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The Use of Retrocession by Retakaful operators: A Perspective of Retakaful Operator

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Abstract

In Malaysia, the insurance and takaful sector is under the purview of the Central Bank of Malaysia, and the same goes for reinsurance and retakaful operations. However, due to the country's dual financial system i.e. the conventional and Islamic financial system, conventional reinsurance and retakaful, fall under different laws. The conventional reinsurance is regulated under the Financial Services Act (2013) while the takaful and retakaful by the Islamic Financial Services Act (2013). Undoubtedly, the takaful industry is expanding in the Malaysian market today by leaps and bounds. Retakaful acts in the same way as takaful, providing (re)takaful arrangement for their policyholders. The survival of the takaful operator is heavily influenced by the retakaful operators. The takaful operator will distribute some portion of their risks that they cannot bear to a retakaful operators. However, the retakaful operators are currently unable to cover the entire risk that were ceded by the takaful operators due to lack of retakaful operators in the market, as well as very limited capital, inadequate accumulated funds, and regulatory solvency issues. At the same time, retakaful operators also face challenges in meeting their commercial goals. They, in turn, use tools such as retrocession to overcome their impending challenges. This paper aims to analyse the importance of retrocession to the retakaful company from a Shariah perspective. The research is timely as not much research has been carried out on Retakaful operations in Malaysia. There is also limited discussion related to the business models of retakaful, as well as no specific guidelines focusing on retakaful itself. Therefore, a qualitative approach is suitable for the purpose of exploring such new areas. Besides, Retakaful industry is considered relatively new compared to reinsurance. The outcome of the research is relevant to researchers, practitioner communities and regulators who are responsible for creating regulations and policies to the retakaful industries.

Keywords: reinsurance, Islamic reinsurance, retakaful, retrocession, intra-group retrocession.

1.0 INTRODUCTION

Life is full of uncertainties and surprises. They may be unpleasant. Since we relatively have no control on what is going to happen, we must be well prepared to encounter any unpleasant surprises especially involving material losses. An effective way is to plan for the future (Muhammad, 2016). By looking deeply into the principles of Islamic laws, one will find that the teachings focus on promoting the wellbeing of the people, and protecting their faith, lives, property and inheritance. It is a natural phenomenon in our daily life that any society will have to face all kind of risks which sometimes may not be expected and are detrimental to our well-being. These risks may adversely affect our life, properties, assets, and business ventures which are so devastating and shattering. Without proper planning, the undesirable effect is that they will be vulnerable to unexpected risks.

In essence, Allah s.w.t. urged His servants to take precautionary measures to prevent something unwanted taking place and to protect against possible danger or failure. Islam also requires us to be well prepared and have a strategic plan to overcome any adverse effect from unexpected risks. One possible way is to purchase an insurance policy (Matsawali, Abdullah, Ping & et. al, 2012). Insurance serves an important need in society and industry for the purpose of risk management. Insurance, as risk management tool, creates certainty about the financial burden of losses (Nurwajihah, 2021). However, conventional insurance is generally forbidden and is not Shariah compliant because of its excessive elements of Gharar, Riba and Maisir. The presence of these unlawful elements in a commercial contract would render them invalid and void (Yusuf & Yuhasni, 2011). With regards to the practice of reinsurance, due to the similar nature of its arrangement, a reinsurance contract is also impermissible according to Shariah.

The emergence of Retakaful is indeed a timely solution for takaful companies to fulfil their reinsurance needs (Setiyawan, 2013). Recognising the need for a risk management tool, Islamic finance scholars and practitioners have developed a permissible form of 'reinsurance', which is commonly known as Retakaful. The operations of takaful are similar to retakaful (Asmak, Ahmad, et. al, Setiyawan, NuHtay), therefore, all Shariah principles that apply to takaful operators also apply to retakaful operators as well. It is according to the definition in the IFSA which states that, *"takaful operator includes a professional retakaful operator."* (IFSA, 2013).

