

## Sharing and Transferring Risks in Retakāful and Conventional Reinsurance: A Critical Analysis

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**Abstract.** This study undertakes an analysis of the risks in *retakāful* whether they are shared by the participating *takāful* operators (TOs) and *retakāful* fund, or are transferred to *retakāful* operators (RTOs). In the latter case RTOs become liable for deficits where the losses, if any, would directly affect all retained portfolios. The study finds, notwithstanding the aim of *retakāful* to allow TOs to reduce the financial impact on their respective *takāful* fund (TF) arising from catastrophic losses, that there exists a mismatch between the theory and current risk-sharing practice of *retakāful* whereby RTOs manage the TF on behalf of their respective participants.

**Keywords:** *Retakāful*, conventional reinsurance, *retakāful* operators, *retakāful* fund, risk-sharing, risk-transfer, *qard hasan*, commission.

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### 1. Introduction

*Takāful* has emerged in the global Islamic finance industry from the fundamental Islamic principles of brotherhood, mutual assistance and cohesion utilizing the contract of donation (*al-tabarru*). Since risks are inevitable both at individual and institutional levels, *takāful* contracts

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have been developed as an Islamic alternative to conventional insurance to help individuals and organizations mitigate these risks. The aim of *retakāful* is to provide *takāful* to *takāful* companies (TCs) to allow *takāful* operators (TOs) to relinquish the inherent risks in the contracts to the common pool managed by the RTCs. As ‘risk managers,’ TOs may get into RTCs to handle the risks they are not in a position to take into the *retakāful* risk fund for the purposes of solvency of the *takāful* funds and for managing their liquidity risk.

In general, a *retakāful* arrangement is structured along the same lines as conventional reinsurance. However, unlike conventional insurance and reinsurance where the risks are transferred from the original insured to the insurance company and then from the insurance company to the reinsurer, the concepts of *takāful* and *retakāful* are based on risk-sharing, whereby a *takāful* operator (TO) manages a *takāful* fund (TF) for and on behalf of participants. It is fundamental to this structure that the contributions of the participants are pooled, used for payment of claims and underwriting surplus or that the deficit belongs to the participants of the respective TF. This research aims to examine, *inter alia*, whether or not the risks are transferred in *retakāful* to *retakāful* operators (RTOs) due to the fact that if *retakāful* does not transfer the risks, the participants would be liable for deficits where the losses if any, would directly affect all retained portfolios. This and other related issues of transferring the risks in *retakāful* will be examined from a Sharī‘ah perspective.

The paper is divided into eight sections. Section 2 deals with the concept and definition of *retakāful* in Islamic finance; section 3 discusses the structure, functions and significance of *retakāful* to the industry; section 4 defines risk, risk-sharing and transferring from both *retakāful* and conventional reinsurance perspectives. Section 5 makes a brief comparison between conventional reinsurance and *retakāful*, the in-depth analysis of the core research namely the Sharī‘ah rulings on the issues related to risk transfer and sharing is undertaken in section 6. Section 7 summarises the findings of the research and draws concluding remarks. Section 8 concludes with suggestions for further research on some specific issues.

## 2. The Concept and Definitions of *Retakāful*

### 2.1 Literal Meaning of *Retakāful*

If we consider '*retakāful*' as a whole as one word it has no linguistic origin. However, considering the word as the combination of two separate words: 're' and '*takāful*', it has its etymological origin. The word 're' is a prefix, occurring originally in loanwords from Latin, used with the meaning 'again' or 'again and again' to indicate repetition, or with the meaning 'back' or 'backward' to indicate withdrawal or backward motion. On the other hand, *takāful* is derived from the Arabic root-word كفل 'k-f-l' which means guarantee, warranty, responsibility, and protection.

### 2.2 Origin of the Word *Retakāful*

No one can claim to be the first user of the word '*retakāful*' as it is used as alternative to reinsurance for getting risk cover on Islamic principles, in most of the non-Arab and non-Middle East countries. It was in fact freely used probably in an attempt to Islamize or Arabicize components of the industry's supply chain. The term was officially acknowledged when the first Asian RTO, Asean *Retakāful* International Limited (ARIL) incorporated the word in its name. Replicating the popular description of reinsurance as 'insurance for insurance companies', *retakāful* has since been conveniently explained as '*takāful* for *takāful* companies (TCs)', which in fact is *takāful* for '*takāful* pools' managed by TCs.

Islamic reinsurance and *retakāful* that is currently in practice, both in Arab and Middle Eastern countries and other parts of the globe, is relatively new as compared to conventional reinsurance. The first independent *retakāful* operator was founded in 1979 in Sudan, whereas the first RTO in a non-Muslim country found a home in Luxembourg in 1983. Islamic reinsurance operators (IROs) or RTOs exist in many countries either as independent companies or as subsidiaries of conventional reinsurance companies. Among the first few independent IROs that were established in different jurisdictions were the Sudan National Reinsurance Company (1979), Sheikhan Takāful Company in Sudan (1983), Islamic Insurance and Reinsurance Company in Bahrain and Saudi Arabia (1985), and BEST RE in Tunisia (1985). The countries where the independent IROs/RTOs are in operation at present include

Brunei, Indonesia, Jordan, Morocco, Pakistan, Qatar, Tunisia, Turkey, Bahamas, Egypt, Iran, Kuwait, Malaysia, Saudi Arabia, Singapore, Bahrain, and the United Arab Emirates. Besides, the key conventional reinsurance companies that provide *retakāful* subsidiary/window facilities are Mitsui Sumitomo (Japan), Swiss Re (UK), Kuwait Re (Kuwait), Hannover Re (Germany), Trust Re (Bahrain), and Labuan Re (Malaysia).

### 2.3 Definition of Retakāful

Basically, the Sharī‘ah-compliant structure of conventional reinsurance is known as *retakāful*. Through *retakāful* contracts a TO or the ‘cedant’ (sometime spelled as cedent) can transfer all or part of its liabilities to a RTO with the aim of minimizing the risk coverage in the event of a claim arising under the contract of *takāful*. By way of sharing risk through the notion of *retakāful*, this mechanism facilitates a broader allocation of risks and safeguards the *takāful* funds (TF) as well as the interests of participants. As a result, the whole process enables *retakāful* to indirectly contribute towards protection of a *takāful* user of a risk of insolvency, underwriting participants, forging team-work between the latter as well as supporting Sharī‘ah-compliant investments.

Although theoretically *retakāful* is no different from *takāful* in terms of the principles of Sharī‘ah, there is a major difference between the two from an operational point of view. In *retakāful* operations, the participants are TOs whereas in *takāful* the participants are individual persons or organizations being covered. Also, *retakāful* is a distinct and separate contract from the original *takāful*. The most recent definition of *retakāful* given by the Islamic Financial Services Act 2013 (Act 759) of Malaysia (IFSA) states:

[...] *retakāful*” means *takāful* cover arranged by a *takāful* operator with a second *takāful* operator on the risks of the *takāful* fund it administers, wholly or partly, and includes any similar arrangement by a branch of the *takāful* operator in Malaysia with its branch outside Malaysia .

This definition replaced the definition previously provided by the Malaysian *Takāful* Act 1984 that defined *retakāful* as:

[...] an arrangement consistent with sound *takāful* principles for *retakāful* of liabilities in respect of risks incurred or to be incurred by the TO in the course of his carrying on *takāful* business.

