Retakaful (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 ameasure of necessity (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 market1.

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 AseanRetakaful 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

1Such 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

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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 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. For this reason, Retakaful is also a contract of donation (uqud al-tabarru'ar) 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 SAC3 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’ah principles and practices, such as its investment, underwriting, claims, finance, including its practice of retro takaful.

**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

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1. As defined by the AAIOFI Shariah Standard No.41 of 2010
2. At its 52nd meeting dated 2nd August 2005 and its 76th meeting dated 9th June 2008
3. At its 76th meeting dated 9th June 2008
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 2002⁴. 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 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.

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⁴At its 24th meeting dated 24 April 200
⁵OGR refers to the rate of contribution charged by primary takaful operator without any deductions.
⁶ONR 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’ 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’s management 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 as in 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 Ceding 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) contribution and 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.

REFERENCES


\(^7\) Some scholars do not allow this practice as they deemed that it amounts to riba.

\(^8\) Written contributions net of returns and cancellations.

\(^9\) Based on the past loss experience (cost of incurred losses during the protection period), loaded for expenses and profit margin.

\(^10\) Charged as a percentage of the cover limit.