

Insurance, Reinsurance, Takaful and Retakaful as Risk Mitigating Mechanisms

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Abstract

Life is full of uncertainty and human being cannot be run away from the misfortune. Since we are not able to predict the future, the best we can do is to manage the risk caused by the uncertainty and misfortune events. The existence of risk has been realized since the beginning of our life and its negative consequence can be severe. Regardless of the religion, it is accepted that risk is one of the factors that are threatening our personal life and business activities. Hence, one of the ways to manage the risks is through insurance and engaging in reinsurance as well. Due to the non-Shari'ah compliant nature of insurance and reinsurance, Takaful and Retakaful play the vital role in risk management, especially among the Muslims. The objective of this study is to highlight the important role of insurance, Takaful, reinsurance and Retakaful as risk mitigating tools. The findings of this paper are value added to the existing literature and it provides the spot light to the researchers for the future research.

Keywords: Takaful, retakaful, risk and risk management

1. Introduction

Risk is one of the determinants that can bring the fruitful results or nightmare to us. Depending on the types of risk faced by us, we should be able to grasp the opportunity given by the risk or to manage in order to minimize the losses from the misfortune. Current practice is people are engaging in insurance or Takaful contract to mitigate their risks. In addition, insurance and Takaful companies are again engaged with reinsurance or Retakaful companies to cede their risks. Thus, the aims of this paper are to highlight the important roles of insurance, Takaful, reinsurance and Retakaful as risk mitigating tools.

This paper is organized in five sections. Second section presents risk and risk management from the conventional view. The third section provides the Islamic view on risk and risk management. The fourth section highlights the practice of Takaful (Islamic insurance) and Retakaful (Islamic reinsurance) from the Islamic view. The last section concludes this paper.

2. Risk and Risk Management from the Conventional View

Throughout the ages from ancient civilizations to today's modern world, risk management in a variety of forms has been undertaken by man to reduce, mitigate, avoid or prevent exposures to risks of various nature and degrees affecting their daily lives (Williams, 1998). In this respect, risk is defined by Vaughan (1997) as "...a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for..."

Davidsson (2010) pointed out that we are forced on a daily basis to make decisions based upon asymmetric information and unknowns. He further differentiated between risks and uncertainties by quoting Knight (1921) in his seminal work: 'Risk, Uncertainty and Profit' which explains that risk and uncertainty are two different concepts. He argues that risk is something that can be quantified by using probabilities whilst uncertainty is something that cannot be quantifiable. The concept of uncertainty is summarised by Lindley (2006) as being uncertain to varying degrees about everything in the future which you do not have full information. Hillson and Webster (2007) explains that risk has two characteristics i.e it is related to uncertainty and it has consequences. He further defines risk as, 'uncertainty that matters', since uncertainty without consequences poses no risk, whereas risk includes negative threats and positive opportunities. Furedi (2006) highlighted the culture of fear of the unknown (risks and uncertainties) which coloured the English language in the use of idioms and proverbs such as, 'opening the pandora's box'; 'letting the genie out of the bottle'; 'skating on thin ice'.

Crockford (1987) classifies risks into pure risks and speculative risks. Pure risk refers to a condition when there is no prospect of gain if a risk becomes a reality or preservation of the status quo if the risk does not happen. This class of risk may be in the form of personal risks, property risks, liability risks and risk arising from the failure of others. On the other hand, speculative risk refers to a position where there is a possibility of either

gain or loss such as gambling or a business undertaking. Vaughan (1997) further classifies risks into:

- 1) Financial risk which may involve monetary value such as loss of asset and non-financial risks such as loss of reputation;
- 2) Static risks (a form of pure risk) which refers to risks which are not significantly affected by the changes in the economy such as perils of nature and people's dishonesty;
- 3) Dynamic risks (a form of speculative risk) which refers to risks resulting from changes in economy, taste, culture or public policy;
- 4) Fundamental risks which affect the entire economy or a large number of persons and are impersonal in origin and consequence such as earthquake, flood, war, tsunami, etc. and particular risks which affects individuals such as burning of a house or risk of death from a road accident.

