ISLAMIC FINANCIAL SERVICES BOARD

Guiding Principles for *Retakāful* (Islamic Reinsurance)

IFSB-18

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts, and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ABBREVIATIONS

GN	Guidance Note
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFSB	Islamic Financial Services Board
IIFA	International Islamic Fiqh Academy
PIF	Participants’ Investment Fund
PRF	Participants’ Risk Fund
RRF	*Retakāful* Risk Fund
RSA	Regulatory and Supervisory Authority
RTO	*Retakāful* Operator
RTU	*Retakāful* Undertaking
SHF	Shareholders’ Fund
TO	*Takāful* Operator
TU	*Takāful* Undertaking

Bismillahirrahmanirrahim.
Allahumma salli wasallim `ala Sayyidina Muhammad wa`ala ālihi wasahbihi

A. INTRODUCTION

I. Background of the Project

1. The Islamic Financial Services Board (IFSB), in pursuit of its objective to promote the development of a prudent and transparent Islamic financial services industry, published an Issues Paper in 2006 together with the International Association of Insurance Supervisors (IAIS). The paper identified a number of regulatory issues pertaining to *Takāful,* which it grouped into four main themes: (a) corporate governance; (b) financial and prudential regulation; (c) transparency, reporting and market conduct; and (d) the supervisory review process. To date, the IFSB has issued three standards and one guidance note based on these major themes. These are:

   IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings*

   IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance)*

   IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings*

   GN-5: *Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Takāful and Retakāful Undertakings.*

   Other standards published by the IFSB are also relevant to *Takāful* and *Retakāful* – in particular:

   IFSB-9: *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services*.

   IFSB-10: *Guiding Principles on Sharī`ah Governance Systems for Institutions offering Islamic Financial Services*

2. During the course of developing IFSB-14, the IFSB received comments from the industry to the effect that a specific standard on *Retakāful* is needed to provide guidance to the *Takāful* and *Retakāful* industry and its supervisors. Recognising the issues that the *Takāful* and *Retakāful* industry faces in relation to *Retakāful*, the Council of the IFSB, in its 23rd meeting, held in Doha, Qatar, on 11 December 2013, approved the development of the present standard.

3. This standard aims to provide guidance relating to *Retakāful* to the regulatory and supervisory authorities (RSAs) of the *Takāful* and *Retakāful* industry. It sets out basic principles and best practices pertaining to *Retakāful* activities of both *Takāful* and *Retakāful* Operators (TOs and RTOs, respectively). It is intended to be applied, by RSAs, to TOs and RTOs in their jurisdiction with reference to both inward and outward *Retakāful* activities.[1]

[1] "Inward *Retakāful* activities" refers to the activity of the receiving *Retakāful* undertaking (RTU) (or *Takāful* undertaking, TU, as some TUs write *Retakāful* contracts in addition to direct *Takāful* contracts) in accepting contracts of *Retakāful*. "Outward *Retakāful* activities" refers to the activity of cedants in arranging *Retakāful* cover for risks accepted by them.

II. The Nature of *Retakāful*

4. *Retakāful*[2] is conceptually similar to *Takāful*.[3] It is the Islamic alternative to conventional reinsurance comprising both Family and General business.

   (i) The key differentiating element between *Retakāful* and *Takāful* is the nature of the participants. For *Takāful*, participants are individuals, groups, businesses and various other organisations. For *Retakāful*, participants are mainly TUs and occasionally other RTUs, in which case the term "*Retrotakāful*" is sometimes used to describe the activity. These participant TUs or RTUs, referred to as cedants, contribute a sum of money from their respective Participants' Risk Funds (PRFs) or cedant *Retakāful* Risk Funds (RRFs) as a *Tabarru'* into a common fund that is managed by the receiving RTO. The common fund will be used to assist the cedants' PRFs or RRFs against a specified type of loss or damage.

   (ii) The key differentiating element between *Retakāful* and conventional reinsurance (in a similar manner to that in which *Takāful* differs from conventional insurance) is that, whereas conventional reinsurance typically involves contractual transfer of risk from the cedant to the reinsurer, *Retakāful* arrangements provide for sharing, rather than transfer, of risks. The shared risks are managed by the RTO.