Nevertheless, retakaful is one of the areas in Islamic finance that need further research. One of the reasons is due to the fact that Retakaful is still very new compared to reinsurance. The number of experts in Retakaful are still small. The bigger socio-economic value of retakaful is that it would make risk-sharing amongst participants extended into a wider geographical boundary, hence expanding the concept of Tabarru' and Ta'awun even further. Instead of limiting the spirit of mutual assistance within one particular Takaful operator's participants, retakaful could make one's contribution to reach bigger and wider recipients (Abu Umar Faruq Ahmad, Ismail Mahbob, Muhammad Ayub, 2016). The Islamic Financial Services Act 2013 (IFSA 2013), various Shariah Standards and the Takaful Operational Framework (TOF) are some of the regulatory policies in Malaysia that are increasingly made as references by other jurisdictions in developing their Islamic financial industry.

Retakaful operators, in turn, rely on retrotakaful or retrocession to meet their capacity needs. In the next sections, the researcher will explore the nature of retakaful, retrocession and retrotakaful, and their Shariah perspectives.

2.0 RESEARCH METHODOLOGY

This research study which utilises the qualitative method, aims to examine the concept of retrocession and the importance of retrocession to retakaful operators as well as to analyse the permissibility of retrocession in retakaful. This qualitative method was conducted in the form of interview data and documentation. The qualitative method used in this research aims to obtain data and explore in depth through the support of data sources from documentation and interviews.

According to (Sugiyono, 2014), two methods of collecting data in qualitative research are explained as below:

1. The semi structured interview was conducted in this research to acquire relevant information by using the interview guide and a set of questions, but no predetermined questionnaires. Upon receiving the answers from the informants, the researcher is free to ask more in-depth questions with regards to the answers given by the informants (Chua, 2014).
2. Documentation method was utilized by collecting and analyzing all forms of documents specifically the primary sources such as article and guidelines by BNM. The main sources used are books, articles, journals, news, magazines, research papers and other valid and certified references such as websites.

The process of data analysis in qualitative research was carried out right after collecting the data. Data analysis was carried out simultaneously and continuously. The documentation data are analysed by using the document analysis. The interview data were transcribed verbatim into text. After the process of completing the transcript, the researcher coded the text and constructed the themes for each interview finding. The last step, the researcher has analysed and re-exmained the relationship between the concepts and themes to ensure that it is relevant with the research.

3.0 RESULTS AND DISCUSSION

3.1 The Definition of Retakaful

The word takaful is derived from the Arabic word of ‘kafala’ which means guarantee, protection, and liability. (Abu Umar Faruq Ahmad, Ismail Mahbob, Muhammad Ayub, 2016). Retakaful practices the same principles and acts the same way as Takaful, which provides Takaful protection for their policy holders (Arbouna, 2000). The main difference is that the participants of the Takaful companies are the individuals whilst in Retakaful, the participants are the Takaful companies (Yusuf & Yuhasni, 2011). In simple terms, Retakaful is Takaful protection for Takaful companies (Asma Abdul Rahman, 2009, p. 4).

The Islamic Financial Services Act 2013 (Act 759) of Malaysia (IFSA, 2013, p. 23) defines Retakaful as follows:

> *“Retakaful means takaful cover arranged by a Takaful Operator with a second Takaful Operator on the risks of the Takaful fund it administers, wholly or partly, and includes any similar arrangement by a branch of the Takaful Operator in Malaysia with its branch outside Malaysia.”*

Islamic Financial Service Board (IFSB-18, 2016, p.2) in the Guiding Principles for Retakaful (Islamic Reinsurance) describes retakaful as the conceptually similar to takaful. It stated that retakaful *“is the Islamic alternative to conventional reinsurance comprising both Family and General business”.* Its function is similar to the takaful where the operator acts on behalf of the participant’s pools to manage the pool. The only difference is that the parties in takaful arrangement is the policyholders and takaful operator whereas in retakaful arrangement, the parties is between the takaful operator and retakaful operator.

The Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI,** 2012) in the (Shariah Standard No.41, Item 2/1) defined retakaful by using the term of 'Islamic reinsurance'. According to AAOIFI, Islamic Reinsurance is *an agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for the avoidance of part of the risks which the insurance funds may encounter. On the basis of which a reinsurance fund having a distinct legal personality and independent financial liability is formed up through making contributions out of the insurance funds paid by the insurance clients on the basis of donation. The reinsurance fund, thus formed, assumes the task of covering part of the risks encountered by the insurance funds".*

3.2 Reinsurance VS Retakaful

Reinsurance, in its simplest definition is insurance for insurance companies. Under a reinsurance arrangement, the reinsurer takes part of the risk that a primary insurer (cedant) has accepted. If a valid claim request is triggered, the reinsurer will pay its part to the cedant depending on the reinsurance structure in the agreement. In return for transferring the risks to the reinsurer, the cedant pays a reinsurance premium to the reinsurer. In a reinsurance agreement, the original policy holder is not involved as the subsequent contract is only between the cedant and the reinsurer.

Retakaful arrangements act the same way as takaful arrangements, which provides takaful coverage for their policy holders or participants with the participants in this case being takaful companies. The only difference is that the policyholders or participants of the takaful companies are the individuals whilst in retakaful, the participants are the takaful companies. In simple terms, retakaful is takaful coverage for takaful companies. Takaful companies require reinsurance facilities as a risk management tools for them to mitigate the impact of misfortune and financial losses. The uniqueness of a retakaful arrangement is that it is based on the principle of mutual assistance (Tabarru' and Ta'awun) concept which is considered as a fundamental feature in retakaful arrangements (Ahmad, Mahbob, Ayub, 2016). It is the main feature that differs retakaful from the reinsurance operation.

Takaful and retakaful are based on the concept of mutual or cooperative risk-sharing whereby the retakaful operators acts as a manager of a takaful fund contributed by the participants (NuHtay, Hamat, Wan Ismail & Salman, 2014). The Operator acts as a Wakeel on behalf of the participants, manages the fund and pays the claims when the misfortune happens (Swiss Re, 2020). Both takaful and retakaful are non-commutative contracts for cooperative protection (Ahmad, Mahbob & Ayub, 2015). Therefore, they will be operated on the basis of charity and cooperation. The contributions by the participants will be pooled and utilised for the payment of claims when there are losses incurred. The participants will be the owners of thatpool of funds and the distribution of the underwriting surplus will go back to the participant's fund. It depends on the participants who will decide by themselves whether part of the surplus that they are entitled should be given to the takaful operators who manage the fund, or some could be kept as reserves.

The emergence of retakaful entities is indeed a solution for takaful companies to fulfil their reinsurance need. In essence, retakaful which is mainly built upon the concept of Tabarru' and Ta'awun (as found in takaful arrangement) would extend risk-sharing amongst participants into a wider geographical area. Instead of limiting the spirit of mutual assistance within one particular takaful operator, retakaful could make one's contribution reach bigger and wider recipients. In turn, in order to mitigate their risks (in a similar manner as takaful operators), retakaful operators s share or cede their risks to other retakaful operators s or reinsurers in a process known as retrocession or retrotakaful.

3.3 The Need for Retrocession for Retakaful Operators

3.3.1 Risk Based Capital for Takaful Operators (RBCT)

It is worth noting that in Malaysia, a licensed retakaful operator, just like conventional insurance and reinsurance and takaful operators, is still subject to regulatory capital or solvency requirements, in this case the Risk Based Capital Framework (RBCT) for Takaful Operators, issued by BNM. The RBCT framework is introduced by BNM to ensure the financial stability of the takaful and retakaful operators, and therefore reducing the impact of any adverse events for the customer. Under this framework, BNM has set minimum capital requirement to clearly consider the institution's own risk profile and risk management practices. At the time of writing, the minimum Capital Adequacy Ratio (CAR) is 130%. BNM expects the capital requirements to also include additional capacity to absorb unexpected losses beyond those that are already covered by the RBCT framework i.e. the level of capital required is more than 130%.

RBCT requirements would affect the commercial performance by affecting the Returns on Equity (ROE) of retakaful operators through its effect on capital requirements. A high capital requirement would put downward pressure on the RTO's ROE, hence making the commercial performance of the RTO less attractive to its shareholders.

3.3.2 Retrocession

Managing capital is therefore an important aspect which determines a reinsurer/retakaful operator's business sustainability and its returns to shareholders. Retrocession is one of the tools to manage capital efficiently for reinsurers/retakaful operators. As such, it is vital to know what retrocession is.

