building value together

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Retakaful
-Risk Sharing or Risk Transfer?

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“It is generally held that the markets are uncertain how retakaful is different from conventional reinsurance”

- Munich Re’s
General Retakaful Manual

The case for risk transfer

- Generally, reinsurance is taken to cover **“tail” risks**, the risk that a claim is, say, at over the 90th percentile of the range of expected claims and / or the risk of an accumulation of claims due to a single event. These risks require capital to enable risks to be “pooled over time”. This capacity can be provided through the capital of “risk takers”. Specified risks are effectively transferred from the reinsured to the reinsurer. It is a risk transfer (defined as speculative risk) as the reinsurer stands to either make a gain or a loss from this transaction.

- There is a well established global reinsurance network. This provides capacity as well as choice which in turn drives competition. Global reinsurers also facilitate pooling across geographies.

- There is a deep liquid market for retro cover allowing undercapitalized reinsurers to accept cover beyond their own capacity.

Why risk sharing

- Sharia's concern with reinsurance has to do with;
  - transparency
  - speculative risk is present in the reinsurance contract
  - use of reinsurance premium (and capital of the reinsurer) to invest in interest bearing securities
- There is also the issue that reinsurance is B to B. Strictly, retakaful is P to P (takaful risk pool to retakaful risk pool). The Operator has no "insurable interest" as losses are for the account of the participants. The takaful Operator is an agent of the participants and places retakaful on their behalf.

Basis of the Global Financial System

- Underlying basis of the global financial system is trading of risk. Any risks, as long as it can be quantified, can be traded.
- Wall Street found that they could insure financial risk without putting up any capital as over 90% of derivatives were done in the Over The Counter (OTC) market.
- Producers (e.g. of commodities) and users (e.g. airlines with jet fuel) use the derivative market to hedge the price of their produce or raw material. Others create a market by betting on price movements.
- Risk transfer is very much embedded in the global financial system. Most pricing of such risks is done through modelling.

"The model suggested that the risk was so remote* that the fees were almost free money. Just put in your books and enjoy the money" – *Tom Savage, President, AIG's Financial Products*

* a 99.85% chance of never having to pay out

Lessons from the 2008 Financial crisis

- It is never ‘this time it is different’; risks do not disappear, you only exchange one (type of) risk for another. For example, risk of default of the bond issuer (in a CDS) is replaced with performance risk of the insurer (in this case the counterparty in the swap).
- Capital is not “expensive”. Cost of capital is not fixed, it should vary according to the level of risks the capital is subjected to. Where the return on capital is high it is probably because the risks undertaken are high, for example there can be excessive gearing on the balance sheet.
- Use of capital comes with accountability but interest-based lending is preoccupied with ‘credit risk’ with little distinction or care as to how the credit is put to use.
- Human behavior is linked to rewards. The human instinct is always to maximize reward while minimizing effort.

How risk sharing works

- Participants who are subjected to similar risks agree to indemnify each other against the occurrence of the event. Each pays an amount towards the claims outgo in the year. This amount is termed the “contribution”, the level of which is determined by the risk characteristics of each participant.

- Pooling of risks allows the law of large numbers to provide predictability to claims payable.
  - stability of claims is subject to the expected number of claims and the range of claims severity.
  - pooling can also be done across time periods, not just across a group of risks. Claims experience can be less volatile taken as an average over any 10 years than over any one year.
  - pooling can be across geographies, a draught affecting agriculture in one country can be offset against a year of plenty in another part of the world.

What is required for risk sharing to work

- "Homo Islamicus" – As coined in the Munich Re's Retakaful manual are a group of participants who remain in the participants' risk pool even if it is in deficit (with *qard* outstanding). They remain in the pool on the basis of solidarity with all who are in the pool. The surplus or deficit is usually determined over one accounting period (usually a year).
  - This can be described as pooling of risk over one "premium" cycle, as there is no obligation on the participant to renew cover after the contribution is fully expensed.
- Capital from the Operator is used to fund the *qard* as required. As the *qard* allows the fund to remain solvent in the year the deficit arises and thus to continue to underwrite risks in the following year, this is equivalent to the participants being able to also pool across accounting periods not just in one year.
  - This is possible as the Operator is providing the pool with a **financial underwriting facility** with losses carried forward.

Does Homo Islamicus exist?

- The question that should first be asked is whether the contribution rate (the rate payable by the participant into the pool) will vary by virtue of whether the pool is in surplus or has an outstanding *qard*? The second question to ask is whether the participant expects a return of any surplus in the pool? The third question perhaps is whether the *qard* is a symptom of poor underwriting on the part of the Operator or, worse, poor pricing?
- A pool with significant *qard* constitutes a performance risk on the part of the Operator (i.e. claims may not be paid). Should a participant join this pool? The level of *qard* may be a proxy for rating. A “triple A” pool will have zero *qard* while a pool burdened with *qard* is indicative of a “triple B”?