5. As a *Retakāful* operation (also, a *Takāful* operation) generally takes the form of a single legal entity, internally divided into segments that are attributable to the participants' interests on the one hand and the shareholders' interests on the other, a distinction is drawn in this paper between the RTU (or TU) as a whole and the RTO (or TO) as the management tasked with managing both the shareholders' interests and the participants' interests. It is the RTO or TO on whom regulatory obligations are placed, as the active organiser of the undertaking.[4]

III. Objectives

6. The principles set forth in this document are intended to meet the following objectives:

   (i) to provide a basis for RSAs to set rules and guidance on the operational framework of entities undertaking inward *Retakāful* activity;

   (ii) to outline a basis for RSAs to supervise TUs' and RTUs' use of outward *Retakāful* arrangements; and

   (iii) to suggest recommended practices for RTOs, TOs and RSAs to help address regulatory issues concerning *Retakāful*.

IV. Other Relevant Standards

7. As noted above, the IFSB has so far produced three specific *Takāful* standards which provide guidance in the areas of governance (IFSB-8), solvency requirements (IFSB-11) and risk management (IFSB-14), and two other standards, which are generic in nature and applicable to all Islamic financial institutions, providing guidance in the areas of conduct of business (IFSB-9) and *Sharī`ah* governance (IFSB-10). While the provisions made in IFSB-10, IFSB-11 and IFSB-14 are applicable to *Retakāful*, the provisions made in IFSB-8 and IFSB-9 are only partially applicable. This document on *Retakāful* does not intend to supersede these standards. In the case of IFSB-10, IFSB-11 and IFSB-14, it draws out some related points particularly relevant to *Retakāful*, but the respective standards should be referred to for the full principles and recommendations as appropriate. In the case of IFSB-8 and IFSB-9, which were not originally intended to apply to *Retakāful*, those parts which are relevant have been incorporated within this standard.

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[2] Other names are used in some jurisdictions for the business referred to in this paper as *Retakāful*.

[3] The principles of this business are discussed at paragraph 18.

[4] In the conventional insurance sector, some analogous structures exist where the ownership and management of the insurance fund are separated – for example, the Lloyd's syndicate model and certain marine mutuals.

8. This document also draws as appropriate upon the recommended practices in respect of reinsurance that have been adopted by the IAIS in Insurance Core Principle (ICP) 13: “Reinsurance and Other Forms of Risk Transfer”, and other relevant ICPs.[5]

V. Scope and Coverage

9. This standard is applicable to all *Retakāful* undertakings, whether operating under Family *Retakāful*, General *Retakāful* or Composite *Retakāful* licences, including window operations. Where a *Takāful* undertaking accepts *Retakāful* business in addition to direct *Takāful*, this standard may be applied to that part of its operations where it does not contradict standards in respect of direct *Takāful*. It shall also be applicable for any other types of Islamic reinsurance institutions offering *Retakāful* or Islamic retrocession services to TUs/RTUs. Certain provisions (in particular, Part V) are also intended to be applied to TUs operating under Family *Takāful*, General *Takāful* or Composite *Takāful* licences in respect of their outward *Retakāful* or reinsurance arrangements, and by RTUs in respect of their *Retrotakāful* arrangements.

10. This standard focuses primarily on *Retakāful* at the level of the individual entity. With suitable modifications, the principles may be applied in respect of group-wide *Retakāful* activities as well as for RTUs operating in different jurisdictions.

11. The principles set out in Section C of this standard are arranged into five parts. Parts I to IV address matters relevant to inward *Retakāful* operations, and Part V addresses matters relevant to outward *Retakāful* operations. This arrangement is for the convenience of RSAs. In the principles, unless the context requires otherwise, references to RTUs and RTOs are understood to include TUs and TOs, respectively, when undertaking the same type of *Retakāful* operations, and vice versa. Each principle is supported by a description of the underlying rationale, and by recommended best practices. While the principles are intended to be capable of regulatory implementation at a high level, the recommended best practices provide an outline of a more detailed regulatory framework for those RSAs that wish to develop one. They may also be applied by RTOs and TOs on a voluntary basis where local regulatory provisions do not cover the issues in question.