However, we believe that the following definition referring to Islamic reinsurance by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is clearer and reflects the underlying spirit of the notion of *retakāful*. It states:

[...] the agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for avoidance of part of the risks which the insurance funds may encounter. On the basis of such agreement a reinsurance fund which has 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. (Item 2/1 of Sharī‘ah Standard No. 41, AAOIFI, 2010).

The definition given by Kuwait Finance House is as follows:

[...] *Retakāful* is a form of insurance whereby the *Takāful* operator pays an agreed upon premium from the *Takāful* fund to the reinsurance company or *Retakāful* operator, and in return, the reinsurance company or the *Retakāful* operator will provide security for the risk reinsured (Ali, Kazi M., 2006).

Both of the above definitions have adopted many conventional terminologies such as ‘insurance companies’, ‘insurance funds’ and ‘reinsurance fund’. Such usage would support the belief that there is no difference between *takāful* and insurance and *retakāful* and reinsurance.

Munich Re *Retakāful*, a major industry player, defines *retakāful* a bit differently as:

[...] is a transaction whereby one company (the “*Retakāful*”) agrees to indemnify another *Takāful* company (the “ceding” company or “cedant”) against all or part of the loss that the latter

sustains under the *Takāful* contracts that it has issued. For this service, the ceding company pays the *Retakāful* a contribution. (Munich Re Retakāful, 2010).

### 3. Structure, Functions and Significance of *Retakāful*

The Sharī'ah principles for *takāful* structures and operations equally apply to *retakāful* structure and operation as the resolution of OIC Fiqh Academy mentioned on the next page suggests. Since the Sharī'ah outlaws some ingredients of conventional insurance contracts such as *Al-ribā* (hereafter *ribā*), *al-qimār* (hereafter *qimār*) or *al-maysir* (hereafter *maysir*), and *al-gharar* (hereafter *gharar*), *retakāful* operations are structured to evade these forbidden components to be compliant with Sharī'ah principles that equally apply to *takāful* and *retakāful* operations. For instance, in conventional insurance, *ribā* accumulates in transactions whereby an unequal exchange occurs between the premium paid and indemnities paid out, as well as in the proceeds accrued from *ribā*-based investments. *Retakāful* structures evade *ribā* among other means by investing pooled funds only in Sharī'ah-compliant investment instruments. The practice of conventional reinsurance also involves *al-gharar* due to ambiguities in the amount to be paid at the time of losses and the time and possibility of losses that can happen. In the event that no claim is made under a conventional reinsurance policy, the reinsurance company may be perceived to receive all of the benefits, or profit, from the reinsurance arrangements as agreed under the terms of a commercial contract. In contrast, *retakāful* structures must follow specific rules to avoid the elements of *al-gharar* in the underlying contracts such as there should not be any ambiguities in respect of participants' contributions and compensation as commercial contracts via the donation process (*'ūqūd ghair mu'āwadah* - 'non-commutative' contracts), the issue of *al-maysir* is avoided.

Given the above Sharī‘ah requirements, a *retakāful* operator avoids elements of *ribā*, *gharar* and *maysir*. There are significant issues that make the functions of RTOs somehow limited. One such issue is the availability of limited options for TOs to invest participants’ contributions in Sharī‘ah-compliant investment portfolios in the majority of Muslim countries except for Malaysia, which has a special law that regulates TOs to conform to investment restrictions that contravene Sharī‘ah principles. Another related issue is that there are a few RTOs who operate within their territorial jurisdiction that allow limited *retakāful* to the TOs in some products. This restriction makes TOs face various risks. To find a solution to these constraints there is a need for prudent risk management in a way that a TO should not be restricted to a single product; rather to allow it to diversify its portfolio to innovative instruments. Furthermore, there is a pressing need for a Sharī‘ah-compliant money-market fund to be developed that is accepted by the regulators. It is urgently needed to generate leasing funds as bond substitutes, Real Estate Investment Trusts [REITS] and other openly tradable securitized assets to widen the investment options for TOs and help them overcoming competitive disadvantages compared to conventional insurers.

### 3.1 Nature of *Retakāful*

*Retakāful*, like *takāful*, is by definition built on the principles of cooperation and risk-sharing as laid down in the objectives of Sharī‘ah (Frenze, 2012), while conventional reinsurance and insurance are a risk transfer mechanism. This nature of *takāful* and *retakāful* has more inclusively been endorsed by the International Islamic Fiqh Academy (Resolution No. 9/2, 22-28 December 1985), which reads as follows:

First: The Commercial Insurance Contract, with a fixed periodical premium, which is commonly used by commercial insurance companies, is a contract which contains major elements of *gharar* or risks which voids the contract and, therefore, is prohibited according to the Sharī‘ah.

Second: The alternative contract, which conforms, to the principles of Islamic dealings is the contract of التأمين التعاوني (co-operative insurance), which is founded on the basis of charity and cooperation.

Similarly is the case of re-insurance based on the principles of cooperative insurance. (The International Islamic Fiqh Academy, 2000).

Given this and other definitions mentioned above, *retakāful* can simply be defined as ‘*takāful* of *takāful*’. From an Islamic legal perspective, a contract of *retakāful* is basically a contract of *takāful*. Therefore, all doctrines that apply to *takāful* equally apply to *retakāful*. The only difference between the two lies in the nature of participants in *takāful* and *retakāful* operations. In *retakāful* operations, the participants are TOs, instead of individual participants or policyholders. Since the current practice of insurance business requires that a *takāful* ceding company cannot function without a *retakāful* facility there is a need for TOs to share their risks with RTOs. Furthermore, without *retakāful* implementation of the underlying principle of *al-tabarru*’ ((hereafter *tabarru*’) is restricted to the orbit of a single *takāful* pool being managed by a TO. However, through *retakāful*, a participant in one *takāful* pool in essence either helps or is being helped by other participants in the other *takāful* pools. This unique concept is absent in conventional reinsurance. The issues relating to proportional and non-proportional arrangements in *retakāful* contracts are discussed elaborately in section 6 of this study.

### 3.2 How Retakāful Works

As discussed above, the operation of *retakāful* is as good as the operation of *takāful* except for the nature of the participants in *takāful*. However, a closer look at how *retakāful* operates in practice is required before delving into the core issue of this paper. A *retakāful* works in the following way (Jamaldeen, 2012):

1. TOs shall contribute a portion of their funds as donations managed by an RTO.
2. Parties involved in the scheme namely TO and the RTO embark on the *retakāful* through signing the contract. The individual policyholders (participants) of the *takāful* products do not get involved directly in the *retakāful* contracts (even though the contributions in *retakāful* are paid using a portion of the *takāful* participants’ fund).



3. In the event of a deficit in the RTF, the RTO will provide an interest-free loan to cover the deficit. The loan amount must be paid in subsequent years or is deducted from any *retakāful* surplus in the RTF.
4. The contributions collected by the *retakāful* company from the TOs are invested in accordance with different Sharī'ah-compliant modes such as *al-wakālah* (hereafter *wakālah*), *al-muḍārabah* (hereafter *muḍārabah*), *al-wakālah-al-muḍārabah* hybrid or *al-waqf* (hereafter *waqf*) contracts. The profits to be accrued and fees to be charged are shared between the TCs and RTCs based on the underlying contracts. Table 1 presents a comparison between two key models namely *muḍārabah* and *wakālah* that are prevalent in the market.

