New Retakaful Operations Increase Capacity in the Middle East, with Certain Risks Ahead

There is a need for retakaful operators and services in the Middle East region, yet capacity for it is still lacking, says **Mr Jonathan Wilton**, CEO of newly-established ACR ReTakaful MEA, a Shariah-compliant retakaful company based in Bahrain.

The primary markets of Islamic insurance services and operators – takaful – are still outnumbered by conventional insurers in the Middle East.

Asia, including the Middle Eastern and Gulf countries, has developing economies that are creating the demand for insurance industries. These will be required to keep pace with their economies' development and service their risk-management requirements.

This is important as Asia is projected to be the world's economic driving force of the 21st century. Additionally, it is currently where about 1.14 billion, or 75%, of the global Muslim population live.

Many of them are devout, and either cannot or will not utilise conventional insurance services because they believe these are in conflict with their fundamental religious convictions.

Takaful, or Shariah-compliant insurance, is a step in the right direction to alleviate these concerns.

The Weaknesses of (re)Takaful in the Market

Despite there being takaful firms operating since 1979, even in the Middle East, these Shariah-compliant insurance companies are still vastly outnumbered by conventional insurers.

More significantly, takaful companies tend to be lightly capitalised and over-reliant on conventional reinsurance companies, even regarding small-risk operations.

They are generally not able to participate in large-risk projects in any meaningful way. With the ballooning of oil wealth in the region, large risks and, indeed, mega-risks are at the core of the very markets in which takaful and retakaful operators should be thriving.

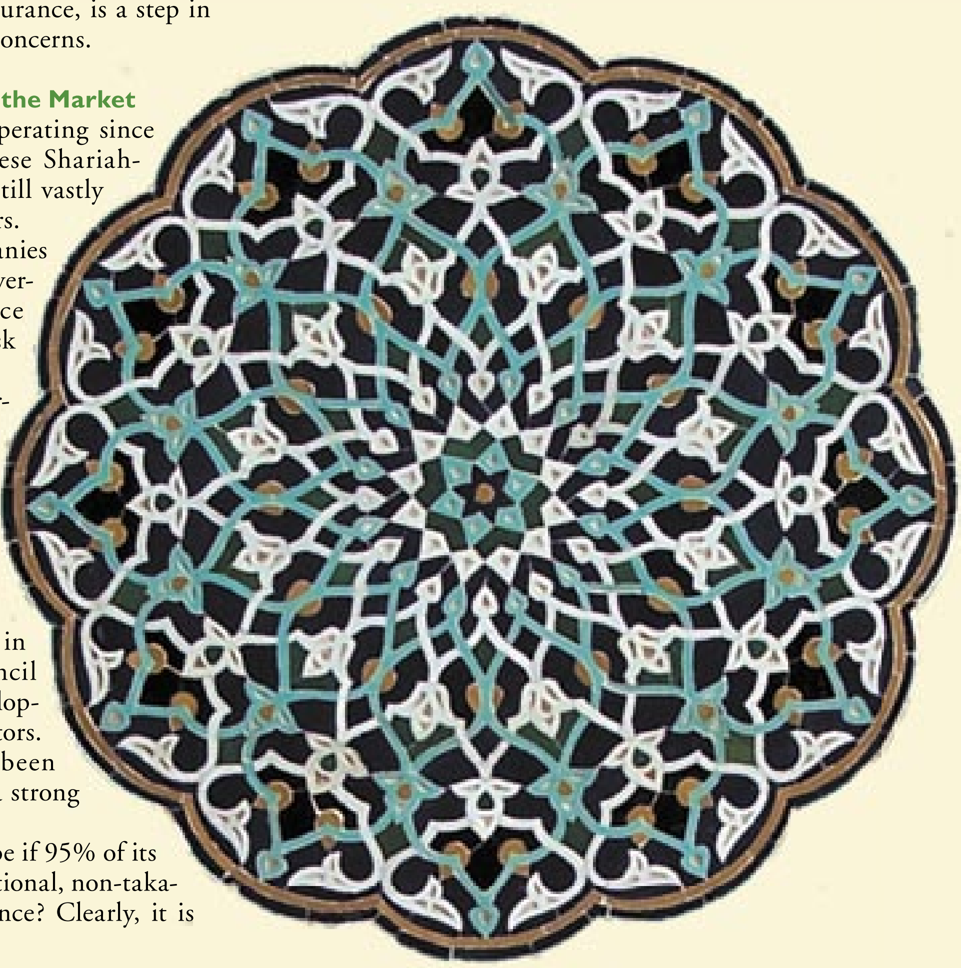
Recent rapid growth in Arab and in particular Gulf Cooperation Council (GCC) countries has spurred the development and expansion of takaful operators. However, their development has been severely curtailed by the absence of a strong retakaful industry.

How genuine can a takaful cover be if 95% of its liability is, in fact, covered by conventional, non-takaful, non-Shariah-compliant reinsurance? Clearly, it is not very genuine.

The Importance of Developing a Retakaful Sector

As the importance of the Islamic financial sector has grown, a commercial imperative has arisen to create a secondary market – retakaful. This will provide a similar essential service to takaful operators, comparable to what conventional reinsurers provide to conventional insurers.

