Plugging the gap in the takaful chain

The debate goes on: despite the growing acceptance of retakaful, and bigger capacity for mega risks, there is undue preference for conventional reinsurance. What needs to be done to stem the leakage of contributions?

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While some market players have observed growing acceptance of retakaful solutions, it is still fairly common to hear of direct takaful operators favouring conventional capacity.

"Is retakaful capacity appreciated by takaful operators in a different approach other than the traditional one?" The answer is no, said Mr Omar Gouda, Managing Director of Africa Retakaful.

Leakage to conventional reinsurance is a main challenge in improving the acceptance of retakaful, said Mr Ng Hang Ming, CEO of ACR ReTakaful. "There is currently excessive application of the principle of darurah, which allows for the utilisation of conventional reinsurance as opposed to retakaful. Regulatory reforms can help contain the dependency on darurah and reduce leakage.

"Raising greater awareness of Shariah principles will also help to enhance the acceptance of retakaful and further close the gap in leakage. Regulators can also play a driving role in this. Bank Negara Malaysia, for example, has introduced several guidelines and a regulatory framework to help address this issue."

Ceding to both retakaful and conventional

Sometimes, retakaful companies are unable to meet the requirements of the takaful operator, said Mr Gautam Datta, CEO of Al Madina Takaful, which cedes to both retakaful and conventional players.

He explained: "We try to accommodate takaful companies with appropriate security ratings ('A' and above) for treaty cessions. There are few takaful companies that fit the bill

Windows vs full-fledged

Earlier this year, Malaysian Reinsurance Bhd received regulatory approval from Bank Negara Malaysia to set up a retakaful division to conduct general and family business.

While the status of MNRB Holdings' wholly owned subsidiary MNRB Retakaful was not confirmed at press time, the market is surmising that the full-fledged entity will naturally be brought into the fold of the new retakaful division.

The development has rekindled the long-running debate over which is better in retakaful – opening windows, or going for the full-fledged model.

Shariah concerns

Those who support the latter often cite the Shariah factor. As Mr Omar Gouda of Africa Retakaful said: "The credibility of windows as a Shariah-compliant entity will always be questioned by the takaful industry."

Mr Mohamed El Dishish of Emirates Retakaful (EmiratesRE) added: "Retakaful is a unique business model that has emerged as a Shariah-compliant replacement of conventional reinsurance; thus, turning the concept into windows is nothing more than a marketing dress to gain takaful market share. Having a window is a trial-and-error project and not a well-established business model."

Mr Kazi Md Mortuza Ali of Prime Islami life said: "It is always better to cede to a full-fledged operator rather than a retakaful window, because a takaful operator can be more sure and satisfied that nothing is done against Shariah principles in the whole organisation, not just the window."

He noted, however, that consideration of technical ability and financial strength of a reinsurer is very important for any direct company. "So when a full-fledged retakaful company with sufficient technical know how and strong financial base is not available for takaful operators, it is always better and sensible to choose a retakaful window of a renowned reinsurance company."

Both bring business advantages

The full-fledged route offers other operational benefits. The biggest advantage, said Mr Marcel Papp of Swiss Re, is having "a dedicated team without the need to 'compete' internally for resources with the conventional counterpart, whereas in a window operation, a lot of services are shared".

However, having such a dedicated team can also be the biggest disadvantage of a full-fledged operation, as it adds to business costs. "Given the small size of the retakaful market, it is very difficult to run a full-fledged company in a commercially viable way and generate the expected returns for the shareholders. In addition, a full-fledged company tends also to get less support from the holding company than a window operation. As a result, it may not be able to offer the same services as a window operation," said Mr Papp.

Those which set up windows also cite practical reasons. Labuan Re, for example, operates a retakaful window as it is "more cost-efficient and there is no regulatory requirement for a full-fledged company", said CEO Johana Era Zainudin. It also helps that a window can provide more efficient use of capital and resources, and it can ride on the company's financial strength rating, she added.

Windows bring diversification in terms of expert teams as well as in terms of portfolio and risk capital, noted Dr Ludwig Stiftl of Munich Re. "Viewed that way, the advantages are exactly those all international reinsurers have over regional players – and all stand-alone retakaful operators are by definition regional. Thus, the advantage of windows is the possibility to bring the international players, like Munich Re, into the scene."

He added: "The advantages of stand-alones are basically the advantages of regional players in general, plus one: they do not have an operational Shariah-compliance risk at the interface of conventional and retakaful, since they do not have such an interface."

Mr Gautam Datta of Al Madina Takaful is of the opinion that ceding to windows is better. "From an operational perspective, it is more convenient and cost-effective to cede to a retakaful window of an established conventional reinsurance company as it provides the cedant with all the benefits of a large brand and financial security of an established company," he said.

The jury is still out on which is better. In the meantime, there appears to be room in the retakaful market for both models.

(two to three) and they are not in a position to take up our whole treaty, so the balance capacity has to be from the conventional companies. There are times when the retakaful company is not able to provide the full suite of reinsurance services to the cedant, so it adds to the cost of reinsurance if cessions are made to retakaful companies. This influences the decision in selecting retakaful companies."

Large-risks sector

"When it comes to facultative cessions, the risks are usually complex, and retakaful companies do not have the wherewithal to price and lead such risks," continued Mr Datta. "They are also not recognised as leaders for the clients, brokers and the following reinsurers. Hence, the leaders for facultative cessions tend to be from the conventional market."

