

REVISITING AND REDEFINING THE CONCEPT OF RETAKAFUL AND THE VIABILITY OF ITS MODEL IN MALAYSIAN TAKAFUL INDUSTRY

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ABSTRACT

This paper aims to explore the concept of retakaful or Islamic reinsurance in Malaysia in the light of a dynamic development of the takaful and retakaful industry which is gaining its momentum all around the world especially in the Islamic countries. The first part of this paper would concentrate on the basic shari'ah principles which govern the transaction of retakaful and explanation on the importance of retakaful as a fardhu kifayah in Malaysia. The second part would deal with the basic mechanism, basis and methods of retakaful available which are similar to the one in conventional reinsurance. The last part of this paper would be focusing on the issue of choosing the most viable operating models that conforms to the shariah principles and the arguments on a few issues relating to the operational models based on a different school of thoughts within the circle of Islamic scholars.

Keywords: Retakaful, reinsurance, shariah, Malaysian takaful industry

INTRODUCTION

Reinsurance based on Islamic principles is known as retakaful. Retakaful functions the same way as the conventional reinsurance as the primary risk mitigating tools for the takaful operators. Basically, retakaful demand is motivated by factors associated with the demand for traditional reinsurance such as the need to balance the portfolios of the takaful operators, the attainment of homogeneity risks, avoiding unnecessary exposures on their portfolio and strengthening of capital for regulatory purpose. Reinsurance in the form of a legally reinsurance contract between two parties serves as a quasi perfect risk management tools for insurers, since reinsurers exist in the secondary insurance market with a direct function to accept cessation of risks from a treaty. Reinsurers are regulated and legally registered not as a primary underwriting insurer which prohibited them from underwriting direct business from the primary insurance market (Malaysian Insurance Act, 1996). Retakaful serves the same purpose as a primary risk mitigating tool for takaful operators but retakaful in a true sense is not a risk sharing method since retakaful operator acts as a risk manager and not a risk taker as in conventional reinsurance. Retakaful operators play a direct and close connection with the takaful operators and the success and viability of the retakaful market totally depend on the viability of the takaful market so it is best thought that retakaful serves as a "takaful for takaful operators" (Maasum, 2007). In principle, retakaful operators are similar in its operational aspects with the takaful operators with both are adhesively sticky to the Shariah principles and the only difference lies on the participants in which participants in retakaful operations are the takaful operators and not individual policyholders (Asmak, 2009). The operational aspect of retakaful is uniquely related to its operational model adopted and these operational models must be Shariah compliant and the most familiar three are the pure wakalah, modified wakalah and mudharabah models. Bank Negara Malaysia (2007) in its guideline for new retakaful applicants and major licensing criteria has outlined the importance and viability of model selected which must be suitable for the Malaysian market within a five year operational period. The models adopted by several retakaful operators and its competitiveness in Malaysia are the highlight of this research

A limited number of literatures exist on retakaful practice in Malaysia with a few discussion are focused on the issue of validity of retakaful in accordance with the Shariah principles (Asmak, 2009) and the development of fiqh aulawiyat in risk management aspect of retakaful operation (Azman, 2008). The objectives of this conceptual paper are:

1. To provide a comprehensive analysis and overview on the importance of retakaful as a substitute for conventional reinsurance and the models adopted by retakaful operators in Malaysia.

2. To highlight several issues pertaining to these retakaful models and its future acceptance and challenges in Malaysian Takaful industry.

Retakaful as a Fardhu Kifayah

Retakaful or conventional reinsurance basically involves two parties to its contract whereby the takaful operator or referred to as a ceding company under conventional reinsurance, aims to limit itself from the burden undertaken from assuming portion of the risk insured. The other party to a retakaful contract is known as retakaful operator where its function is to assume portion of the risk transferred by the takaful operator. Basically a retakaful contract resembles one in the obligation assumed under a legal reinsurance contract between a reinsurer and a direct insurance company. Maasum (2007) dictates the main objectives of retakaful into three. The first objective is to safeguard the operators against the possibility of insolvency and to engage the operators in sharai'ah compliant investment. Second objective is to provide adaptable underwriting practice for the operators and the last objective, to prohibit interest in the reserves of retakaful fund. Those three objectives clearly show that even conventional reinsurance and retakaful share the same functions but the objectives have put both the risk mitigating tools into a different set of games and aims altogether.

Muslim scholars have in the past, emphasized on the need for takaful operators to engage retakaful operators as a mean to transfer risk based on the argument of prohibited elements such as interest (riba), uncertainty (gharar) and gambling (maysir), which are all common in the operation of conventional reinsurance. Islamic Fiqh Academy in their resolution in the year 1985 (as cited in Maasum, 2007) rules the operational aspects of conventional reinsurers are not shariah compliant and therefore is strictly prohibited (haram). During this meeting of scholars, they had decided that a proper set up of takaful or retakaful operation must be advised by a permanent shariah advisory board, an investment strategy which complies with the sharai'ah and operating models that in accordance with the shariah concepts (Benbouzid, 2005). With this resolution, questions now have been raised on the importance of retakaful for takaful operators and can retakaful provide the same amount of underwriting capacity as provided by the conventional reinsurers? What is the most viable operating model available which resembles the conventional model but at the same time shariah compliant? Retakaful is known to be sharai'ah compliant since it is free from the element of interest, uncertainty and maysir but how conventional reinsurance practices are equated with the three prohibited elements? Riba is mentioned in the Quran surah an-Nisa as taking from other's wealth in an unfair manner.

