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Re*takaful* (Islamic Reinsurance): Historical, Shari'ah and Operational Perspectives

Sheila Nu NuHtay, Mustapha Hamat,
Wan Zamri Wan Ismail and Syed Ahmed Salman

Institute of Islamic Banking and Finance, International Islamic University Malaysia

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Abstract: Risk cannot be separated from our daily life activities, including both personal and business activities. One of the ways to mitigate the risk is through insurance. However, insurance has the elements such as interest, uncertainty and gambling which are prohibited from the Islamic perspective. Thus, Muslim scholars have introduced *Takaful* (Islamic insurance) and then, *Retakaful* (Islamic reinsurance) becomes the central role for the *Takaful* operators since they cannot survive without *Retakaful*. Thus, the purpose of this research is to elaborate on historical development of *Retakaful* and its Shari'ah and operational aspect in order for us to appreciate the role of *Retakaful* to support the *Takaful* operators to whom we rely on to get the protection in the case of misfortune. Library research is adopted in this paper since secondary data is used in this study. We hope that this paper will enhance the body of knowledge in the area of *Takaful* and *Retakaful*.

Key words: *Takaful* · *Retakaful* · Operating model and Malaysia

INTRODUCTION

Insurance and reinsurance operators are the twins and they cannot survive if they are not supporting each other. *Retakaful* is the backbone of *Takaful* industry to provide solvency protection to the *Takaful* operators in order to ensure that the claims can be paid when due. Normal practice is the insurance operators pay the premium to the reinsurance operators in exchange for the claims to be made by reinsurance operators if the policy holders of the insurance operators claim. The main reason for insurance operators to buy the reinsurance is that insurance operators might not be able to pay the claims if the amount is large. It can happen mostly in the case of fire, flood and etc [1, 2].

Insurance is prohibited from the Islamic perspective and *Takaful* has been introduced as an alternative to conventional insurance. Similarly, reinsurance is prohibited and an alternative is *Retakaful* with which *Takaful* operators are required to mitigate their risks. Thus, it is necessary to understand its history, its Shari'ah and legal framework and operational aspect. However, there is no study focuses and highlight on it. Therefore, the purpose of this paper is to highlight the history of *Retakaful*, Shari'ah and legal framework and *Retakaful* operational aspect.

This paper is organized in four sections. The second section highlights the historical development of *Retakaful* until now. The third section mentions Shari'ah and legal background of *Retakaful*. The fourth section presents the operational aspect of *Retakaful*. The last section concludes the paper.

Historical and Current Perspective of *Retakaful:* The *takaful* industry in the beginning of its establishment in the early eighties has generally relied heavily on conventional reinsurance to provide capacity as well as reinsurance cover for its *takaful* risks. Scholars allowed this practice as a measure ofnecessity(*dharurah*)in order to protect the nascent industry.In this respect, some *takaful* companies in the Middle-East are allowed and licensed to write *Retakaful* business to meet this inadequate *Retakaful* capacity in the market[1].

This is followed by the another company called BEST Re based in Tunisia which provides both conventional and *Retakaful* facilities and later followed by the establishment of Asean*Retakaful* International (L) Ltd, thus alleviating in a small measure, the lack of *Retakaful* capacity for the fledgling *takaful* industry. In 1997 the *takaful* operators in Malaysia, Brunei and Indonesia, with the desire to enhance cooperation among themselves as well as promote shared values and technical exchange

[1]Such as the Islamic Insurance and Reinsurance Company (IIRCO) based in Jeddah which has now ceased operation

Corresponding Author: Sheila Nu NuHtay, Institute of Islamic Banking and Finance, International Islamic University Malaysia

programmes, formed a loose grouping called the ASEAN *Takaful* Group.