### 3.3 Functions and Significance of Retakāful to the Takāful Industry

*Retakāful* is an alternative for reinsurance that complies with the underlying principles of the Sharī'ah, where risks are shared collectively and by participants' free will. It is the modern application of the concept of interdependence, which is evident in different texts of the fundamental sources of Sharī'ah. The Sharī'ah scholars not only allow the concept of *retakāful* but also encourage it while they do not permit some of the methods that are currently used in conventional reinsurance. The concept emerges from the system of *al-'aqilah*' under which the ancient Arab tribes mutually agreed that if a member of a tribe is killed inadvertently by a person of another tribe, the accuser's paternal relatives will make a mutual contribution for the purpose of paying the blood money to the victim's relatives. Islam approved this system as is evident from the Prophet's (pbuh) paying tribute to some of his companions who put forward a similar concept and practiced it in their life.

**Table (1). Comparison between *Muḍārabah* and *Wakālah Retakāful* Models.**

<i>Wakālah retakāful</i> Model	<i>Muḍārabah retakāful</i> Model
<i>Wakālah</i> concept is essentially an agent-principal relationship, where the participant acts as the principal while the operator acts as an agent on behalf of the participants.	<i>Muḍārabah</i> concept is a <i>rabb al-māl</i> (capital provider) – <i>al-muḍārib</i> (hereafter <i>muḍārib</i> ) relationship, where the participant acts as a capital provider, while the operator acts as an entrepreneur.
As a <i>wakīl bil-istithmār</i> (investor) the RTO is entrusted to invest a portion of the RTF in Sharī'ah-approved investment portfolios.	As <i>muḍārib</i> the RTO is entrusted to invest a portion of the RTF in Sharī'ah-approved investment portfolios.
The TF generated from <i>tabarru'</i> (participants' contributions) belongs to the participants.	The TF generated from <i>tabarru'</i> (participants' contributions) belongs to the participants.
The operator does not share in underwriting surplus (UWS). He gets a fee for services rendered at the outset of the contract for managing the RTF. This may include a performance fee as an incentive that is charged to the surplus, if any.	Proceeds are shared between the participants and the operator based on a pre-agreed proportion of investment profit or surplus of the TFs after deducting all costs and expenses related to the investment.
The ultimate investment and UWS are returnable in full to participants, but the operator takes a fixed fee, usually both directly from the base contributions and additionally from the individual participant's account.	The operator enjoys a (possibly different) share in both investment surplus and UWS from which real management expenses/operational costs are deducted.
Liability for losses is borne by the participants.	Liability for losses is borne by the participants.

Source: Compiled by Authors.

The similar notion of interdependence is also reflected in *al-nihd/al-nahd* (النهد) at a later period as reported by Imam Al-Bukhari in his *Sahih* that “Muslims did not see any harm in *nahd*”. The idea of this was that participants used to pool their travel expenses, for example, and then spent on their needs during their journey. This was also approved by Muslim predecessors and was put into practice. Albeit, this is not at the expense of a group of people who joined the deal while leaving out others in the same deal. These practices gradually evolved into a system of mutual help and financial assistance in a community, which the Prophet (pbuh) validated.

With regards to the compliance with the principles of Sharī'ah *retakāful* provides a platform for holistic adherence to the same from

end-to-end. For instance, from ethical and moral perspectives, stakeholders of Islamic financial institutions (IFIs) must ensure Sharī‘ah-compliance in every aspect of their transactions. By mitigating the losses through cooperation, *takāful* helps in fulfilling the objectives of Sharī‘ah by providing protection and relieving hardships. *Retakāful* serves the role to extend further the compliance-supply chain of the *takāful* industry. From a technical perspective, *retakāful* helps TOs in spreading and mitigating risk. Some of the benefits afforded to TOs are as follows:

### ***Provides additional underwriting capacity***

The larger spread provided by *retakāful* enables TOs to cover more risks thus generating more *tabarru‘* funds. Translated into financials, it enables TOs to continuously enlarge and strengthen their investment pools thus ensuring their long-term sustainability. It also enables both TOs and RTOs to create sub-pools with some sort of homogeneity. Examples would be sub-pools for Fire, Marine and Motor Takāful/Retakāful. This could further be cascaded down into specific classes. Operators have the flexibility to define “homogeneity”. Such flexibility is left to the good judgment of each operator and deemed necessary to serve each operator’s business plan and strategy and to protect the integrity of the RTFs they manage. For example, homogeneity can be based on territories, business sources, product lines or even specific group of clients. In the present scenario where RTFs of respective sub-classes are still small, it is not practical for RTOs to create sub-pools except for the two major portfolios of General and Family Retakāful. It points to the need for separation of accounts of these two portfolios. One advantage of having only a single pool for General Retakāful would allow cross-subsidization of one sub-class from another. This should have a smoothing effect and avoid volatility in the performance of the General RTF.

### ***Covers against catastrophic losses***

*Retakāful* takes out the fear of a potential crippling effect on TF and ultimately TO’s financial position on the ground that such losses will be shared by the co-participants. It encourages TOs to be more dynamic in their product development and marketing initiatives.

### ***Assures absorbing losses above the capability of the TO's pool***

*Retakāful* also enables entry into new markets which could be new territories, new segments, new product lines or any new business strategy such as joint ventures. Many uncertainties are associated with anything new which, from *takāful* perspective, are those associated with potential occurrence of losses. *Retakāful* provides the assurance of absorbing losses above the capability of the TO's pool.

### ***Provides value added services and expertise***

RTOs' experience in operating and writing business from diverse market environments equips them with good knowledge and resources that benefit TOs in improving operational efficiency.

### ***A cost-effective substitute for capital***

*Retakāful* could be considered a contingent asset and a cost-effective substitute for capital at times of making good of large losses suffered by a TO's pool.

It is worth noting that only risks as defined in the agreement between a TO and an RTO will be automatically covered subject to the terms and conditions agreed upon. The downside of giving a blanket cover to all type of risks underwritten by TO may endanger the stability of the RTFs especially when such risks are unprotected and excluded from the RTOs own retro-*takāful* program. Such exclusion should not be viewed as a stifling factor but as an incentive for TOs to focus on risks that they are good at (underwriting).

## **4. Differences between *Retakāful* and Reinsurance**

There are some fundamental differences between *retakāful* and reinsurance although technically both schemes undergo the same underwriting and risk assessment processes. The type of risk that a *retakāful* company has to cover underpinning the contract does not involve any unlawful and unethical businesses. Like *takāful*, RTCs have to have a distinct business model based on Islamic principles of brotherhood (*al-ukhuwwah*), cohesion (*al-taḍāmun*) and mutual assistance (*al-ta'awun*) utilizing the charitable contract of donation

(*tabarru'*) to a pool, not premiums; and this is what makes its business really mutual. Here are some key similarities and differences between the two:

- (1) In principle, reinsurance law derives from English law, or from the law of the respective country, whereas *retakāful* is based on the Sharī'ah, meaning that the *retakāful* contract between TO and the reinsurer/RTO, be obliged to conform to the principles of Sharī'ah. Although the question then may arise as to which jurisdiction does it fall under, especially if the reinsurer/RTO is based in another country.
- (2) Practically so far, contracts between TOs and reinsurers/RTOs are exactly the same as the conventional non-Sharī'ah compliant reinsurance contracts.
- (3) As far as the solid financial standing and technical advisory services are concerned, the RTOs themselves mostly resort to retro-*takāful* with leading conventional reinsurers.
- (4) Nevertheless, theoretically *retakāful* can be undertaken with a conventional reinsurer under the following conditions:
  - (a) In the event of insufficient *retakāful* capacity.
  - (b) The agreement should be of a temporary nature and lay down the challenge to TOs and RTOs alike to work toward for a swift resolution of these anomalies. Therefore, the agreement should be reviewed periodically.
  - (c) The contract between TO and the reinsurer should adhere to the principles of Sharī'ah.