The choice between retakaful and reinsurance

- Key to this decision lies with the Takaful Operator. Has he fully discharged his responsibilities?
  - Under the wakala contract between the Operator and the participant, the Operator is obligated to manage the takaful risk pool to ensure claims are paid. Some volatility in the claims experience is to be expected. The priority should be to ensure the pool does not fall into a position of deficit.
  - In return for the wakala fees the Operator has received, the Operator is obligated to protect the risk pool against unplanned volatility; this requires retakaful not reinsurance so as to preserve the sharia compliance of the originating contract.
  - His choice of Retakaful provider should be driven by an assessment of the ability of the provider to provide the type of cover and services required of the takaful pool and at reasonable cost (it is important to note that choice is not driven by the cost factor alone).

The Should Nots

- His choice of provider SHOULD NOT be dependent on;
  - The reinsurance commission that the Operator gets from the provider (need to distinguish this “retakaful brokerage” from the commission the takaful pool gets from the provider, as such commission goes to reduce the cost of the retakaful cover to the pool). Ethically there is a case to be made that the Operator **should not** receive any brokerage from the provider as this can be interpreted as an inducement not to act in the best interest of the takaful pool.

- The choice of basis of retakaful SHOULD NOT affect;
  - The contract with the participant. For example a quota share arrangement on original contribution basis (which splits the risk from the first dollar) would infer that the Operator has “contracted out” a part of the contract with the participant without the consent of the participant. This is because such “contracting out” usually affects the ultimate benefits of (and/or risks carried by) the participants in one way or another as the benefits are variable.

The Should Nots

- His choice of provider SHOULD NOT be dependent on;
  - An expectation of a surplus distribution from the provider. There have been many instances where an Operator looks down on the pooling of his takaful pool’s risks with other cedants’ takaful pools on the basis that other pools’ experience is inferior to his. The reason for retakaful is to allow a greater pooling of risks so as to minimise reliance on capital and by extension minimise risk transfers.

Should retakaful be done by pooling across all cedants in a year or separately for each cedant across several years

- I would argue that keeping separate accounts for each cedant is actually “financial” retakaful and not retakaful in the sense it is envisaged. In financial retakaful, the Retakaful provider is providing financing for *qard* to the takaful pool in return for a fee. This *qard* would otherwise have to be financed by the Takaful Operator. On a “look through” basis there is a danger that this could be interpreted as *riba,* where the provider’s share of surplus is actually disguised interest on capital set aside for *qard*.

- The role of retakaful is to expand the pooling across other similar takaful pools and across takaful pools in other geographies. The argument put forward by a Takaful Operator not to pool with other cedants is loss-of-surplus-share on their portfolio. The issue of sharing of surplus with other pools should be put to the participants of the originating takaful pools, not to the Takaful Operator. It is P to P, not B to B. As long as the contribution rate to the retakaful pool is determined at best estimate, the issue of unfair sharing of surplus should not arise.

Can retakaful deal with highly volatile risks

- What about hurricanes, tsunamis, large engineering risks, airplanes and such-like risks? Can retakaful provide cover?
- Retakaful does not yet have the global spread and depth of capacity to provide such cover. “Capacity” in retakaful *speak* is not about capital but about how big the “risk pool” is. The bigger the risk pool the less the dependence on capital. For sure the retakaful market cannot be as fragmented as the reinsurance market and still ensure each pool is of a size that makes pooling for that risk feasible.
- In the meantime, Retakaful providers will need to retro excess risk to the conventional retro market on a net (read “no surplus refund/ commission”) basis. Needless to say this arrangement should be free of brokerage to the retroceding Retakaful provider.

So why is retakaful different from reinsurance?

- It is apparent that the confusion in the market place between retakaful and reinsurance has to do with the way retakaful has been executed to date. Both the Takaful Operators and Retakaful providers have to shoulder the blame for perpetuating this confusion, the former for insisting that the providers maintain a separate pool for their risks and the latter for not communicating clearly the reasons not to.

- To summarize the reasons why retakaful is different from reinsurance;
  - Executed properly, retakaful pools risks, rather than transfers risks.
  - Retakaful pools risks for the participants. Unlike reinsurance where the insurer is protecting the shareholders account from losses due to claims volatility, the Operator has no “insurable interest” as losses are for the account of the participants.
  - Retakaful providers do not pay brokerage to Operators.
  - Retakaful investments are sharia compliant.

So (really) retakaful or reinsurance?

- There is no issue that, with the availability of capacity in the retakaful market now, the takaful operator should use retakaful. This is the participants’ decision, not a decision the Operator has to make.
- Retakaful providers should make the effort to differentiate themselves much more clearly from reinsurance. Thus, there should be pooling with other cedants and the pooling should be modeled so as to be equitable among cedants. There should be an effort to reduce the volatility of claims so as to minimise the need for a *qard.*
- There should be no brokerage paid to Takaful Operators. The Operator’s client is the participant. For corporate governance to work there can only be one client and the interest of the agent (the Takaful Operator) should be fully aligned with that of his principal (the participants).
- Finally, it is crucial for the development of retakaful for pooling to spread across geographies; this is the only way to reduce reliance on speculative capital.

Questions

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