Retrocession is defined as an arrangement whereby a reinsurance company assume the risks of another reinsurance company. This is done to prevent any chance of the reinsurance company not being able to meet its financial obligations when meeting claims. It is basically the reinsuring of a risk by a reinsurer. Obviously, reinsurance companies also need help in covering their risks. If a reinsurance company feels that it is being too exposed, then it would be prudent to use retrocession to cede some of its risks to another reinsurer. Unforeseen events like flooding, earthquakes, tsunamis and hurricanes can be tantamount to huge amounts of claims to be filed and will affect financial position of the reinsurer. It becomes even worse if the claims are filed simultaneously due to the catastrophes occurring in the same year or close to each other timewise. Retrocession would be desirable in these cases as it would prevent the reinsurer from being overexposed to huge unforeseen claims. As mentioned earlier, retrocession also helps the Retakaful operators manage capital more efficiently. From the Shariah perspective, retakaful operators should rely on retrotakaful (which is the Shariah compliant version) rather than retrocession. However, this is not always possible, and retakaful operators still relies on conventional retrocession in particularly, Intra Group Retrocession. (Unpublished doctoral thesis, Puteri, 2023).

3.3.3 Intra-Group Retrocession (IGR)

Intra-Group Retrocessions is a form of retrocession between two related transacting companies. The transacting legal entities of an IGR ultimately have the same parent company and shareholders. The benefit of IGR (as compared to external retrocession) is that the business stays within the group, rather than being ceded to external counterparties that in reality are competitors. As most retakaful operators are subsidiaries or branches of conventional reinsurance companies, IGR is a more acceptable arrangement compared to external retrocession. The Shariah and regulatory aspects of retrocession will be discussed in a later section. (Unpublished doctoral thesis, Puteri, 2023).

3.4 The Significance of Retrocession in Retakaful Operators Arrangement

3.4.1 Better Financial Returns for the Retakaful Operators

Intra Group Retrocession arrangements enable the retakaful operators to share their risks with another related entity preserving their capital. With well managed capital and a freed-up cash flow, retakaful operators can channel their efforts into enlarging their market share through business development and innovation comparatively to conventional reinsurers. Without IGRs, the retakaful operators are constantly at risk from claims that would greatly affect their solvency and even render them commercially non-viable. Hence, IGRs would be the preferred option as they enhance capital management with increased capital efficiency. With IGR and the combination of the favourable factors mentioned above would enable retakaful operators to improve their Returns on Equity (ROE). If more capital needs to be injected and without having prior arrangement with IGR, the ROE will suffer given the small size and volatility of the retakaful business. The retakaful business would then look unattractive to shareholders. (Unpublished doctoral thesis, Puteri, 2023).

Since the market is very competitive aggravated further by the small pie available to retakaful operators vis-à-vis their conventional rivals, it becomes imperative for retakaful Operators to adopt retrocession to improve their ROE. Without these retrocession arrangements, the retakaful operators's business model is not financially sustainable. Thus, retrocessions become a necessity for the retakaful operators especially those with limited financial capacity in sight (at least in the short term) in the traditional retakaful markets.

3.5 Shariah and Regulatory Perspectives of the Retrocession Arrangement

Despite the availability of retakaful operators in Malaysia, a big part of the business is still ceded to conventional reinsurers as they can offer better terms at more favourable rate due to their large economies of scale compared to retakaful (Interview with CEO Company A). From a Shariah perspective, any retrocession arrangement should be based on the concept of retakaful rather than on conventional reinsurance basis. But due to their shortcomings such as lack of retakaful capacity, high cost of retrotakaful cover, lack of A-rated retakaful operators (Asma Ab Rahman, 2014) and based on Takaful Operational Framework (TOF) (TOF, 2019), it still permits the retakaful operators to cede out to reinsurers under unavoidable circumstances as stipulated below:

a) No retakaful operators are known to accept the particular risks.
b) No retakaful operators have the capacity or expertise to accept the particular risks.
c) A retakaful arrangement with a retakaful operators creates potential detrimental effects to the retakaful funds.