The concept of risk as explained by the researchers mentioned above is closely related to the burden or probability of loss, financially or non-financially, big or small, depending on the degree and severity of the risk. The burden or probability of loss may be measured in terms of perils and hazards as described by Mehr (1986) who defines peril as the cause of loss or the loss-producing agent of a risk such as the perils of fire, windstorm, sickness, etc. Hazard on the other hand is a condition that may increase the likelihood of loss from a certain peril such as carelessness, negligence, use of inferior materials in building construction, unhealthy lifestyle, etc.

In a nutshell, risk management refers to the process by which various risks exposures affecting a person or a body corporate are identified, measured or assessed, mitigated or controlled and monitored in its pre-loss and post-loss positions. Vaughan (1997) cited Mehr and Hedges (1974) that pre-loss objectives relate to economic post loss assurance and avoidance of anxiety, whereas post-loss objectives relates to the completeness and speed of recovery. The implementation of risk management is closely related to the issue of 'cost of risk' which may refer to cost of losses or cost of uncertainty itself. Cost of risk is defined as "...the implicit or explicit price a company must pay to manage its risk exposures; it is typically comprised of the expected costs and direct and indirect losses arising from risk retention, loss control, loss financing, and risk reduction activities..."⁷.

Whilst cost of losses may be easily identifiable such as loss or destruction of asset, cost of uncertainty is subjective in nature such as anxiety, fear, and worry and most importantly, may cause misallocation of resources, poor organizational decisions resulting in unnecessary high cost of capital. In tandem with the more complex and the modern borderless world of business and finance, risk management has become a vital component of today's management practices.

Therefore, a comprehensive, well defined and well executed risk management program helps to facilitate effective planning and resource allocation to successfully achieve the desired personal or business objectives and goals. There are various risk management methods or techniques for dealing with risks which according to Vaughan (1997) may be classified as follows:

Risk Avoidance: This is a negative approach to risk where exposures to risks is not permitted to come into existence, such as not engaging in actions that may give rise to risks. For example, to avoid risk associated with ownership to property, an individual should only rent or lease such property, instead of buying it. This may not be the practical option in business where certain risk taking is required for the opportunities of profit.

Risk Retention: Generally, certain risks which are negligible and are of little financial value are retained. For the same reason, insurance or takaful cover will not be provided for these types of risks.

Risk Reduction: This may be undertaken by loss prevention and loss control through safety programs and loss prevention measures such as use of security guards, burglar alarms, sprinkler systems. Additionally, risks may also be reduced in the aggregate by the use of the law of large numbers, i.e. by combining a large number of exposure units to reasonably make accurate estimates of future losses. For example; insurance or takaful cover warranted, or in some cases encourages risk reduction efforts in return for better pricing through discounts, etc.

Risk Transfer/ Risk Financing: Where risks are transferred to another party who is willing to bear such risk, either for a price or voluntarily, partly or wholly. This a method of providing funds to meet the pre and post cost of loss. Insurance is a form of risk transfer/risk financing from an insured to an insurer.

Risk Sharing: Which are shared among two or more parties who are willing to mutually share the consequences of the risks either for a price or voluntarily? Takaful is a method of risk sharing mechanism between participants of a takaful scheme managed by a takaful operator.

3. Risk and risk Management from the Islamic View

Principally and fundamentally, in Islam the concept of risk and uncertainty are the in realms of the unknown (*al ghaib*) which are only in the knowledge of Allah (swt), whose affairs of this physical and metaphysical worlds and the world hereafter are entirely in His command and control, as stated in the Holy Quran:

"...and with Him are the keys of the invisible. None but He knoweth them. And He knoweth

⁷ Extracted on 28th October 2012 from <http://thelawdictionary.org/cost-of-risk/>

what is in the land and the sea. Not a leaf falleth but He knoweth it. Not a grain amid the darkness of the earth, naught of wet or dry but (it is noted) in a clear record (the Preserved Tablet or '*Lohmahfuz*')...." (Surah Al Anaam, Verse 59).