"And (for) their taking of usury while they had forbidden from it and their consuming of the people's wealth unjustly. And we have prepared for the disbelievers among them a painful punishment" (An-Nisa (4:161))

The practice of riba under conventional reinsurance is mirrored in the commission scheme of a treaty made between a cedant and a reinsurer. Three types of schemes commonly used under a proportional treaty are the flat rate, profit and the sliding scale commission. Flat rate and profit commission schemes function to repay back a portion of acquisition costs and management expenses incurred by the cedant and the rate of commission is very much determined by the profit made by the reinsurer. It is questionable as the ceded premiums being invested by the reinsurer in financial instruments that may contain elements of interest or riba. Retakaful operation, in contrast does not depend on the expenses incurred by the takaful operators.

Gharar and Maysir on the other hand, relate with the element of uncertainty and gambling whereby in Islam the element of ambiguities must be eliminated in a contract of selling items whose existence and descriptions are not conformed and this equates the trade as being similar to the activity of gambling. Gharar exist in the contract of trading risk where there is asymmetric of information which leads to deception (El Gamal, 2001). In a conventional reinsurance treaty, the reinsurer will gain profit from the premium ceded whereas the cedant may not obtain any profit at all if no claim is made throughout the treaty period. Since reinsurance itself cannot be considered as an object of sale, the treaty made is considered not valid with the existence of gharar which is prohibited (Zuhayli, 1997) Taking the cue from Zuhayli (1997) argument on the issue of gharar on commercial insurance where he suggested an alternative in the form of cooperative insurance which eliminates gharar, the operation of retakaful is in fact a

cooperative reinsurance pool in which case all the takaful operators will contribute in a pool of fund and legitimate claims are then made from the fund and eventually all unclaimed profits are then shared with all the takaful operators. The discussion on the importance of retakaful as a compulsory alternative to the conventional reinsurance and hence a fardhu kifayah or an obligation that must be fulfilled by Muslims in a particular country for the development of ummah in that country must be discussed in the context of *al-darurah* (Asmak, 2009) and *fiqh aulawiyat* (Azman, 2008). In Islam, the permission of doing something which is not originally allowed in a situation of *darurah* is clearly stated in the Quran:

“He hath only forbidden you dead meat and blood, and the flesh of swine and that on which any other name hath been invoked besides that of God. But if one is forced by necessity without willful disobedience nor transgressing due to limits then is he guiltless. For God is Oft-forgiving most merciful” (al-Baqarah: 173)

The verse from surah al-baqarah above has been explained or interpreted by some Muslim scholars and jurists into several meanings. A scholar suggests that during *darurah*, Allah allows Muslims to take non halal foods if there is no halal food available in that situation. Others opinions include that Muslims in the above critical situation of *darurah* must wait at least one day and one night to end before they can consume non halal foods (Asmak, 2009) The principle of *al-darurah tubih al-mahzurat* gives an exemption to Muslims in a situation of *darurah* to do something even the act of doing it is originally prohibited and in the context of using conventional reinsurance, if no retakaful operator available in that country, the shariah allows takaful operators to engage the service of conventional reinsurers but Asmak (2009) argues that this allowance can only be made with the principle of *ma ubiha li al-darurah yataqaddaru biqadariha* which means the act of doing something prohibited even allowed by the jurist must not be excessive when it comes to *darurah*.

A further exciting argument on the problems or dilemmas faced by the takaful operators in engaging retakaful operators as a method of sharing risks is noted in issue of rated retakaful operator. Rating practices in the reinsurance industry in particular is considered paramount important and it is the best method applies by the regulators in ensuring the solvency of the reinsurers. Prospective investors, stakeholders and cedants in the case of conventional reinsurance access the probability of default of a particular reinsurer based on the information channeled through the rating agencies. Problem arises with this rating exercise is detrimental to the Islamic financial industry as most of these retakaful operators are not rated (Ernst & Young, 2010). In Pakistan for example, takaful operators are permitted to engage conventional reinsurers as a mean of risk sharing in view of lack of sufficient financial strength rating of retakaful operators (Maqbool, 2009).

Azman (2008) introduces the concept of *fiqh aulawiyat* in prioritizing between a rated conventional reinsurer with a non-rated retakaful operator. He questioned on the framework of risk based capital (RBC) as a tool applies by regulator for rating by assessing the financial strength and viability of a particular retakaful operator. Basically, RBC is a theoretical framework applied for calculation of minimum capital requirement of a particular insurer that must be maintained in order to be financially sound taking into consideration the risk profile and its size. RBC works by observing the amount of capital requirements which should not fall below a determined level. The use of RBC as a tool to gauge the financial stability of a retakaful operator is considered inefficient since retakaful component if applies in various RBC models is too marginal. The fact is the framework of RBC is not suitable against the operational aspects of takaful or retakaful operators since the operators are just a party entrusted to manage takaful fund whereas they are not liable for any underwriting losses (Frenz & Soualhim 2010). In fact, Hsiao (2005) argues that RBC is not able to show exactly the problem of optimal capital for insurers and cannot be applied as a method for ranking and rating. By referring to the objectives of Islamic law or *maqasid al-shari'ah* as ruled out by the Islamic jurists or *usuliyun*, Azman (2008) concludes that priority must be given by takaful operators in a certain country for those unrated retakaful operators over rated conventional reinsurers. This suggestion is made based on the legal maxims of *fiqh aulawiyat* when *masalih* and *mafasid* are involved, the solution is a genuine *maslahah* or benefit cannot be abandoned for an obvious *mafsadah* or harm. However, caution needs to be taken in a situation involving takaful operators with considerable portfolios of long tail liability risks and special risk with low level of capital. Takaful operators with the above said company and portfolios structures must give priority to rated conventional reinsurers since conventional reinsurers are more

