operators is not catching up with the rapid growth of *Takaful* industry. In order to cede the risks faced by the *Takaful* operators in addition to engaging with the *Retakaful* operators, this study seeks the experts' opinion towards the possibility of introducing *Retakaful* pool method and proposing the framework for *Retakaful* pool

method. The findings from interviewing 9 experts by using the Delphi technique show that there is a possibility to introduce *Retakaful* pool method in Malaysia and this proposed method seems to pro with the concept of mutual help and cooperation among the Takaful operators. The results of this study will be interest of the regulators, *Shari'ah* advisors, industrial players and the participants.

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End notes:

1 Extracted on 15th November 2012 http//www.piam.org.my/annual/2011/003.htm.