Among the concrete technical exchange program undertaken was to establish a regional *takaful*pool called the ASEAN *Takafultakaful* Pool (ATG Pool) whereby members agree to cede to the pool their fire *takaful* business as a priority before ceding to the *Retakaful* and reinsurance market. This pooling arrangement helps to lessen the acute shortage of *Retakaful* capacity at that time. Currently there are more than ten full-fledge *Retakaful* operators providing various *Retakaful* solutions to the global *takaful* market.

Shariah and Legal Background of *Retakaful:* Like *takaful*, *Retakaful* is also a risk sharing mechanism. In *Retakaful*, the participants are the various *takaful* operators who seek to share their *takaful*risks through the mechanism of *Retakaful* managed by *Retakaful* operators. This means that principally, *takaful* has similar traits with *Retakaful* in its contractual dimensions except for certain peculiarities which are unique to the *Retakaful* operational framework. In relation to this, the Islamic Financial Service Act 2013 (Malaysia) defines the *Retakaful* as:

> "*takaful* cover arranged by a *takaful* operator with a second *takaful* operator on the risks of the *takaful* fund it administers, wholly or partly…"

Retakaful generally follow the same Shariah principles and practices of *takaful*[2]. For this reason, *Retakaful* is also a contract of donation (*uqud al-tabarruat*) between the *takaful* operators to share their respective *takaful* risks and liabilities based on defined *Retakaful* contributions, into a defined *Retakaful* Risk Fund, to cover defined *Retakaful* risks, in a defined *Retakaful* period, managed by a *Retakaful* operator based on various contracts such as *al-mudharabah, al-wakalah* or hybrid models. The concept of *Retakaful* according to Karim [3] widens the spectrum of the principle of solidarity whereby a participant in one *takaful* pool essentially helps or is being helped by other participants in other *takaful* pools managed by the various *takaful* operators who cede their *takaful* risks or pool of risks to the *Retakaful* operator.

The underlying principles applicable in the primary *takaful* contracts such as indemnity, permissible *takaful* interest and utmost good faith are also applied in *Retakaful* contracts. The SAC[3] approved that the abovementioned principles shall also apply to *Retakaful*, realising the importance of these principles in *Retakaful* are much deeper due to the high information asymmetry of the *Retakaful* risks and the 'wholesale'/portfolio nature of *Retakaful* where individual risks are not described (except for facultative *Retakaful* placement). In essence, *Retakaful* operators are required to manage all facets of its business based on Shari'ahprinciples and practices, such as its investment, underwriting, claims, finance, including its practice of *retrotakaful.*

Operational Aspect of *Retakaful:* Similar to conventional insurance, *takaful* operators need *Retakaful* to support its business activities especially in a competitive market environment and high customer and shareholders expectations. Generally, a primary *takaful* operator seeks to obtain the following objectives from its *Retakaful* program [4, 5]:

- To maximize net retained profits, usually keeping the first portion of the good risks in its own account and ceding the balance to *Retakaful* for prudential purposes.
- Make best possible use of the financial resources of *Retakaful* operators to back the business especially for large and complex risks (leveraging).
- Ensure optimal retention of risk in line with the financial standing of the *takaful* operator. Unduly low retentions will result in uneconomic outflow of contributions and profits whilst a high retention shall expose the company financially.
- Produce steady underwriting results from year to year by controlling the 'adverse' year through adequate *Retakaful* arrangement.
- Help company's overall growth in all aspects such as gross contributions, net contributions and net profits.
- Provide adequate underwriting capacity and expertise to enable the business to grow amidst the fiercely competitive market environment and high shareholders and customer expectations.