Inward *retakāful* from insurers can only be accepted if it is conditional on outward *retakāful* subject to conditions (a) and (b). It is required for the very purpose of *takāful* and *retakāful*, i.e., mutual effort for mitigating the losses in ways conforming to Islamic Sharī'ah.

Some may think that there is no significant difference between *retakāful* and conventional reinsurance. Neither are people convinced if the concept of *retakāful* differs from that of conventional reinsurance and what category of *retakāful* adheres to the notion of Sharī'ah-compliance and as a result how the different ideas work. An interrelated question frequently arises as to how the theory of risk-sharing transforms to *retakāful* which is thought to be a replacement for conventional reinsurance and is based on risk-transfer. To address this question we refer to the *wakālah-waqf* model adopted by Swiss Re Takāful, Malaysia and accepted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the National Sharī'ah Advisory Council of Bank Negara Malaysia (BNM), and used by TOs in Pakistan, South Africa and the Middle East. Similar to a typical *retakāful* arrangement, in this model, participants act as TOs. The RTO collects contributions from the TOs to cover specific risks borne by the TOs. The RTO being an agent, administers RTF on behalf of the participant companies. The RTO invests contributions received in Sharī'ah-complaints products, and shares the profits and losses on investments with the TOs on *muḍārabah* basis. Any surpluses from the TF are also to be returned to the participant companies after taking into account reserves. Some remarkable efforts have been made by BNM and Malaysian Takāful Association (MTA) in order to craft an atmosphere of confidence, eliminate uncertainties, and widen the scope of *retakāful* for practitioners and reinsurance brokers, hence smoothing the progress of the conversion of conventional reinsurance to *retakāful*.

Table 2 presents the key dissimilarities between *retakāful* and reinsurance. In short, three main areas differentiating *retakāful* from conventional reinsurance operations can be stated as:

- (1) Separation of accounts of RTOs' Shareholders from the RTF,
- (2) Investment of both RTO Shareholders' Funds and the RTF in only Sharī'ah-compliant instruments and ventures, and
- (3) The need for a Sharī'ah reference authority within the RTOs' governance framework.

**Table (2). Difference between *retakāful* and reinsurance.**

<b><i>Retakāful</i></b>	<b>Reinsurance</b>
<i>Retakāful</i> contract between TO and the <i>retakāful</i> company must be based on the concept of cooperation and comply with the principles of Sharī'ah.	Laws and regulations are set by the respective regulatory authorities and jurisdictions.
<i>Retakāful</i> operations must conform to the principles that have been laid down in Sharī'ah, which include <i>inter alia</i> : (a) RTOs shall not provide any cover to conventional insurers; (b) RTOs shall accept Sharī'ah-compliant policies only; (c) RTOs shall not set up an individual fund for a single TO; (d) a <i>qard ḥasan</i> shall not be the contractual responsibility of the RTO; rather, the operator may provide the fund for <i>qard ḥasan</i> if the pool is in deficit; (e) RTOs shall not issue any surplus to individual participants if the fund is in deficit; (f) RTOs shall not have conventional retro-insurance cover in place unless it is required by the law of the land only up to the degree of the legal requirements; (g) RTOs shall not provide proceeds as commission for an individual treaty; and (h) RTOs shall not give a pre-determined percentage of surplus to an individual operator, but to the reserves and for the delivery to the participants.	Given that the elements of Sharī'ah-compliance are the main factors that distinguish <i>re-takāful</i> from conventional reinsurance, the latter would not necessarily need to conform to these and other principles of Sharī'ah that are specific to <i>retakāful</i> operation.
Acts for community well-being and optimizing operations for affordable risk protection.	Works with profit motive and as such acts for maximizing returns to shareholders.
All or part of underwriting surplus are retained and/or distributed to participants. Under Malaysian regulation, RTOs are allowed to have a share of the surplus. Any deficit in the RTF will be covered by RTO via the <i>qard ḥasan</i> mechanism. Payment of the <i>qard ḥasan</i> will be from future surpluses of the RTF.	Underwriting surplus/profit goes to the reinsurer's share-holders account, likewise deficits are expected to be made good by the shareholders.
TCs as participants/members of the RTF managed by the RTO share the defined risks incurred by any of them. In other words, RTF bears a part of TFs' risk on the principle of mutual help.	It transfers the risks to reinsurance company by way of paying premiums. Given that, an insurance company reduces its risk of paying large claims by insuring a portion of its risk with another reinsurer or reinsurance company through the process of reinsurance.
The donations collected by RTO as contributions from the TOs, that are available for investments, are to be invested in Sharī'ah-compliant instruments and ventures.	There is no restriction on the type of instruments and ventures a reinsurer could invest in.

<b><i>Retakāful</i></b>	<b>Reinsurance</b>
The ownership of RTF is retained by the participants collectively, and the fund is managed by the operator. Participants give up individual rights to gain collective rights over contributions and benefits. The RTO acts as an agent on behalf of the RTF to run the business activities and investing the inventories of the fund	The fund belongs to the reinsurance company since the contract is commutative in nature between policyholders and the reinsurance company. The reinsurance is a buy and sell contract wherein policies are sold to the policy-holders.
Dissolution: reserves and excess/surplus must be returned to participants, although consensus opinion prefers donation to charity on the ground that a <i>waqf</i> has to be perpetual in nature; and if company is dissolved, the surplus should better go to charity.	Dissolution: reserves and excess/surplus belong to the shareholders.
A <i>retakāful</i> company has to have its own Shari'ah Committee to oversee its Shari'ah-compliance and that the entire operation is Shari'ah-compliant.	Establishment of Shari'ah Committee, governance and audit, contracts used and the scope of underwriting is not needed for a reinsurance company.

**Source:** Adapted with modifications from Fisher & Taylor, 2000.

## 5. The Risk and Risk Transfer in *Retakāful*

### 5.1 Concept of Risk in the Context of *Takāful* and *Retakāful*

The notion of 'risk' has diverse meanings and implications from different dimensions in *retakāful*. From a legal perspective, the risk is the set of "circumstances" that are a dormant source of unwanted change or which entail the probability of detrimental change. When the risk becomes visible, it turns into a peril. In other words, whereas the risk is the chance of loss, the peril is the direct source of the loss. For example, if a property burns down, then fire is the peril. However, from a financial point of view risk is an exposure to loss of value in cash as per the agreement of trade or business. In the context of insurance/*takāful*, risk refers more to uncertainty than to probability of loss in a business. Further, risk or *al-damān* in a business has to be distinguished from *gharar*, sometime also termed as *al-mukhātarah*. The basic principle of Islamic contract law is that the owner of an asset has both its risk as well as reward, and one cannot get reward without bearing its commensurate liability or risk. While probabilities of risk in a business can be objectively measured, the measurement of uncertainty is almost impossible. The word 'uncertainty' distinguishes the defects of managerial lapses from the general business risk in an economic activity (Knight, 1921/2002: lix). It means that uncertainty relates to such



possibility of profit or loss in the business that is not under the control of the entrepreneur and that cannot be precisely predicted. Similarly, chance is more than human ignorance of causality which is “really” absolute. No perfect probability class can be known as such and every knowledge or choice situation involves some element of chance. Hence, “the contingency seems to be a prerequisite” (Knight, 2002: lix, lx, lxi, 199). Mainly such uncertainties and chances are covered in insurance and *takāful* contracts that invalidate the former ‘exchange’ contracts, but are acceptable in the latter ‘non-commutative’ contracts. Hence, for Sharī‘ah-compliance in letter and spirit, it is necessary that *takāful* and *retakāful* operations are conducted as non-commutative contracts for the participants so far as mutual indemnification of risks/losses is concerned.