The basis of the TOF requirements above is Bank Negara Malaysia (BNM)'s Shariah Advisory Council Resolution (SAC) No.47 which allow takaful operators to distribute their risks via conventional reinsurance on the basis of *Hajah* or needs, in cases where no retakaful operators are capable of absorbing these risks. This is in line with the Islamic Legal Maxim "Needs to take the rule of necessities." To cite another example of the application of this Maxim, the Securities Commission of Malaysia in the Guidelines on Listed Real Estate Investment Trusts, also permits the real estates to be covered by conventional insurance in the Islamic capital market only when the takaful scheme offering Islamic REITS is not available (Lee et. al., 2019).

3.6 Case Study of Company A – A global retakaful operator based in Malaysia

This section is based on interviews with the CEO of a global retakaful operator (hereafter referred to as Company A). From the interview sessions it was reported that the Shariah Committee of Company A has approved using retrocession (in particular Intra Group Retrocession) on the grounds of *Hajah*. The basis of the approval was that the retrocession is required to fulfil the capital adequacy which is vital for the continued success of the organisation. Although theoretically Retrotakaful is an option; however, the potential high costs and the non-availability of Retrotakaful arrangements necessitate that Company A look into retrocession arrangements.

1. Retakaful operators generally do not offer Retrotakaful as their normal line of business and even if they do, it would be at a significantly higher cost compared to conventional retrocession.
2. Many retakaful operators are not highly rated by rating agencies for credit risk. Nevertheless, at the time of writing, the Company A's parent company has received strong ratings of AA- by Standard & Poor's, Aa3 by Moody's and A+ by AM Best. It would not make a good and effective risk management sense for Company A to retrocede its portfolio to a retakaful operators which has lower rating (and therefore a higher credit risk) than itself. From the perspective of its role as an operator, such a move would be akin to not discharging its fiduciary duties to participants.

The necessity to opt for retrocession is worth considering based on '*Hajah*' as it is of vital importance for financial sustainability discussed previously. However, Shariah also calls for a collective effort to reduce the need for specific *'hajah'* over time, based on the legal maxims that "necessity is to be assessed and treated proportionally" and "when a matter tightens, it will widen and vice versa". Thus, it is imperative to constantly review the acceptable level of retrocession. From the regulatory and Shariah perspective, BNM does not allow retrocession to be at the same level since inception and calls for Company A to plan for its reduction over time. In doing so, Company A would be able to reduce its dependence on retrocession.

3.7 CONCLUSION

Entering into a retrocession or IGR agreement enables the retakaful operators to pass on their risks to another entity and enabling them to preserve their capital. With well managed capital, this would permit the Retakaful companies to write more business, hence, accelerating growth and attaining financial stability position similar to conventional reinsurers. Without IGRs, the retakaful operators are constantly at the risk of not being able to manage capital well. Should a big claim occur, their small capital would be inadequate to fulfil their obligations to pay out claims or perhaps their capital would even be wiped out. If the retakaful operators require additional capital in the course of their business but were not able to receive financial support from IGR, the ROE would be adversely affected and retakaful business might then look unattractive to shareholders; more so given the small size and volatility of its business.

In this case of reinsuring with conventional reinsurer, practitioners in retakaful industry are required to constantly review the acceptable level of IGR. From the regulatory and Shariah perspective, BNM does not allow for the IGR to be at the same level since inception and the retakaful operators have to plan for the reduction over time and not to be too dependent on IGR. Perhaps it is high time for regulators to devise specific guidelines for retakaful operators to address the issue of using retrocession by the latter. This would provide clarity and avoid ambiguity in retakaful business arrangements. In the case of *Hajah* in the Islamic financial industry, Shariah permits and allows Islamic financial institutions to do something that is forbidden however, they require prior consultation with Islamic finance professionals to measure and assess the level of *Hajah* situation in the respective industry.

The outcome of the research is relevant to researchers, practitioner communities and also regulators who are responsible for creating regulations and policies. The researcher is aware that this research is specifically using retakaful operators which operated in Malaysia (excluding Labuan based retakaful operators). Further research may include Malaysian companies and companies outside Malaysia.

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