Retakaful Operational Models: *Retakaful* may be operationalized based on similar structures applied in

[2]As defined by the AAIOFI Shariah Standard No.41 of 2010

[3]At its 52nd meeting dated 2nd August 2005 and its 76th meeting dated 9th June 2008

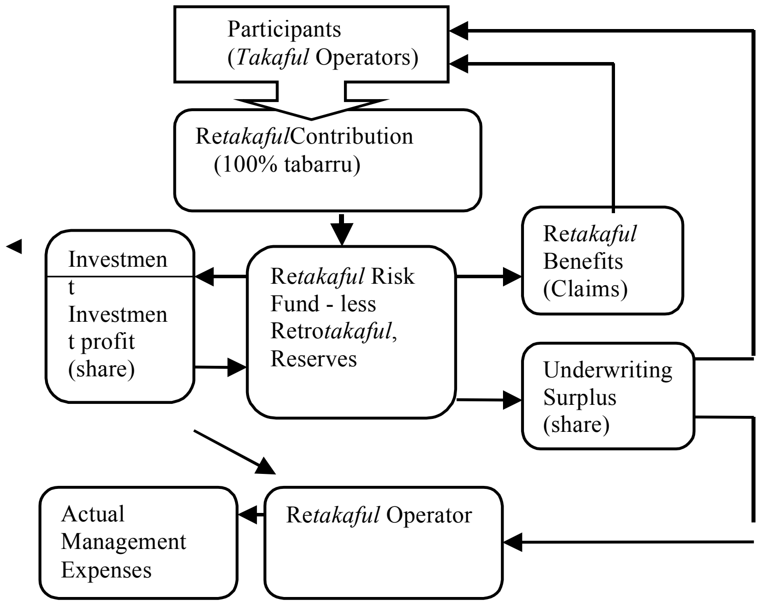

Fig. 1: Modified al Mudharabah*Retakaful* Model

takaful either on *al--mudharabah*, *al-wakalah* or hybrid model combining both *al-mudharabah* and *al*-*wakalah* as depicted below [4]:

Retakaful Based on *al-Mudharabah* Model: The principle of *al-mudharabah* when applied to *Retakaful* contract defines the *Retakaful* operator as the entrepreneur (*mudharib*) who undertakes the *Retakaful*business activities and the participants (*sahibul mal*) consisting of the various *takaful* operators making *Retakaful* contributions into the *Retakaful* Risk Fund to the *Retakaful* operator (based on *tabarru*). The *Retakaful* contract may specify the proportion of profit (surplus) to be shared between the *takaful*and the *Retakaful* operator. A simple *Retakaful* structure based on modified *al-mudharabah* model is depicted below:

Retakaful Based on *al-Wakalah* Model: Under, this model the *Retakaful*operator (the *wakeel*) manages the *Retakaful* Risk Fund(*muwakkalbih*) as an agent of the primary *takaful* operators (participants) (as the *muwakkil*) and is paid an upfront fee (the *ujrah*) for its services. Profits and losses from the management of the *Retakaful* Risk Fund belong entirely to the primary *takaful* operators (participants), unless the losses were due to the negligence or misconduct of the *Retakaful* operator. This model was approved by the SAC in 2002[4]. A simple structure of a hybrid *wakalah-mudharabah* model as commonly adopted by the industry is depicted below:

Management of the *Retakaful* Risk Fund: A *Retakaful* Risk Fund is managed in a similar manner as the *Takaful* Risk Fund such as the management of claims, reserves, *retrotakaful* and investment activities to ensure that the *Retakaful* Risk Fund is financially strong and sustainable to meet its *Retakaful* liabilities as well as shareholder's expectations. However, under *Retakaful* (with respect to both proportional and non-proportional *Retakaful*), there are certain treatments of the *Retakaful* contributions and claims which are unique and necessary to the operation of *Retakaful* business and which are defined in the *Retakaful* contract and practices. Under proportional treaty, they may consist of as follows [6]:

- Bordereaux-refers to the schedule of cessions made under a *Retakaful* treaty, or of losses arising from the business ceded to the *Retakaful* operator. This is normally rendered on quarterly basis.
- Contribution Basis-which seeks to define whether the *Retakaful* contribution received from the primary *takaful* operator is either on Original Gross Rate (OGR)[5] or Original Net Rate (ONR)[6] or flat rate.