## **5.2 Risk in Conventional Insurance Vis-a-Vis Types of Risks Shared in Retakāful**

In conventional insurance the term 'risk transfer' refers to the basic concept of the payment of a fee or premium by someone who is unable to bear a specific risk to an insurance company (the insurer) which is detailed in the insurance contract and the company agrees according to the contract to cover this risk. For example, a person wishing to procure home insurance, would need to pay the relevant premiums against the liability arising out of the risk involved in possessing a home taken by the company as the insurance coverage. In the event of any unforeseen loss or devastation, such as damage to the property from fire or natural disaster, the insurance company will be liable for compensation due to these end-results under the terms of the insurance policy.

*Retakāful* is actually a contract between two risk pools namely TF maintained by the TO and RTF maintained by the RTO. It mainly deals with high risk in terms of value and volatility. One of the key purposes of any *takāful* company to take out *retakāful* is to transfer a large part of the volatility within its portfolio to RTF and to leave them with more homogeneous and stable portfolios to manage. Hence, in *retakāful*, the concept of risk transfer or risk-sharing is distinctive. Here, a legitimate question may arise whether it is risk-transfer or risk-sharing. Typically, the *takāful* and *retakāful* both are risk-sharing operations (among the participants) although they look like risk-transfer instruments since their operators become liable for meeting the participants’ and shareholders’

claims underpinning the contracts and if there is any shortfall, they resort to ask them to provide an undertaking for rendering *qard ḥasan*, and/or adjust the pricing for fresh contracts or contracts to be renewed. In principle, the undertaking for *qard ḥasan* is a violation of the envisaged risk-sharing arrangement among the participants. In the event the amounts of *qard ḥasan* are sizeable, taking place repeatedly, and at times the participants are anticipated to leave the fund during its shortfall or insolvency (and as a consequence no surplus would remain for them), it could practically be named as a sort of *retakāful* involving ‘risk-transfer’ to the company.

In the light of the above discussions, it is pertinent to know what types of risks are meant when *retakāful* is said to share the risk. In conventional finance, these risks can be categorized into various kinds depending on the situations and practical needs such as credit risk, liquidity risk, market risk, operational risk, legal risk, and solvency risk, for the purpose of *takāful/retakāful* some contemporary scholars have attempted to classify the risk covering the participants’ claims only as ‘fundamental’, ‘allowable’ and ‘disallowable’. However, some scholars opine that the risk can either be classified as ‘pure’ (only the possibility of loss or no loss) mitigation of which is allowable or ‘speculative’ (the possibility of loss, profit or no change in value). These views do not necessarily limit the types of risk to be borne by the contracting parties from the Sharī‘ah point of view, except ‘speculative’ risk, since the Sharī‘ah has laid down a good foundation, as has been provided by the legal maxim: “a particular activity is permissible unless there is a clear prohibition against it”. Based on this premise, as a general principle, practices of financial transactions are originally permissible in Islam unless there is an evidence of some prohibited elements involved in such activities, which would then effectively change the original ruling. These scholars also view that transferring risk to any of the transacting parties is not permitted in Sharī‘ah. Practically, *retakāful* providers are legally responsible for meeting all the claims made by TOs underpinning the contract and in the event of shortfalls in the fund, they are obliged to call their shareholders for a *qard ḥasan*, and/or fine-tune the pricing for the fresh contract or the contract being renewed. If *retakāful* is not transferring the risk to the RTOs, the participants (TOs) would be responsible for shortfalls in the RTF. In that case, losses would directly have effects on all retained portfolios. As a principle, *retakāful*

operations have to be a mode of risk-sharing among participants. Accordingly, a suitable wording for documentation of the contract may be suggested as:

[...] The participant (TO)... agrees to help other Takāful Operators that contribute towards the Retakāful Fund for mutual indemnification in the event of loss or damage as per terms of this agreement.

### **5.3 Risk Transferring in Conventional Reinsurance**

The facility to reinsure enhances the fundamental aim of insurance, which is spreading the risk using the law of large numbers so that no single person finds itself with a burden beyond its ability. Reinsurers may also possess added skills and potential diversification benefits. In other words, risk is dispersed in reinsurance to a broader area and protects the fund of the original insurer. This practice provides policy holders some added security as they will not be affected if the reinsurer is in deficit. The benefit of reinsurance is that it facilitates broadening the scope of risk between a large numbers of insurers. All reinsurance mechanisms must inherently transfer insurance risk to the reinsurer in order to provide underwriting benefits to the cedant, and as such it is necessary that (a) the reinsurer deduces significant insurance risk under the reinsured portions of the original insurance contracts; and (b) it is possible that the reinsurer may suffer a considerable loss from the transaction.

Reinsurance as a method of reducing risk has the following features:

- restricts liability on particular risks, permitting the direct insurer to take on a larger risk or a greater range of risks
- alleviates a business level to large swings in loss experiences
- shields against losses that may occur due to natural disaster
- escalates the direct insurer's ability to provide cover, without the need for further capital.

## 6. Sharī'ah Related Issues: Risk Transfer and *Retakāful* Commission

The issue of risk transfer that we are investigating in the present study indirectly refers also to a few other related issues like indemnification (*al-kafālah*) in the *tabarru'*-based framework of *takāful/retakāful*, and undertaking for providing *qard hasan* in the case of underwriting deficits (UWD) to the TF/RTF and payment of *retakāful* commission to the TO's Risk Fund. These Sharī'ah related issues have to be investigated separately for the theory or the conceptual bases of *retakāful* and the practice of the RTOs as of now. In practice, there are some issues in the way the risk pool are constituted by the RTOs. Creating separate pools for each participating TO or for different countries/jurisdictions, as some RTOs are presently doing may render the system a tool for risk transfer to the company. Hence, it has to be avoided, and regulators may phase out the practice as early as possible. While extreme care is needed for application of the principle of *al-darurah* and in respect of various principles and conceptual foundations, some relaxations may be granted with regard to application for specified time in such a way that the Sharī'ah tenets are observed at least in letter.

Before discussing the specific Sharī'ah related issues as indicated above, it is imperative to keep in view the following salient features of the *takāful* and *retakāful* system:

- a) The *raison d'etre*: Sharī'ah compliance is the *raison d'etre* and the key element of *takāful* to serve as an alternative to the insurance system; if Sharī'ah compliance is not taken care of, there is no need for any new/separate system.
- b) A System based on mutual help: *takāful/retakāful* refers to a *tabarru'*-based contract among the participants in *takāful* and among the participating TCs in *retakāful*;
- c) Risk remains with the ownership: A fundamental principle of Islamic law of contract is that the owner of an asset has both risk as well as reward pertaining to that asset; ownership cannot be separated from the risk of the related loss; risk can be managed/mitigated, but not transferred without transfer of the relevant asset. Conventional insurance is a means to transfer the risks and losses relating to life and ownerships from the

policyholders to the insurance companies, and this is the root cause of the prohibition of insurance and reinsurance in the Sharī'ah.