adapted to this kind of portfolios and are more specialized to undertake special type of risks which are not common. As for the time being, there is no specific RBC model tailor-made for retakaful or takaful operators in Malaysia as both the shareholders' fund and takaful fund are considered as one in assessing the solvency margin. With a minimum paid-up capital of RM100 million, solvency ratio in Malaysia must at least be 100% of eligible assets over liabilities. A similar solvency framework applies for retakaful operators based in Labuan as solvency is calculated based on overall fund basis but different solvency statements must be reported to the regulator for both shareholders and takaful funds. A proportion of 20% from net contributions is required to meet solvency level for general takaful business and only 3% proportion of reserves as for family takaful business (Frenz & Soualhi, 2010). The operation of retakaful operators in Malaysia is considered necessary in fulfilling the fardhu kifayah as required by the shara'iah, taking into consideration the arguments on the theory of fiqh aulawiyat as proposed by Azman (2009) and some other Muslim scholars who thought that conventional reinsurance is permissible but with certain restrictions and conditions that must be observed and followed (Asmak, 2009).

Brief Overview of Malaysia's Takaful and Retakaful Market

Malaysia as a progressive Islamic country has gone through a significant phase of Islamic financial evolution since Bank Islam commenced its operation on the 1st of July 1983. The main objective of the establishment of Bank Islam was obvious and clear as the government would like to have a financial institution operating based on Shariah principles. The establishment of the first takaful operator has not been that soon as it was in year 1984 that the first regulation was passed in the form of Takaful Act 1984, amended year 2007, which form the legal framework for the setting up of takaful in the local Islamic financial industry and in 1984, the first takaful operator was established in Malaysia. Bank Negara Malaysia (BNM) is empowered by the government to supervise and regulate the operation of takaful and it is believed that BNM has been exercising a prudent approach in giving approval for the setting of takaful or retakaful operators in Malaysia since then as opposed to the open approach which they have for the Islamic banking sector. To gain inputs and advise from the shariah experts, BNM has formed its own National Shariah Council (SAC) in year 1987. The role and functions of SAC is now enhanced by the introduction of a new Central Bank of Malaysia Act 2009 which elevated the status of SAC as the only commanding body to give its views and rulings on matters concerning Islamic finance.

The financial sector master plan issued by BNM in year 2001 has clearly paved way for the development of takaful with eleven recommendations made in order to provide a solid framework for the operation of Islamic banking and takaful. Among the highlight of these recommendations is provision number 5.6 in the master plan which states that acceleration of takaful business must be in line with the advancement of Islamic banking and retakaful facilitation will be provided by the central bank for the benefit of all takaful operators in accordance with the syariah principles. As to date, there are a total of eight locally owned takaful operators in Malaysia and four retakaful operators, in which two are foreign owned, being granted the licensed to operate under the supervision and guidance from the Islamic banking and takaful department of Bank Negara Malaysia.

Arrangements and Basis of Retakaful

As with conventional reinsurance method, retakaful arrangement between cedant and the retakaful operator can be made by way of treaty or facultative. Without having to go through the technical aspects of the two methods, treaty is an arrangement where the whole portfolios or the book of takaful business are ceded to the retakaful operator and the operators are in the obligatory position to accept the whole blocks of portfolios ceded as long as the those portfolios are within the terms of retakaful contract between the cedant and the retakaful operator. In other words, this is an obligatory retakaful method in which the takaful operators know that they will have the benefit of enjoying what is known as the 'automatic retakaful capacity'. Treaty arrangement is considered beneficial to both parties if the nature of portfolios ceded is homogeneous which does not require specialized underwriting techniques and specific pricing mechanism. Facultative retakaful in contrast is an optional method in which both sides would be having a choice whether to cede or not and whether to make acceptance or not. Facultative method is normally chosen by takaful operators in view of individual risk which is not fit to any portfolios already ceded under a treaty and

this might be caused by factors such as unusual risks of large and complicated in nature. Facultative retakaful involves high administrative cost for the retakaful operators to manage since they need to carefully make a selection and acceptance on individual risk basis and at the same time try to minimize the problem of adverse selection.

Both treaty and facultative methods of retakaful can be arranged using what is known as proportional retakaful and non-proportional retakaful basis. Proportional retakaful basis stands for proportionate sharing of risks in terms of the insured value and losses. Retakaful contribution made under general lines retakaful is based on the gross contribution originally charged by the takaful operators. Gross retakaful contribution will then be deducted taking into consideration the acquisition costs incurred by the takaful operators and this portion of deduction will be channeled into the takaful fund. A different mechanism of computing contribution for risks ceded is applied for family retakaful (Frenz & Soulhi, 2010). Two forms of proportional retakaful commonly used are the quota share and the surplus basis. Non-proportional basis of retakaful does not require both parties to share risks and claims in proportion, This basis requires a setting of limits for the takaful operators which act as a retention and they will retain all claims incur provided the amount is below the retention limit fixed earlier in the retakaful contract between the parties.