[4]At its 24th meeting dated 24 April 200

[5]OGR refers to the rate of contribution charged by primary *takaful* operator without any deductions.

[6].ONR refers to the rate of contribution charged less acquisition costs incurred by the primary *takaful* operator.

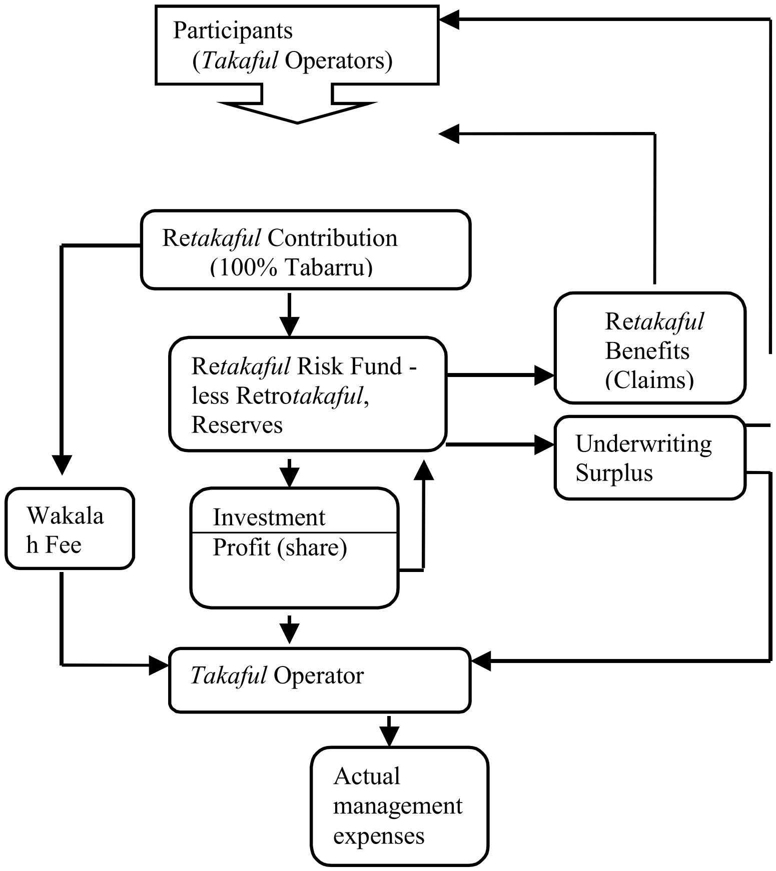

Fig. 2: Hybrid *Retakaful* Model

- Contribution Reserve Deposit-the amount retained by the primary *takaful* operator from the *Retakaful* contribution ceded to the *Retakaful* operator as a security for due performance of treaty obligations by the *Retakaful* operator.
- Clean-cut Accounts-refers to the system of accounts of a proportional treaty wherein the *Retakaful* operator's unexpired liability in respect of cessions made and outstanding losses are settled through transfer of contributions and loss portfolios, instead of running-off over a period.
- Contribution Portfolio Entry and Withdrawal-refers to the accounting entry in a proportional treaty account to transfer the unearned contributions from one year to the next. To relieve the *Retakaful* operator at the end of the year of liability in respect of unexpired risks, it is debited an amount, usually a percentage (usually 30-40 percent) of the ceded *Retakaful* contribution as Contribution Portfolio Withdrawal. The *Retakaful* operator of the next year is credited with the amount as Contribution Portfolio Entry.
- Loss Portfolio Entry and Withdrawal-refers to the accounting entry in a proportional treaty account to transfer liability in respect of losses outstanding from one year to the next. To relieve the *Retakaful* operator at the end of a year for future liabilities in respect of outstanding losses, it is debited for an amount, usually a percentage (usually 90-95 percent) of losses outstanding at the end of the year, as Loss Portfolio Withdrawal. The *Retakaful* operator for the next year is credited with the same amount as Loss Portfolio Entry.
- Reserves-refers to the basis or retention of reserves, whether calculated on OGR or ONR and the mechanics of retention and release. Reserves are released when portfolio is withdrawn and retained when portfolio entry is given.
- Run-off Accounts-refers to accounts pertaining to an underwriting year drawn up periodically subsequent to the close of the treaty year.