- d) Condition for valid income/return on the pools' funds: All investments from the shareholders' funds and the policyholders' funds, TFs and RTF have to be in Sharī'ah compliant instruments and projects;
- e) Parties in *takāful* and *retakāful* contracts: A *tabarru'*-based contract takes place between the TF and RTF on the basis of which a contribution is made by the former to the latter; both TO and the RTO act on behalf of their respective funds. TF and the RTF are the 'common underwriting fund' or the mutual risk pools from which losses' claims lodged by the respective participants are to be paid;
- f) TOs/RTOs as risk managers not risk takers: In *takāful*, the TCs, rather than bearing the risk only manage the risk fund on behalf of the participants for which they are entitled to get fees/management charges. The TOs or the RTOs are not exposed to underwriting risk and as such risk is borne by the TF and the RTF. As such, companies neither take underwriting risk nor retain obligation to pay claims. The participants bear the risks jointly and own UWS or UWL to the TF;
- g) Clarity/disclosure needed on management fees: the amount of the management fee for the RTO or the percentage of contribution as fee has to be agreed at the beginning of the contract between the TOs and the RTO;
- h) *Takāful* - a holistic system of mutual care: While *takāful* is an institution of social help and solidarity to mitigate the impact of losses, *retakāful* is a means to widen this spectrum and the means of mutual indemnification by combining the participant *takāful* TOs. A participant in one *takāful* pool helps or is helped by the participants in other *takāful* pools based on the concept of *kafil al-kafil* as established in the Hanafī *fiqh* (*Majallah* No: 627-657 & 857-858).

## 6.1 Issue of Risk-transfer and Risk-sharing

The issue in the system of *takāful* is not of risk-sharing or risk transferring *perse* – the basis and the parties involved are to be considered. If risk in *takāful* or *retakāful* is transferred to TCs or RTCs, it will invoke prohibition as in the case of conventional insurance. However, TF can transfer some risk to RTF on the basis of *al-tabarru'*, and it is acceptable as per Sharī'ah law. TO, as manager of the TF, shifts for the purpose of *retakāful* a part of the liability of the TF to the RTF. As regards the risks, whereas in *takāful* the participants, who make donations to the *takāful* pool, share the risks jointly; in *retakāful*, risk is spread from one pool to others on the basis of *al-tabarru'* – risk is spread to a *retakāful* pool to be borne jointly by the participant TOs. Hence, the risk is shared by the two types of pools for mutual help and mitigation of losses. For Sharī'ah-compliance, therefore, no part of the risk can be shifted or transferred to the RTO, who manages the companies, but it can be transferred to the RTF.

Shifting a part of the risk from the TF to the RTF reduces the possibility of the TF experiencing deficits requiring the TO to offer *qardḥasan*. In case a TF faces UWD, TO (company's shareholders) is responsible to extend *qardḥasan* to the TF; the RTO has no obligation to support a deficit of the 'original *takāful* pool' via a *qardḥasan* facility. However, RTO is obliged to grant *qardḥasan* if the RTF experiences a deficit, and in that case TO cannot be called upon to grant a *qardḥasan* to the RTF. *Qardḥasan* provision is crucial as TOs and the RTOs have to maintain solvency of the respective portfolio(s) as per business practice. Hence, *retakāful* is ultimately a means to strengthen and protect the *takāful* system through shareholders' undertaking for providing *qardḥasan* in case RTF experiences UWD.

Another question sometime raised pertains to the validity of 'indemnification' or *kafālah* in *tabarru'*-based contracts like that of *takāful* or *retakāful*. The argument given by those who express Sharī'ah-related concern in this regard is that as *takāful* is a non-commutative contract (*'uqūd ghair mu'āwadah*) for mutual help among members of a group, it should not mean indemnification or guarantee which is the feature of conventional insurance. In the *muḍārabah* model of *takāful*, the argument of *kafālah* does not work at all as none of the two partners

in *muḍārabah* (*rabb al-mal* and *muḍārib*) can be a guarantor to the other even in the *wakālah* model. The main principle is that a *wakīl* is simply *al-amīn* or trustworthy and cannot be held liable to bear the loss that happens without negligence on his part. However, the possibility of providing guarantee by the *wakīl* (TO/RTO) on its own will have to be analyzed. Authors of this study are of the view that as *kafālah* is a non-commutative contract, indemnification can be provided free of any charge for guarantee *per se* in *takāful* and *retakāful*. It means that TOs and the RTOs, on behalf of the TFs and the RTFs respectively, can guarantee to the respective participants that in case of any defined loss to any of them, the respective fund will indemnify the losses. However, the Sharī'ah scholars, particularly Sharī'ah Boards of standard-setter organizations like AAOIFI and IFSB and that of regulators like BNM, the State Bank of Pakistan (SBP) may consider the issue keeping in view the Sharī'ah maxim, “*al-‘ujrah wal ḍaman la tajtami‘ān*” (a fee or rent for any service and liability/guarantee for loss cannot be combined) and advise the industry accordingly. For example, in *ijārah*, lessees who have to pay rent cannot be held liable for any loss to the leased asset (except in the event of proved negligence); and in *muḍārabah*, the *muḍārib* cannot provide a guarantee for the capital or the profit and the business loss has to be borne by the *rabb al-māl* or the capital provider. The *Retakāful* system has to be operated on the basis of risk-sharing through the *retakāful* pool consisting of risks brought from the member *takāful* pools and managed by the member TOs. Hence, the RTO has to manage risks pertaining to different classes of business and the *takāful* funds (TFs). As the RTO is obliged to maintain solvency of the whole portfolio or of each individual portfolio, it has to grant *qarḍ ḥasan*. It has repercussions for the shareholders' capital. As a result of this the RTO is indirectly exposed to underlying risks assumed by the RTF. The RTO also faces the operational risk with regard to taking the on-going business. Hence, it needs to determine capital requirement on the basis of comprehensive assessment of risk also including the obligation of *qarḍ ḥasan* facility. RTOs, therefore, may also need to spread the underwriting risk to “Retrotakāful Risk Fund” based on the principles applicable for *retakāful*.

This leads to some questions relating to categories of *retakāful* pools and related practical issues – should there be a single pool for all businesses or different pools be created keeping in view the nature and

class of businesses, efficiency of the TOs, geographical distribution or the model of *retakāful* adopted. In this regard, experts are of the view that though a single pool may provide the benefit of cross-subsidization among classes of business or types of *retakāful*, it may be an “unfair proposition” as good quality risk may be subsidizing the sub-standard risks. Therefore, the *retakāful* portfolio can be split on the basis of business classes like property RTF, a casualty RTF, an engineering RTF and so on. It refers to a practical issue as the provision of *qard ḥasan* may ultimately undermine the real spirit of the *tabarru* ‘-based *takāful* or *retakāful* contract. As indicated above, RTOs sometimes form separate pools for each participating TO or for different countries/jurisdictions, which, although apparently Sharī‘ah-compliant (as declared by their Sharī‘ah advisors), undermines the real spirit of the Sharī‘ah by providing *qard ḥasan* in case of UWD and keeping unnecessary reserves in case of UWS, without proper disclosure (risk pools have to be based on business category and not on TO basis). Such relaxation might be given under specified regulatory regimes till there is a sufficient number of RTOs working under any fool-proof regulatory structure. This could be allowed by applying principle of *al-darurah* (the doctrine of necessity), which unanimously renders the prohibited things temporarily permissible. This constitutes an established Islamic legal maxim that states “the necessities justify the forbidden”. The underlying objective is to facilitate the development of the emerging system in a competitive environment. There are many instances of use. One major usage relates to the tolerance level allowed for ratio-based Sharī‘ah screening, stating a tolerance level, not reflecting full Sharī‘ah-compliance (El-Gamal, 2006). With regards to the issue whether the doctrine of necessity is relevant to the matter mentioned as above, the bottom line is that what has been made forbidden for an essential reason within the transaction can only be made permissible for cases where *extreme necessity* is involved. In this regard, Ibn `Ashur elaborates:

[...] *Al-daruriyyāt* refer to basic necessities that must be satisfied for a certain community, collectively or individually. If *al-daruriyyat* have not been fulfilled, the social system of such community will be malfunctioning.” (Ibn `Ashur, 2001).