In some cases, this basis will not involve any participation from the retakaful operators in paying claims if the amount does not exceed the cut off point. Once the amount of losses exceeds the predetermined cut off point, the retakaful operators will be contractually liable to pay the balance but up to the limit agreed in the retakaful contract. Non-proportional retakaful basis can be arranged based on per risk or excess of loss basis, per event or catastrophic excess of loss or by protection of loss ratio incurred by the takaful operators during the year of underwriting or better known as stop loss basis. However, Maysami and Kwon (2009) claim that non proportional retakaful practice is questionable as there is uncertainty with regards to claim' assessment whereas the principle of gharar and maysir require both parties to be clearly defined and certain on the amount of cover throughout the period of retakaful treaty. Non-proportional, however, is possible if it can be arranged on a reciprocal basis. As a result of that, proportional retakaful basis is considered a much more appropriate arrangement.

Retakaful Operational Models

Basically, retakaful models are similar with takaful models in the sense that both are applying the same underlying contracts. Frenz and Soulhi (2010) state that in principle, a wakalah based takaful operator might be able to cede to a retakaful with an operating model of mudharabah for example and this implies that retakaful transactions can be done between two parties with different operating models. One point worth noting for takaful operators here is that caution must be taken into the environment where the retakaful operator is based whether or not they are operating in a market populated by conventional reinsurers must be taken into consideration. Problem might incur when the retakaful arrangement made by the takaful operators are lead by a conventional reinsurer and in this case, prior retakaful arrangement made between the takaful and retakaful operators could lead to difficulties. Furthermore, within a retakaful organization structure, there could be a possibility of two separate operating models to suit the line of business chosen as portfolio such as family retakaful might contain a different risk characteristics with for example general retakaful and hence entails a different operating models.

There are basically two shariah compliant models in the form of a pure wakalah and pure mudharabah but these two basic structures have now been enhanced into a more complicated hybrid model such as the modified wakalah and waqf model. Recently, another model, known as wadi'ah, has been suggested after research was done by a group of scholars from International Shariah Research Academic for Islamic Finance (ISRA) appointed by BNM. This paper will look into the theoretical framework of all these five operating models with an objective of making a comparison for an understanding for academic purpose and not to suggest if any, the most viable retakaful model suitable for Malaysian environment even though some of these operating models already in place are questionable when it comes to shariah principles and practices and for these reasons, each operating model will be dissected without no prejudice. Interesting to note here that implementation of retakaful models vary across companies and markets and this might happen because of Shariah guidelines for the manner of which takaful and retakaful business are to be

conducted are solely focused on the implementation and conducts but not the structures. The interpretation of the shariah may differ slightly depending on the views and beliefs of those appointed in the shariah supervisory board. An appropriate choice of operational model which is acceptable by Muslim scholars worldwide is considered important for those locally based retakaful operators that wish to underwrite internationally.

Pure Mudharabah Retakaful Model

The mudharabah retakaful model is a copy version of a pure mudharabah operating model of a typical takaful operator. Mudharabah contract is defined when a party who provides a capital (ra'sul mal) to another party who acts as a mudharib with an aims to gain profit from their commercial activity and this profit will then be shared among them based on a pre-agreed ratio (Syed Othman, 2007). Pure mudharabah is basically a profit sharing partnership model adopted into a takaful operation where capital or contributions are provided by the takaful cedants and the retakaful operator acts as a manager for both the participants' risk fund and the participants' investment fund with their expertise. Under a mudharabah based retakaful contract, both the investment and underwriting profits must be defined to both parties on how the profits are to be shared and the retakaful operator under the mudharabah model would not charge the cedant with certain amount of fee as income made by this retakaful operator is derived after the profit made from the risk's and investment fund managed by them.

Islamic scholars from countries such as Bahrain, Qatar, Kuwait and Pakistan, however, have shown their disapproval over the pure mudharabah model as they are against the concept of sharing the underwriting surplus by both cedant and the retakaful operators. This happens because the underwriting profit is not clearly defined. Frenz and Soulhi (2010) point on three main technical issues that go against the principle of syariah. First, they question the term 'underwriting profit' as it does not exist because even in a situation of no claims, the return made is actually zero since it would equal the amount of invested capital or contributions so the term 'profit' in underwriting should be technically referred to as 'surplus' in underwriting.

Another technical issue on mudharabah model which go against the syariah principle is on the provision of qard hasan or benevolent loan to the cedant in the situation of underwriting deficit or capital loss since the provider of these capitals are the cedant. Furthermore, a situation of capital loss can be greater than the total amount of contributions of all cedants but since these capital providers' liability are limited to the portion they contributed, questions arise as who are going to bear the claims payments because the cedants who are the mudarib would not be allowed under the syariah to provide indemnity. A modified mudharabah model is an alternative viewed by Islamic scholars as a solution to the issue of sharing underwriting profit that should not be allowed under a pure mudharabah concept. A modified mudharabah model will channel back the investment income into a takaful fund and the takaful operators then will share this income with the participant on the surplus made from the fund (Ma'sum, 2007). The framework of modified mudharabah is viewed reasonable as this will enable the operators to compete and avoiding overpricing of risk (Soualhi, 2008) but Ma'sum (2007) claims that this modification made is specifically appropriate for general takaful lines since it is a short term contract in nature. However, a full implementation of modified mudharabah model into a retakaful operational landscape has yet to be tested.