The religion of Islam also seeks to free man from the shackles of ignorance (*jahl*) and guide man in his fear and apprehension of the unknown to only rely on Allah (swt) based on the principle of *Tawheed* instead of practicing polytheism (*shirk*) through acts such as shamanism, astrology, fortune-telling, magic, superstitious beliefs, etc, as described in the Holy Quran:

'...O you who believe, intoxicants, and gambling and sacrificing stones, and divining arrows are an abomination...of Satan's handiwork, eschew this that you may prosper...' (Surah Al Maidah, Verse 90).

Attitude towards risks and uncertainties is also closely related to the concept of *al-Qadaa' wal al-Qadar* (Divine Ordainment and Predetermination) which is an article of faith in Islam. *Al-Qadar* simply means "the ability of Allah (swt)" who knew, willed, and created all things in due proportion and according to a precise measure. *Al-Qadaa'* refers to the perfectly precise execution and accomplishment of all things pre-destined to occur, in accordance with Allah's (swt) knowledge and will. This belief which acknowledges Allah's (swt) omnipotence and the predestination of man's action, according to Perho (2002), who cited Ibnu Qayyim Al Jawziyyah's book, '*Shifā' Al-Alīl Fīmasā'il Al-Qadā' Wa-Al-Qadar Wa-Al-Hikma Wa-Al-Talī*' (healing the person with wrong concept about predetermination and causality), indicates that man has the responsibility to exercise his choice (*ikhtiar*) and will (*irada*), and then carries out his actions (*fa'ala*) accordingly. In addition, Islam also preaches the concept of *tawakkal* (means to rely on Allah (swt) or to put complete trust in Allah (swt) in man's endeavors in fulfilling his role as *khalifah* and slave of Allah (swt) :

"...I put my trust in Allah, my Lord and your Lord! There is not a moving (living) creature but He has grasp of its forelock. Verily, my Lord is on the Straight Path (Truth)..." (Al Quran, Surah Hud, Verse 56).

The concept and practice of *ikhtiar*, *irada*, *fa'ala* and *tawakkal* as mentioned above is evidenced in a Hadith that one day the Prophet (pbuh), noticed a bedouin leaving his camel without tying it. He asked the bedouin:

"...Why don't you tie down your camel?" The bedouin answered, "I placed my trust in Allah." At that, the Prophet said, "Tie your camel and place your trust in Allah..." (Narrated by Tirmidhi and Ibn Majah Book 60, No.2517).

In the annals of the Prophet's (pbuh) emigration from Mecca to Medina, the Prophet (pbuh) undertook a risk management decision to emigrate through unfamiliar routes to avoid been tracked by his Meccan opponents. This is also in congruence with the Quranic expositions on the practices of risk management in the story of the Prophet Joseph (pbuh) and his brothers in Egypt:

"... and he said, O my sons, do not enter from one gate but enter from different gates; and I cannot avail you against (the decree of) Allah at all. The decision is only for Allah; upon Him I have relied, and upon Him let those who would rely (indeed) rely..." (Surah Yusuf, Verse 67)

In mitigating business risks, Ibn Abbas (ra) reported that when Al Abbas bin Abdul Muttalib (ra) handed over his assets (camels) for a *mudharabah* venture with his partner, he stipulated a number of conditions of risk management viz; that he should not take the camels across the sea, nor take them to the bottom of a dry river bed, nor trade them for live animals, any contravention of these conditions may render the partner to bear the compensation and this was approved by the Prophet (pbuh) (Al Zuhaili, 2002).

The above is a testimony of Islam's recognition of the existence of risks and it is incumbent upon Muslims to apply the appropriate means to manage them in order to alleviate the consequences of risks and refute the wrong misconception of leaving our affairs entirely to fate. In fact, we can safely say that Muslims are enjoined to take some risks within the ambit of Shariah principles and practices to achieve the desired objectives of reward as expressed by Al Qaradawi (1981) who quoted from the Holy Quran:

"...whoso migrateth for the cause of Allah will find much refuge and abundance in earth..."(Surah An Nisa' Verse 100).