The inability of most retakaful players to provide lead capacity for large and specialty risks (LSR) is the reason why takaful players depend on both retakaful and traditional reinsurance companies, said Mr Ali Ibrahim Al AbdulGhani, CEO of Qatar Islamic Insurance, which cedes to both in light of the required rating.

"There is enough retakaful capacity in the market in general, but not so much for the LSR market," noted Mr Ng. Mr Datta agreed: "Some capacities have been developed through underwriting agencies with the support of large conventional companies, but I would not classify them as true retakaful capacity for LSR."

Mr Ng added: "One reason is that the volume and spread of LSR business available to retakaful operators are currently just not sufficient for retakaful operators to build an economical and self-sustaining LSR portfolio. Furthermore, LSR itself carries an element of 'high severity, low frequency' type claims, which greatly skews the balance and homogeneity of the participants' fund. Retakaful operators therefore would generally rather commit capacity

Unique challenges facing retakaful

"The key challenge faced by the relatively new retakaful market is its perceived weaker position compared with its more established conventional counterpart. This challenge is in itself directly correlated with other difficulties retakaful operators face, namely: the lack of (re)takaful expertise, the lack of products unique to the retakaful market, and the lack of retakaful risk appetite."

– **Mr Ng Hang Ming**, CEO, **ACR ReTakaful**

"Doing the business in the same traditional way and the approach of the reinsurance industry is the main challenge. Retakaful is still presented and managed in the same way as the reinsurance market. Most retakaful operators may be required to go back to the basics of takaful, which are the cooperative concepts. Takaful is not just about sharing profits, it is much more than this. It is a complete product which requires the real cooperation between all the industry players, including retakaful operators."

– **Mr Omar Gouda**, Managing Director, **Africa Retakaful**

"The challenge of growth with a well-balanced geographical spread is the unique and crucial one. Gaining grounds in our local markets in favour of international markets is a real challenge."

– **Mr Mohamed El Dishish**, CEO, **EmiratesRE**

"There is still a mismatch between supply and demand, ie, retakaful capacity is available but demand is still scarce."

– **Ms Johana Era Zainudin**, CEO, **Labuan Re**

"The biggest challenge for retakaful is the lack of scale, made worse by the fact that retakaful risks cannot be mixed with conventional business in the same pool. As a result, retakaful pools tend to be too small, especially on the general side. This makes it very challenging to write volatile business (such as large and specialised risks) on a retakaful basis as a few losses can put the risk fund into a deficit."

– **Mr Marcel Papp**, Head Retakaful, **Swiss Re Retakaful**

to volume-based and diversified commercial and personal lines of business than to LSR."

Ingredients for lead capacity

In order to lead, said Mr Datta, "the retakaful company has to provide a set of services, including underwriting and risk engineering, which is not easily available. Lead capacity is also difficult because the retakaful companies have not achieved the size in terms of pooled premium to put out a lead line in financial terms.

"For example, on a large risk, a lead line would be considered valid if it is at least 25%, which may be too high for a retakaful company because it has not built the premium pool to a size that can withstand the 25% lead line exposure. At present, they are more keen to build the portfolio, which will give them the base for assuming lead positions in future."

To boost LSR capacity, "retakaful operators may consider pooling their resources to manage the inherent volatility of this type of business", suggested Mr Ng. "This would be enhanced if both takaful and retakaful operators worked collaboratively over a duration of a period to provide economies of scale and manage volatile experience."

Capacity is just one facet

But as some pointed out, capacity is only one aspect of looking at LSR. "As important are underwriting, risk management capabilities and the necessary rating," said Mr Marcel Papp, Head Retakaful, Swiss Re Retakaful.

Dr Ludwig Stiftl, Head of Munich Re's Center of Competence for Retakaful agreed, saying: "The placement of LSR is not dependant on capacity alone, but just as much on the expertise and experience of the underwriting and risk management team. And that is still considered to be with the conventional players."

With takaful still a fledgling industry compared to its conventional counterparts, the road ahead is long. As Mr Kazi Md Mortuza Ali, CEO of Prime Islami Life of Bangladesh noted: "Full-fledged retakaful operators around the world are still in their formative stages. In the course of time, as they gain adequate experience and expertise, full-fledged retakaful operators will come forward to take on LSR in order to become market leaders."

Onus is on retakaful players

Going back to how best to plug the leakage, there is perhaps room for retakaful providers to work harder at distinguishing themselves, and for takaful providers to truly recognise the value of retakaful. As Mr Gouda pointed out, they should view retakaful "not only as a source of additional capacity, but mainly as Shariah-compliant capacity which will assist the development of the takaful concept".

"For the retakaful market to continue developing healthily, it is most imperative for takaful operators to be made aware of the value that retakaful operators can bring to the whole ecosystem," said Mr Ng.

"The onus for this falls primarily on retakaful operators, who will need to seek out more platforms and opportunities to impress upon their takaful counterparts of their utility. Retakaful operators have been providing valuable support to takaful companies, not just through capacity, but also through product design and evaluation, treaty wordings, training and support, risk-based pricing and marketing knowledge. Whether as individual companies or collectively as a sector, these efforts must continue with greater momentum as such qualitative support helps to address first-hand the perceived shortcomings of the retakaful market and increase awareness of the benefits of retakaful."