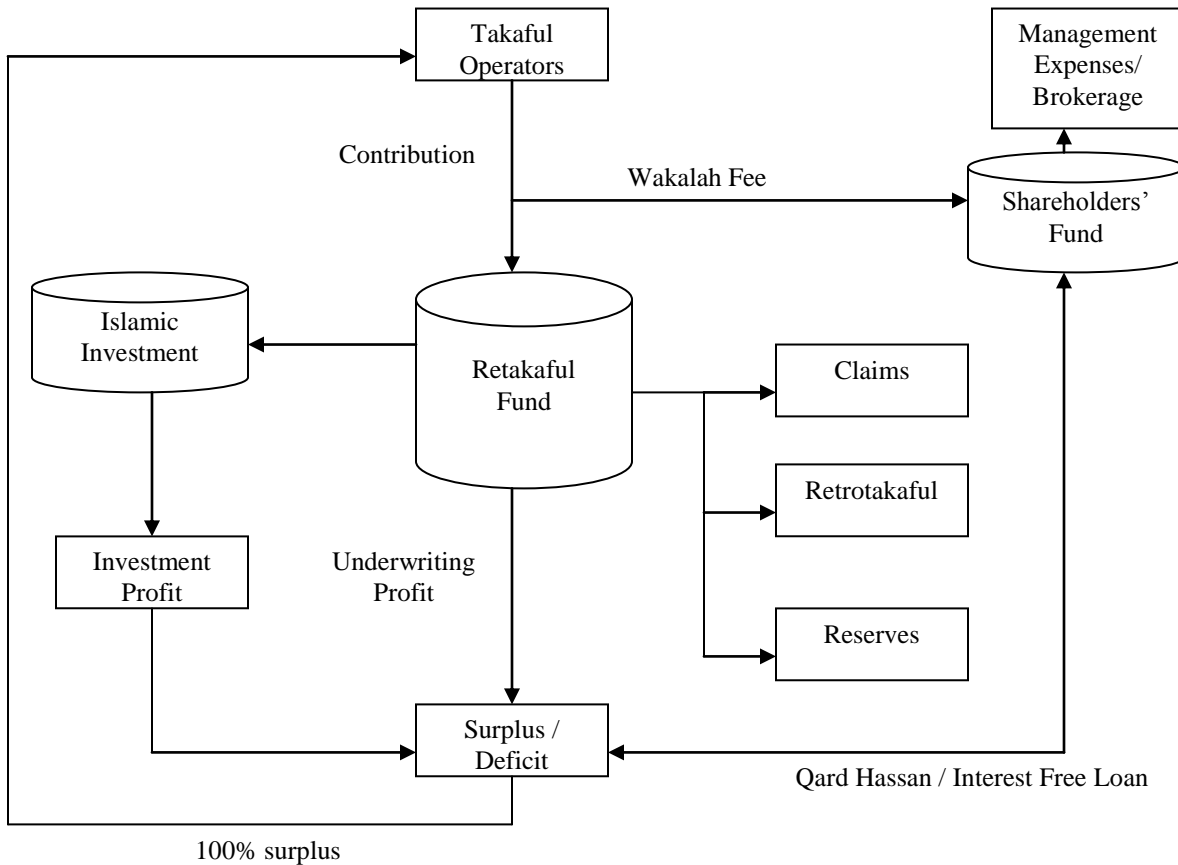
Pure Wakalah Retakaful Model

The term 'wakalah' shall be understood as an agency contract whereby a person appoints another person to act as an agent on their behalf in a financial transaction. A clearer definition of wakalah is when an entrepreneur is paid an agreed fee for applying his expertise in conducting a commercial activity but this entrepreneur will not share in the profit or loss which shall be returned to the capital provider and entrepreneur in this case must fully bear his own expenses (Zainal, 2008).

Pure Wakalah model works when the retakaful participants contribute to the retakaful fund a certain amount of money known as a donations or tabarru' for the objective of having mutual indemnity among the retakaful participants who participate in the plan. Applying the concept of agency contract into the framework of wakalah retakaful model will require certain amount of fixed fee and this fee in known as the wakalah fee. Wakalah fee is then channeled into the shareholders' fund and certain proportion of this fee

will be used to cover the management expenses and acquisition cost. The retakaful fund is the source of fund use to cover any claims incurred by the retakaful cedants, proportion to be ceded back to another retakaful carrier and also certain proportion for the provision of reserves. Note that 100% of the amount of surplus from the underwriting and investment activity will be returned back to the retakaful participants at the end of the financial year but in case of underwriting deficit, a benevolent loan or qard hassan with an interest free loan will be injected from the shareholders' fund. To date, this model is currently being applied by Swiss ReTakaful operating in Malaysia which they claim to have worldwide acceptance with the guidance from Sheikh Taqi Usmani.

Figure 1: Pure Wakalah Retakaful Model (Adapted from Frenz, 2007 and Mohd, 2010)



Soualhi and Frenz (2010) conclude that pure wakalah model is effective as a mean to inject a fixed and consistent flow of income for the retakaful operator and its main advantage over the pure mudharabah issue is on the wakalah fee that can be obtained up-front in order to finance miscellaneous costs and expenses such as the acquisition and management expenses incurred by them. However, caution must be taken into determining the appropriate amount of wakalah fee as a high fee might discourage the retakaful participants and eventually lead into the downfall of the model. Wakalah retakaful model is doubted by the above author as the only source of income generated comes from the fees which is questionable for long term survival in a more challenging retakaful market in the future. Mohd (2010) on the other hand opposes to effectiveness of pure wakalah model from syariah point of view as he claims that the ownership status of the tabaru' or retakaful fund is not certain. This is confirmed by Soulhi (2007) on the issue of

ownership as the tabaru' fund is very much associated with the issue of surplus distribution. Soulhi (2007) suggests a possible solution to this ownership issue by proposing what is known as a concept of conditional contribution with a provision of waiver clause. Both Soulhi (2007) and Mohd (2010) also propose on the concept of depositors based on the framework of wadi'ah yad damanah. The retakaful model of wadi'ah which conforms to the above principle will be discussed later in this paper.