The relevant rules will also differ in the case of different structure – mutual or proprietary. In principle, however, the more suitable structure for *takāful/retakāful* may have two layers: mutually cooperative structure for the participants in *takāful* and TOs in *retakāful*, and a proprietary structure for Sharī‘ah-compliant management of the company.

Here the question may arise as to whether Sharī‘ah allows TOs’ dealings with conventional reinsurers using the notion of *ḍarurah* as far as the relevant risks are concerned. To respond to this Sharī‘ah issue, it is to be mentioned that initially, due to the acute shortage of *retakāful* insurers and insufficient reinsurance capacity of RTOs in the market Sharī‘ah scholars allowed existing TOs to cede primary *takāful* premiums to conventional reinsurers based on the doctrine of necessity. However, this concession was offered for a temporary period and is no longer valid since the required numbers of RTCs are now available in the market. Moreover, the use of *retakāful* by TOs enables them to practice *takāful* on higher than insurance levels on which RTCs carry out their work and as such the quality of *retakāful* capacity has been increasing.

An issue emerging from *ḍamān* is that *qard ḥasan* has emerged as an organized mechanism driven mainly as a regulatory requirement for the *takāful* industry. As *takāful* is based on the concept of *tabarru‘* and mutual help for mitigation of losses to co-members, *qard ḥasan* provision should not have been a part and parcel as it has become in practice. It reverts ultimately to the capitalistic approach that risk to capital/investments must be avoided some way or the other. However, the need for avoiding bankruptcy generates the need for granting *qard ḥasan* in case of pool deficits. Hence, it is suggested sometime that regulators or the social welfare department of any state may form such pools funded by industry participants, or the welfare budget, from which actual losses to the pools may be paid (Khan, 2013). This implies an extended concept of *takāful* and mutual help in any society. However, in addition to the fact that implementation of this idea might be cumbersome; there could be some Sharī‘ah reservations in this arrangement as well.

Another point is: should *qard ḥasan* be based on actual deficits (available funds being less than claim amounts) or based on technical

deficits (where reserves are created based on actuarial estimation that includes outstanding claims and claims that may have happened but yet to be made known to TO/RTO?). *Qard ḥasan* is a unique concept practiced by the *takāful/retakāful* industry. It is an organized mechanism driven by practicality or by regulatory requirement or both. *Takāful* in this concept is like mutual insurance whereby participants of a pool (TF/RTF) are supposed to pay additional contribution in instances of insufficient funds to meet claim obligations. In view of the large number of participants, some of whom may be domiciled in different jurisdictions, collecting from each participant is not practical. To overcome this shortcoming, TO/RTO decides to extend *qard ḥasan* (at its own will or by regulation) to the RTF to cover the deficit. The task is to establish the point when *qard ḥasan* is to be activated. Should it be based on actual deficits or based on technical deficits? Technical deficits contain many guesstimates and uncertainties with regard to the claim amount. An element of *gharar* is very apparent here. As regards actual deficit, the amount of shortfall is definite and known. From the pure *takāful* perspective, *qard ḥasan*, therefore, should only be granted based on the actual deficit. This amount will be recovered by the TO/RTO when the TF/RTF is in surplus. There should not be impairment as under Sharī'ah all loans need to be paid irrespective of time. Impairment implies that RTO is bearing part or whole of the risks (in the pool). In other words, the risks which should have been borne by the pool participants are being transferred to the TO/RTO. While *qard ḥasan* may be a practical solution, the methodology of its implementation and treatment could, however, undermine Sharī'ah principles in a risk-sharing *takāful* contract.

## 6.2 The Issue of Retakāful Commission

Although the issue of *retakāful* commission that RTO pays to the TOs does not have a direct relationship with the core issue of risk transfer in *retakāful* we have examined this due to the fact that the existence of reinsurance commission is considered a salient feature of proportional reinsurance. Given that, the issue will not cover examples of market practice in detail. It is sometimes argued that when this method of paying commission to the TOs by RTO is adopted in *retakāful* to form proportional *retakāful* contract, it becomes non-Sharī'ah compliant. The reinsurer receives a share of the premiums which includes the pure risk

premium, acquisition costs and overheads incurred by the insurer. The whole amount of the premium is not available to pay claims or for investment. Some part of it is spent on business acquisition, staff salaries, operational expenses, and other fixed costs. The reinsurer returns a certain portion of the premium to the ceding company by way of reinsurance commission as compensation for expenses incurred. Thus, it is a reimbursement of the cost incurred by the insurance company in procuring the business in the proportion of the premium ceded, and to make some contribution toward expenses for servicing the business.

The TO does incur the same cost for business acquisition on behalf of the 'TF' as the conventional insurer. Therefore, when a part of risk is ceded to the *retakāful* pool on a gross contribution basis under proportional *retakāful*, all-inclusive direct contributions including the pure risk contribution, acquisition costs, and overheads are passed on to the *retakāful* pool. As such, some practitioners are of the view that as all amounts of the premiums are not available to pay claims, some part of it is not the basis of UWS; and so RTO can validly reimburse some part to the TOs. It is further argued that:

[...] to be fair to both parties, the *Retakāful* pool must return its proportional share on acquisition costs and internal overheads incurred by *Takāful* operator. .... Under this scenario, *retakāful* commission has nothing against the Sharī'ah principles. In fact, its existence is important to ensure the fairness between *takāful* pool and *retakāful* pool. Sharī'ah principle will be violated, however, if the *Retakāful* commission is refunded to *takāful* operator shareholder account, instead of *takāful* pool. *Takāful* operator is entitled to receive it since these expenses which *retakāful* commission reimbursed for are incurred by *takāful* pool, not *takāful* operator (Dalil Khairat, 2013).

As a rationale for the above view, it is argued that *retakāful* pool requires more funds or resources for portfolios of low quality or high volatility. Consequently, to allow this portfolio to be ceded into the *retakāful* pool, it needs to contribute more than other cedant portfolios which are relatively of better quality. This is actually a fair solution. The level of risk is determined by the level of volatility. More volatile a portfolio, the riskier it is. Hence, its charge should be higher.

However, the point to be pondered here is whether the reinsurance commission is among the factors that determine the quantum of UWS or UWL? In case of the insurance system, *prima facie* it plays a role in determining the quantum of UWS/UWL as reinsurance commission is determined by factors like the loss cost, actual acquisition cost incurred, profitability, investment income prospects, original pricing and the impact of competition in the market.

## 7. Summary and Conclusions

In the foregoing sections, an attempt has been made to examine the Sharī‘ah issues related to *retakāful*. The paper analyzes whether in *retakāful* the risks are genuinely shared by participating TOs/*retakāful* fund (RTF) or just transferred to *retakāful* operators (RTOs). We continue also to examine if *retakāful* is transferring risks to the RTOs and whether participants are liable for deficits where losses directly adversely affect all retained portfolios.