Naturally, to embark on the travel or migration is wrought with risks and dangers, but the rewards are much more satisfying. The divine scriptures, Prophets and Messengers as pointed out by Mirakhor (2010) have been sent by Allah (swt) as guidance to man on how best to make decisions and take actions to mitigate risks of this life and to enhance the chances for a blissful life in the hereafter. Islam, he argues has always provided the necessary tools, ways and means by which uncertainties of life can be mitigated.

4. Insurance, Reinsurance, Takaful and Retakaful as Risk Management Tools

Among the risk management techniques, the mechanism of risk transfer and risk sharing can be done through insurance and Takaful. Insurance and reinsurance may generally be considered as a risk transfer mechanism from the insured to the insurer whilst Takaful involves risk sharing between Takaful participants through a pooling method and managed by a Takaful operator. Insurance in its various forms have been practiced since the ancient civilizations of the Babylonians, Phoenician, Greeks, Indians, Chinese, Romans civilizations. As a

specific industry within the financial system, insurance and reinsurance developed rapidly in Europe beginning from the eighteenth century with the establishment of many insurance companies which includes Lloyds of London (Mishra and Mishra, 2007; Mehr, 1986; Carter, 1981; Vaughan, 1997).

In pre-Islamic Arab customs, some form of risk sharing among tribal members in the practice of compensation through blood-money (*diyat*) as described by Khorshid (2004) who cited Imam Malik's '*Al Muwatta*' (The Approved) under the chapter, '*Kitab Al Uqul*' which was subsequently allowed in Islam. Another pre-Islamic practice of the Arabs was called '*Daman Khatar al-Tariq*' a form of surety established by the merchants of Mecca to assist victims of natural disasters or hazards of trade journeys (Obaidullah, 2005).

Besides its risk management function, insurance according to Mishra and Mishra (2007) fulfills various benefits to the individual, businesses and society. It brings benefit to the individual through the provision of safety and security against loss exposures affecting their assets and properties and businesses, thus ensuring peace of mind. Life assurance on the other hand provides for opportunities for investment as well as meeting family needs for medical, educational, old-age needs and provision of a secured estate for one's dependents. It benefits the business sector by reducing the uncertainty and anxiety of potential business losses to the business assets resulting from pure risks which may affect the viability and sustainability of the business, thereby enabling the business owners to devote more effort to the other equally important business risks such as market risk, credit risks, legal risks, operational risks, etc. Insurance also assist the business owners through the provision of employees benefit schemes to ensure the welfare of its employees as well as to retain and attract talent to the organisation. Society as a whole benefits from insurance as social safety net to reduce the financial impact of losses involving lives, limbs and property due to disasters or calamities, thus reducing the total dependence on the government, other public institutions and charitable organisations.

Sigma (2011) reported that in 2010 the total global insured losses cost the insurance industry US\$ 43 billion. It was also reported that natural and man made catastrophes cost the world economy an estimated US\$ 350 billion and 30,000 lives in 2010. The insurance industry is therefore a vital component in ensuring an efficient financial system of a country as well as contributing to the the country's economic growth and most importantly, the provision of a cushion against the impact of losses in the economy.

5. Conclusion

It is undeniable that risk is a significant factor in our lives and it has been recognized that the proper risk management can bring the benefit to us. The concept and practice of insurance has been started since the pre-Islam time and it has been appreciated as the helpful tool to us. The original concept to insurance is based on the mutual help. However, the current practice of insurance is more towards profit oriented and it involves the prohibited elements from the Islamic aspect. This paper has further explained the importance and need of insurance and reinsurance for us. However, we should ensure that these mechanisms are in line with Shari'ah compliant by innovating new products, i.e. Takaful and Retakaful products. The highlights in this paper will enlighten the body of knowledge and it is expected that researchers and academicians will be interested to use this paper as a stepping stone for future research.

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