Wakalah Waqf Retakaful Model

The issue of ownership of the tabaru' fund under the pure wakalah model has been one of the controversies which subject to a further discussion among the Muslim scholars. In Pakistan for example, there exist a model based on the concept of waqf and this model is merged with the attractiveness of wakalah model as a mean to generate up-front fee and mudharabah investment scheme. Waqf in the context of Islam is a religious institution which manages a property dedicated by another Muslim for the purpose of charity. Once the properties are declared as waqf, the original person who donates it could no longer claims ownership out of it (Daud, D.L., et al, 2011). In other words, the waqf properties belonged to Allah s.w.t. though the one who benefits from it can be any other Muslim. The implementation of waqf in takaful is operated normally using the hybrid wakalah and mudharabah model (Soualhi and Frenz, 2010). How this model can be applied in the context of retakaful is interesting to digest with. Applying the concept of waqf into retakaful operational model will first require retakaful shareholders to lay initial capital for the purpose of creating a waqf fund where the retakaful participants will then become the members of the fund. The initial outlay is based on the advice given by the shariah board of the retakaful operator and operates under the rules contained in the waqf deed. Technically, the retakaful fund contains a seed capital and indirectly will reduce the possibility of providing qard hassan in the event of deficit Soualhi and Frenz (2010) however argue that the acceptability of waqf model is not certain as the separation of legal entity for both the fund and the management can be a problem in view of the conventional definition of legal entity of a corporation.

Modified Wakalah / Hybrid Wakalah Mudharabah Retakaful Model

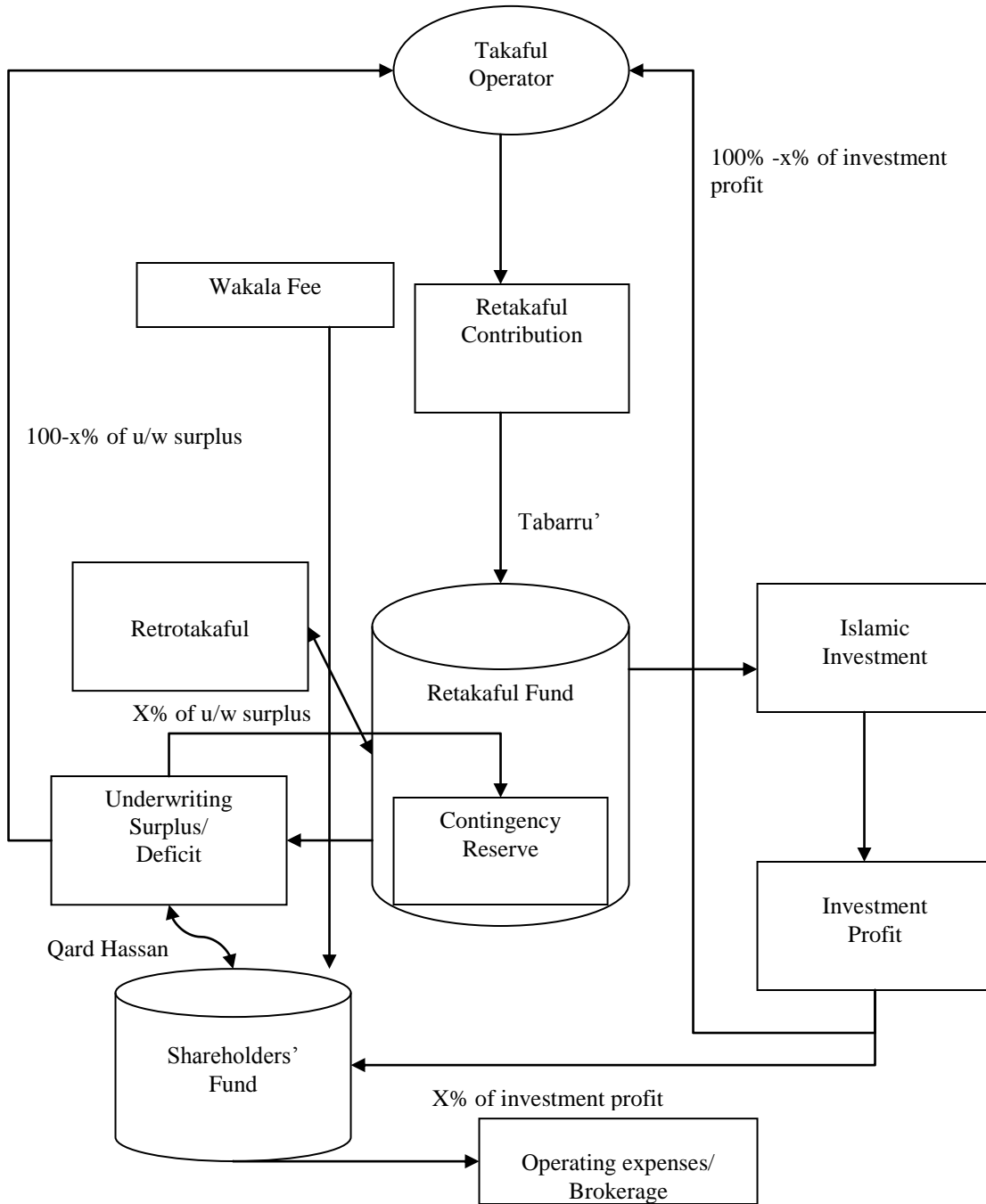
Modified wakalah retakaful model combines the best sides of both mudharabah and wakalah operating model and hence it is considered as the most effective shariah compliant retakaful model by Muslim scholars and currently being implemented in Malaysia by three licensed retakaful operators, Munich Retakaful, ACR Retakaful and Malaysian National Retakaful (MNR). The wakalah fee is paid by the retakaful participants out of their fund or from the tabarru' fund. The wakalah fee is then channeled by the retakaful operators into their shareholders' fund for the reimbursement of their management expenses and other costs. Contributions from the participants are transferred into the retakaful fund and Soualhi and Frenz (2010) suggest that there could be a separate retakaful fund to cater a different portfolio of takaful policies. As usual, all claims are settled and paid out of the retakaful fund and in certain situation, retotakaful will take place depending on the nature of risks. One interesting aspect about the modified model is the existence of contingency reserve which acts as a buffer in a situation of deficit in the underwriting annual result. The provision of contingency reserve is made out of the surplus from the retakaful fund but if it is not adequate, the balance will be injected by the qard hassan interest free loan. Final surplus will then be distributed back to both the retakaful participants and the contingency reserve based on certain ratios agreed earlier in the retakaful treaty.