- Underwriting Year Accounts-refers to the system of treaty accounts where contributions and losses pertaining to a particular underwriting year are kept separate from that of other underwriting years. Run-off accounts are rendered to reflect the development of contributions and losses of that underwriting year.
- Cash Call-refers to a provision in proportional treaties that allows the cedant (primary *takaful* operator) to seek and receive immediate payment of the *Retakaful* operator's share of a large loss without waiting for collection through the periodic accounts.
- Commission[7] or *Retakaful* service fee-is paid by the *Retakaful* operator to the *takaful* operator (cedant) on the *Retakaful* contributions ceded, of which rate are agreed upon by both parties at the time of negotiating the terms of the treaty. In principle, the commission should be sufficient to cover the original commission, plus the cedant'smanagement expenses, but the margin is also tied to the performance of the portfolio.

Under Non-Proportional *Retakaful*, the key features are as follows [6]:

- Treaty Limits-this specifies the point at which the *Retakaful* operator becomes liable and the amount for which it is liable. Limits are typically expressed asin the following example:

"**Limit:** RM 3,500,000 Ultimate Net Loss each and every loss each and every risk, each and every occurrence or series of loss occurrences arising out of one event.

Deductible: RM 3,500,000 Ultimate Net Loss each and every loss each and every risk, each and every occurrence or series of loss occurrences arising out of one event."

The above statement means that the *Retakaful* operator will pay up to RM3.5m in excess of the first RM3.5m payable by the Cedant for each loss occurrence. Normally cover is arranged in various layers, primarily for pricing purposes for the additional covers required.

- Gross Net Contribution Income (GNCI)[8]-this is the amount against which Excess of Loss rates are based in order to derive the *Retakaful* contribution. Pricing is initially based on the Estimated GNCI (EGNCI) contributionand then adjusted after the close of the year, when the Actual GNCI is known.
- Retakaful Contribution-Minimum and Deposit Contribution (MDC)is payable by quarterly in advance, during the year. The purpose of the Minimum and Deposit Contribution is to ensure that the ceding company does not deliberately overstate its EGNCI (to achieve lower rates) and the *Retakaful* operator receives a guaranteed contribution to meet its expenses and to cover the liability it has assumed. The rate for non-proportional may be arrived at a number of methods such as, flat rate method, burning cost method[9], rate on line method[10].
- Reinstatements-to ensure that the amount of cover under an Excess of Loss Treaty is limited in terms of the aggregate amount that is recoverable per layer. For example, if a layer of RM5m Excess of RM3m provides for 3 Reinstatements, the total amount recoverable under the layer is RM20m i.e. the RM3 x RM5m reinstatements + the RM5m cover.

CONCLUSION

In sum, this paper highlights the interdependent nature of insurance and reinsurance operators and the need of reinsurance operators for the insurance operators to ensure the solvency. Both insurance and reinsurance practice is not in line with Shari'ah and *Takaful* and *Retakaful* become the replacement for them. Similar to the conventional practice, *Retakaful* operators are the backbone of *Takaful* operators. Thus, this paper focuses on the historical development of *Retakaful* until now, the Shari'ah and legal framework of *Retakaful* and its operational practice. It is expected that the paper will be the value added to the existing literature and the interest of industrial players, regulators, Shari'ah advisors, customers and the public.

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[7].Some scholars do not allow this practice as they deemed that it amounts to riba.

[8]. Written contributions net of returns and cancellations.

[10]. Based on the past loss experience (cost of incurred losses during the protection period), loaded for expenses and profit margin.

[11].Charged as a percentage of the cover limit.

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