Some of the world's mega-reinsurers have recognised the commercial opportunity here, initiating takaful subsidiaries of their own or creating so-called takaful windows to gain access to this new stream of business. A stand-alone retakaful industry is needed if takaful is to take its place alongside Islamic banking, providing a genuine alternative for Muslims who make up an increasingly wealthy and powerful 20% of the world. This will involve a retakaful sector with the capacity to give independent Shariah-com-



pliant coverage from the ground up, all the way through to the inevitable catastrophic losses which lie somewhere ahead of us in the future.

However, if we are honest, we must concede that the retakaful industry does not yet exist in any meaningful form.

But the seeds have been sown, the requirement has been recognised, and some pioneers are setting out to make the necessary investment in money, people and expertise to bring to fruition a genuine retakaful entity.

Why Takaful?

There is a strongly-held belief in some, though not all, Islamic societies that conventional insurance is "un-Islamic"; that it runs counter to fundamental Shariah principles, and so cannot be purchased by individual Muslims or by Islamic enterprises.

The value of insurance in developed societies, whether in respect of the property of individuals and families, or of large industrial and commercial risks, is well-understood.

To extend that value to those Islamic societies which have had difficulty in reconciling conventional insurance with their religious beliefs, Islamic co-operatives and takaful companies gradually developed from the late 1970s onwards.

Takaful companies, if they are to grow and prosper, will need a Shariah-compliant retakaful market. They similarly emulate the prudence with which conventional insurance companies pass on a proportion of their exposure to secondary markets in the form of reinsurance companies.

It is to meet this requirement that retakaful companies are increasingly being formed, both in the Middle East and in Southeast Asia.

Still, a major obstacle to retakaful is that, although the concept and practice of risk-sharing has been present in Islamic societies since their earliest days, it was never formalised until the relatively recent introduction of modern-day takaful. Mr Zainal Abidin, Chief Executive of ACR ReTakaful SEA Bhd, said that the Middle East "has great potential as the penetration rate for takaful is still very low, both for life as well as non-life services."

This is in contrast to other places like Malaysia where retakaful and takaful started with retail-level services and progressed to the larger-scale risks of the non-life product lines.

Companies in the Middle East have more opportunities for the commercial, large and specialised risks for retakaful, but do not yet have the level of market penetration that those in Malaysia have, said the head of the Kuala Lumpur, Malaysia-based retakaful operator.

Retakaful Capacity

A factor that has been holding back the development of a strong and vigorous takaful market has been the absence of a strong and vigorous retakaful market. To a degree, this has been a circular problem, and it is in the hope of converting that circle into a virtuous one that a number of major entities within world reinsurance have addressed themselves to the provision of this hitherto missing capacity.

For retakaful capacity providers, competition from fellow retakaful operators is not unwelcome, as all participants seek to gain critical mass and eliminate the need for takaful insurers to dilute the Shariah-compliance of their business model by using conventional reinsurance support.

It is generally regarded as permissible by Shariah scholars for takaful companies to buy protection from non-takaful reinsurers, provided there are no practicable alternatives.

This has tended to be the situation until recently. Takaful operators, most of whom have very limited financial resources when compared with long-standing international insurance groups, have found themselves obliged to go outside the Shariah arena in order to safeguard their balance sheets and gain capacity.

However, with the establishment of growing numbers of A-rated, well capitalised retakaful companies, the days of forced compromise may be drawing to a close.

In addition, the entry of new retakaful operators with a proven track record in conventional reinsurance, such as the newly-established ACR ReTakaful Holdings, will aim to boost confidence in the retakaful sector. ACR ReTakaful has a capital of US$300 million.

Certain Risks, but High Hopes Ahead

In the field of small-risk insurance, the capacity requirements of takaful insurers are increasingly being met within the resources of the companies themselves. This is aided by the relative absence of major insurance catastrophe perils such as earthquakes in much of the Islamic world, with the notable exceptions of Turkey, Iran and Indonesia. But the position with regard to major risk coverage has been less satisfactory.

As GCC economies take off on the back of spiralling oil prices, the construction of colossal infrastructure projects and mega-risks such as Burj Dubai have become almost commonplace. In many cases, much, if not all, of the future project finances for these investments will come from the Islamic banking sector.

In instances where all, or a significant proportion, of the finance for a project is being provided by an Islamic bank, there is a compelling expectation that as much of the insurance as possible should be placed with a Shariah-compliant takaful operator.

These operators have been disadvantaged in cases of mega-risk projects, in particular, where risks demanding a high technical insurance input such as complex infrastructure projects and energy-related processes are involved.

A sufficient and genuine retakaful capacity will hopefully exist in time. And if supported by a strong and Shariah-compliant industry, takaful companies will not be at a disadvantage in relation to their conventional competitors.

On the contrary, by virtue of the requirement of the Islamic capital providers to effect their coverage with Shariah-compliant carriers, they will be at an advantage.

Why should investors put their money into retakaful enterprises? Can they expect better returns than might otherwise be generated in more conventional ways?

That is a question for the individual investor, but one to which the answer should become more interesting and positive when retakaful capacity increases.