The modified wakalah retakaful model clearly allows on the sharing of underwriting surplus between the cedants and the retakaful operators but there are certain disagreement and inconsistency exist between the regulations issued by the Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) and the views from the Shari'ah Advisory Council of Bank Negara Malaysia. Mohd (2010) claims that the operational concept of modified wakalah contradicts the AAOIFI standards as it prohibit the takaful operator from taking a share in the underwriting surplus. This prohibition is clearly mentioned under Disclosure No.13 issued by AAOIFI which reads:

'Entitlement to the insurance surplus belongs only to the policyholders (retakaful participants). Shareholders do not share in this surplus because it belongs to policyholders collectively as defined by the

insurance agreement. Several fatwas and Shari'ah rulings have been issued confirming that policyholders have the exclusive right to the insurance surplus.'

Figure 2: Modified Wakalah Retakaful Model (Adapted from Soualhi and Frenz, 2010)

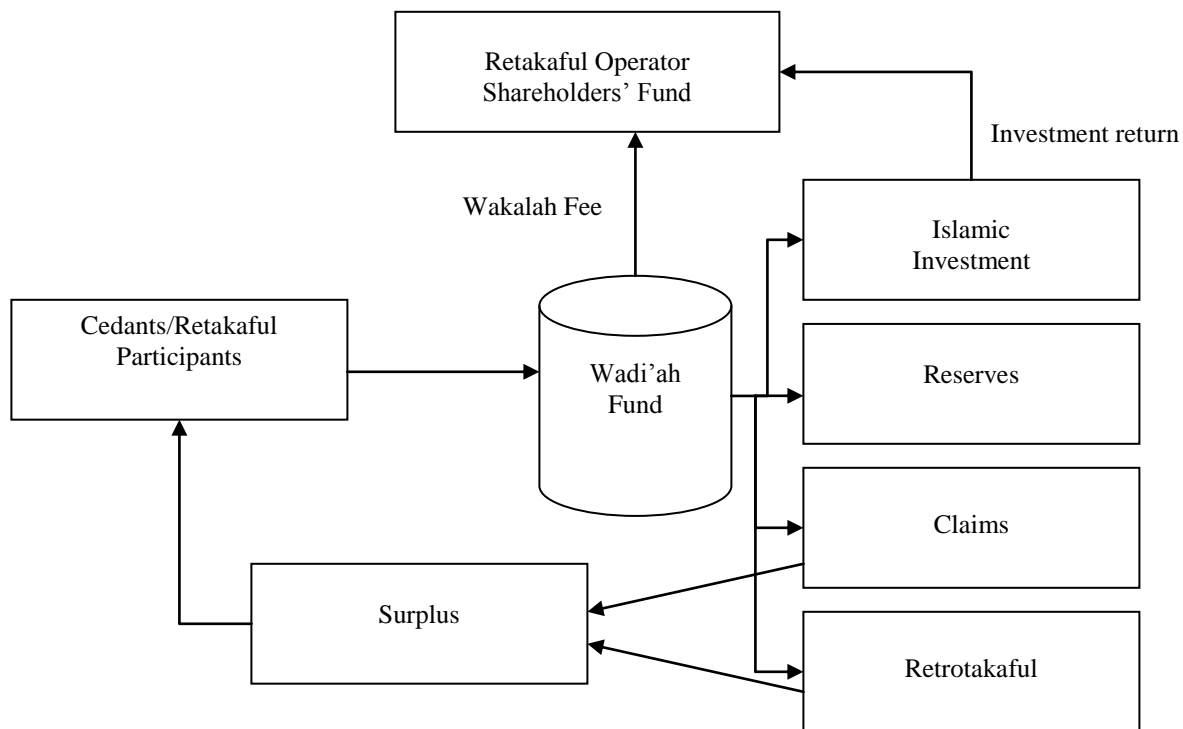


BNM in their draft for operational framework for takaful has clearly permitted the sharing of underwriting surplus by allowing the operator to take up to 20% in the investment profit and not more than 50% of the underwriting surplus. Apart from Malaysia, other provinces which allow the practice of sharing the underwriting surplus are Saudi Arabia, Brunei, Indonesia, Iran and also Labuan. It is interesting to see how this controversy and conflict between two groups of Muslim scholars on matter pertaining to the surplus will be resolved in the near future and Soualhi (2007) concludes that further ijthah is required from Muslim scholars all around the world in order to form a solid parameter with regards to equitable underwriting surplus distribution. Mohd (2010) however warns that future expansion of local retakaful operators into international market especially in the Middle East could be hardened by the fact that they are operating based on the modified wakalah model and hence he suggests on a possible alternative retakaful model based on the concept of wadia'ah yad al-dhamanah which means safekeeping with guarantee.