The paper concludes that in *retakāful*, a *tabarru‘*-based contract takes place between the *takāful* fund (TF) and the *retakāful* fund (RTF) on the basis of which the TF and the RTF serve as the ‘common underwriting fund’ or the mutual risk pools from which claims lodged by the respective participants are paid while both TO and the RTO act on behalf of their respective funds. Developments in the *takāful* industry, since its inception, have focused on the retail sector. Not much thought has been given to the upstream wholesale *retakāful* and retro-*takāful* sectors. In fact, regulations and rulings applied to TOs were applied to RTOs without taking into account the functional differences between the two sectors, their stakeholders, distinct products, service offerings, etc. Furthermore, the norms and practices of conventional reinsurance were emulated almost on a “lock, stock and barrel” basis by the fledgling *retakāful* industry. With loose supervision (Sharī‘ah and operational) and guidance from respective authorities, the practices are allowed to continue till today.

The findings of the research can be summarized in the following points:

- With regard to Sharī‘ah-compliance pertaining to the issue that no part of the risk can be shifted or transferred to the RTO who manages the companies, but it can be transferred to the *retakāful* Fund (RTF) which becomes *waqf* once the contributions by any of the parties or the participants are earmarked to it. The *Retakāful* system has to be operated on the basis of risk-sharing through the *retakāful* pool consisting of risks brought from the member *takāful* pools managed by the member TOs. While *takāful* is an institution of social help and solidarity to mitigate the impact of losses, *retakāful* is a means to widen this spectrum and the means of mutual indemnification by combining the participant TOs. Risk is spread from *takāful* pools to the *retakāful* pool, on the basis of *tabarru’* and mutual help, to be borne jointly by the participant TOs. If the risk in *takāful* or *retakāful* is transferred to TCs or RTCs, it will invoke prohibition as in the case of conventional insurance.

- *Qard ḥasan* provision is crucial in the system as TOs and the RTOs have to maintain solvency of the respective portfolio(s) as per business practice. However, it may undermine the real spirit of the system based on the principle of mutual solidarity among participants. However, the need to avoid deficits generates the need for granting *qard ḥasan* in case of pools deficits. As the RTO is obliged to maintain portfolios, it has to grant *qard ḥasan*. By way of *retakāful*, shifting a part of the risk from the TF to the RTF reduces the possibility of the TF experiencing deficits requiring the TO to offer *qard ḥasan* as a trustee. Hence, *retakāful* is ultimately a means to strengthen and protect the *takāful* system through shareholders’ undertaking to provide *qard ḥasan* in case RTF experiences UWD.

- *Retakāful* commission in proportional *retakāful* is a reimbursement of the cost incurred by the TO in procuring the business in proportion to the contribution ceded, and to make some payment towards expenses for servicing the business. Hence, these commissions are considered valid by the practitioners. However, consent needs to be taken at the inception of the contract from participant TOs for taking *retakāful* cover (if needed). Further, it has to be decided jointly by Sharī‘ah scholars and practitioners

whether the *retakāful* commission is among the factors that determine the quantum of UWS or UWL?

- As *kafālah* is a non-commutative contract, indemnification can be provided free of any charge for guarantees *per se* in *takāful* and *retakāful* meaning that TOs and the RTOs, on behalf of the TFs and the RTFs respectively, can provide guarantees to the respective participants that in case of any defined loss to any of them, the respective fund will indemnify the losses. The operators have the right to get a fee for managing the *takāful* pools and investment activities on behalf of the participants.

- RTOs may be discouraged to constitute separate risk pools for each participating TO or for different countries/jurisdictions, which are apparently Sharī'ah-compliant, but this undermines the real spirit of Sharī'ah-based risk principles, by providing *qard ḥasan* in the case of UWD and keeping unnecessary reserves in case of UWS, without proper disclosure. The regulators may like to introduce a phased plan aiming ultimately to constitute the risk pools only on the basis of the category of the business and the nature of the risks involved. They also need to encourage increasing number of RTOs to enter into contracts to the maximum possible extent.

## 8. Suggestions for Further Research

This paper proposes further research on two specific issues in relation to the non-proportional transaction.

- the disparity between contribution and claims (in a non-proportional treaty arrangement) is considered “an excess” or “an addition” which some sectors believe could have *ribawi* implications. Although being a non-commutative contract, it seems to be acceptable;

- whether the “risk of financial loss” which is intangible in nature can be a subject matter in an exchange contract.

Another area of research is financial [or performance] guarantees in *takāful* products. For instance, Performance Guarantee *takāful* which is similar to conventional Performance Bond Insurance and Advance Payment Guarantee *Takāful* which is a *takāful* provided by the contractor

that guarantees that he will settle the advanced cash paid by the owner of the contract. Many quarters are questioning the validity of both of these products.

Going forward, *retakāful* may have to look into innovations in developing alternative products which have been proven to benefit the conventional reinsurance sector in further spreading the catastrophic losses to a wider group of risk-carriers. For example, *sukuk retakāful* (Catastrophe Bonds), *retakāful* sidecars, captive RTCs, etc. The underlying principles of these products are not built on *tabarru'* and *ta'āwun* concepts. Nevertheless they fall under the risk management sector where *takāful* and *retakāful* reside.

As mentioned at the outset, not many thoughts were given to *retakāful*, and issues related to its practices. Thus the concept of *taawun* and *tabarru'* might not have been rigorously deliberated by Sharī'ah scholars. Some practitioners, may for commercial reasons, prefer to side-step these issues. Therefore, Sharī'ah experts are urged to revisit and review the relevant issues and arrive at resolutions that could be adopted by the industry. This is vital for the developments in *takāful* and *retakāful* going forward.

The non-proportional treaty transaction and a few other *takāful* and *retakāful* products being offered and sold by TOs and RTOs have been disguised as risk-sharing mechanisms. It is time for the Sharī'ah fraternity in collaboration with industry practitioners to review, adapt and recognize them in their true and proper identities (such as risk-sharing, risk-transfer and sale-and-purchase contract). Such recognition would improve the clarity and transparency aspects of every transaction in *takāful/retakāful* which could further enhance their effectiveness and efficiency in their role as risk management tools of the Islamic finance industry.

The future growth and development of the *takāful* industry as a viable commercial venture requires strong support by the *retakāful* sector and methodical guidance by regulators. Without such support, the industry would not be able to develop as a significant and effective component of the Islamic finance value chain. In this respect, it is suggested that regulators encourage more RTOs within the region and

put their utmost efforts to encourage them to accept business from TOs without limiting their activities..

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## المشاركة ونقل المخاطرة في إعادة التأمين التقليدي والإسلامي: دراسة نقدية

أبو عمر فاروق أحمد وإسماعيل بن محبوب ومحمد أيوب

المستخلص: تُقدم الدراسة تحليلاً نقدياً للمخاطر في عملية إعادة التكافل سواء كانت مشتركة بين المؤسسات المشاركة في التكافل، وصندوق إعادة التكافل، أو يتم تحويلها إلى شركات إعادة التكافل؛ حيث تصبح هذه الشركات مسؤولة عن العجز وحيث أن الخسائر، إن وجدت، من شأنها أن تؤثر بشكل مباشر على جميع المحافظ الاستثمارية المحتجزة. تخلص الدراسة إلى أنه تمشيًا مع أهداف عمليات إعادة التكافل التي تسمح لمؤسسات إعادة التكافل بالتقليل أو التخفيف من الأثر المالي على صندوق التكافل الخاص بكل واحد منها الناشئة عن الخسائر الكارثية؛ لا يزال هناك تباين بين النظرية والممارسة الحالية لتقاسم المخاطر في صناعة إعادة التكافل؛ حيث الشركات في هذا القطاع تُدير صندوق التكافل نيابة عن المشاركين فيها.

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