Wadi'ah Retakaful Model

Wadi'ah is basically a contract of deposit between two parties, one is a depositor and another one is a custodian. In this contract the depositor deposits his property for the purpose of safekeeping. Wadi'ah yad al-dhamanah is a wadi'ah with two different contracts, which are the deposit and guarantee. A dhamanah when combined with the wadi'ah contract will result in a concept of guarantee safe custody (Mohd, 2010).

Figure 3: Wadi'ah Retakaful Model (Adapted from: Mohd, 2010)



The Wadi'ah model works similar as with other retakaful models except for the treatment of the wadi'ah fund which clearly defines the ownership. Retakaful participants in this model contribute to the wadi'ah fund and in the contract; these participants will engage the service of the retakaful operator as a manager for the retakaful fund and in return will receive a portion of wakala fee. The fund accumulated will be

channeled for investment as they will guarantee on the fund which reflects the basic concepts of dhamanah. Profits from the investment are taken by the retakaful operator and balance of the fund after the deduction of reserves, net retro takaful and claims will then be distributed back as a surplus, if any, to the cedants or retakaful participants. Mohd (2010) claims that the Wadi'ah model has justified the requirements of shariah by having complied with its principles, compatible with the takaful markets and transparent and mutually cooperative in nature. Recently, BNM and MNR have commissioned a group of scholar from ISRA in developing this model and they claim this model would assist takaful operators in achieving a greater market since the provision relating to underwriting surplus is made in accordance with the guidelines of AAOIFI which has been the subject of debate as mention earlier. It is interesting to view the development of this model whether it will be fully implemented by MNR as the current operating model use is the modified wakalah model. Soualhi and Frenz (2010) point out that wadia'ah yad damanah combines with wakalah retakaful model is among the viable model available in the industry now as it complies with the AAOIFI and theoretically is the only model which clearly defines the ownership issue of the tabarru' fund.

Issues to Be Considered In Future Research On Retakaful

Issue concerning the provision of qard hasan should be further discussed by our Muslim scholars and clear interpretation and explanation must be made available to both the participants and the retakaful operators on the mechanism of qard hasan as different operating models exist. There is a serious repercussion to the retakaful operators in a situation of irrecoverable qard hasan taking into consideration opportunistic behaviour that might exist on the part of the retakaful participants. Further research need to be undertaken to look into the risk modeling aspect of retakaful operators with high volatile business when it comes to the provision of qard hasan. Second issue that needs consideration is on the distribution of underwriting surplus that has been debated and no standard consensus is achieved among Muslim scholars worldwide. As mentioned earlier in this article, both AAOIFI and the syariah board of BNM have different interpretations on this issue which result in a different preference of operating models worldwide and at the same time has hindered the international marketability of our local retakaful operators. Eventhough the wadi'ah model has been suggested as an alternative, it remains unclear on the direction that will be taken by our retakaful operators as the main guidelines use are not standardized. Enterprise risk management (ERM) study must be conducted in the future for retakaful operators. Issues such as the provision of qard hasan, availability of Islamic investment, solvency and risk based capital, rating, reserves and other specific risks which are unique to the retakaful operation such as shariah compliance risk must be assessed into a standard ERM framework that can be accepted by all regulators. Furthermore, attempt must be made to have a separate ERM framework for different operating retakaful models because each model operates on a different landscape of risks.

CONCLUSION

Efforts to redefine the operational aspect of retakaful in Malaysia are necessary in view of the evolving regulations and accounting standards worldwide. This paper has briefly investigated on the basic model applied by the retakaful operators without going into details in its technicality which is reserved for future research. The author concludes that retakaful market in Malaysia is steadily growing in a moderate pace in view of the uncertainty surrounding few issues such as validity of certain models and its acceptability in worldwide market especially in the Middle East countries. The author discovers that with exception of Swiss Retakaful, the other three operators in Malaysia are operating using the same model of modified wakalah which is widely regarded as the most effective model for managing both the two investment and underwriting funds. The issue of surplus distribution needs further scrutiny as two different schools of thought exist among the shariah scholars. The author concludes that these differences might cause a serious disadvantage to Malaysian based retakaful operators as the opportunity to expand their business to Middle East countries especially is uncertain with the non-conformity with the AAOIFI accounting and auditing standards. In addition to that, the author concludes that the emergence of wadi'ah retakaful model as a solution to the shari'ah interpretation problems in defining the ownership issue of tabbaru' fund should be taken seriously by the regulator as standardization of operating model can be achieved without affecting the profitability of the retakaful operators currently operating on different models but consideration must be

made on possible difficulties such as getting approval from the respective shariah board of each retakaful operator and also problem pertaining operational changes which involve the restructuring of the whole retakaful organization. Giving all the possibilities, the transformation to a full fledged wadi'ah retakaful model needs time and clearer guidelines from the syariah board of BNM must be issued to all retakaful players in Malaysia on wadi'ah structure.

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