[5] References in this document to ICPs are to the version as amended on 12 October 2012.

B. UNDERSTANDING THE CONCEPT OF *RETAKĀFUL* AND ITS UNDERLYING CONTRACTS

12. This section describes the concept of *Retakāful*, and how *Retakaful* business is in practice structured and operated. It draws on information from a survey conducted by the IFSB as part of the development process for this standard. However, because of the diversity of practices around the world it cannot be comprehensive. This section is intended to be descriptive rather than normative, and a description of a current practice does not necessarily imply that it is considered appropriate. While this section sets out issues that affect *Retakāful* business, it is Section C that sets out the IFSB's recommendations for the regulation of *Retakāful*.

I. The Concept of *Retakāful*

13. The need for *Retakāful* arises primarily when an individual TU does not have the capacity to absorb all the claims that may foreseeably be made on it by its participants. It is of the nature of *Takāful* that the level of claims that may foreseeably occur is greater than the level of claims that is expected to occur. As a consequence, the level of capital that an RTU needs is related to the foreseeable level of claims, rather than the expected level of claims (to which the level of contributions is more closely related).[6] The difference between the two tends to be particularly evident at the commencement of contracts and early in the life cycle of portfolios of contracts, and to decline as the maturity profile of the contracts in a portfolio develops. This phenomenon is often referred to as "new business strain". New business strain is particularly a feature of Family *Takāful*, where the contracts are long-term in nature, but it exists also in General *Takāful* business. By using *Retakāful* to reduce the volatility of the risk that they retain, TUs are able to manage their own capital requirements and to increase their capacity to accept new business. New and expanding *Takāful* operations typically need to place particular reliance on *Retakāful* for this purpose, whereas a more mature operation may be able to reduce its reliance on *Retakāful* due to diversification of its exposures and increased stability in technical provisions.

14. In addition, a TU may use *Retakāful* selectively to balance its portfolio of risks, sharing its peak exposures so as to improve its resilience on the occurrence of particular events. A further reason for using *Retakāful* occurs where a TO lacks technical expertise to underwrite certain types of business. In such cases, the TO receives technical support from the RTO as well as obtaining *Retakaful* cover from the RTU, as it builds its own experience.

15. Similar to the concept of reinsurance, a TU enters into a contract with an RTU which specifies in detail the conditions under which the RTU will reimburse the TU for all or part of the claims paid to the participants. The RTU normally does not have a direct relationship with the participants of the TU; their claims are met by the TU, and the TU then has a claim against the RTU. Regardless of the RTU's ability to meet any of its obligations to the TU, the TU's obligation to pay the claimant remains unchanged. *Retakāful* arrangements therefore expose the cedant TU to credit risk. On the other hand, the participants in the TU's PRF do not have recourse to the RTU in the event of default by the TU (in the absence of specific provision in their contracts that they may do so),[7] and may be unaware of the existence of the *Retakāful* arrangement.

16. *Retakāful* is not the same as co-*Takāful*. Under a co-*Takāful* arrangement, two or more TUs agree with a participant to accept separate percentage shares of a risk, each TU being responsible only for meeting claims based on its own agreed-upon share of the cover

[6] "Capital" here refers to the surplus of the assets of an RTU over its liabilities, some of which may be accumulated in RRFs, and some held in the shareholders' fund (SHF). From a *Sharī`ah* point of view, there is no obligation on an RTO to use capital in the SHF to cover a deficit in an RRF which is insufficient to satisfy all valid claims. However, RSAs will sometimes place such an obligation (*Qard*) on an RTO, or require a commitment to that effect as a condition of licensing.

[7] Such "cut-through" clauses are a feature of some commercial lines contracts.

provided.[8] Although a co-*Takāful* arrangement may be set out in a single document, each TU's *Takāful* contract is with the participant and not with the other TUs involved. One TU may act as "leader", writing a significant share of the cover and initially negotiating the terms and conditions of the contract with the participant; other TUs then take smaller shares on the same or modified terms and conditions. This practice is common for large risks in the conventional insurance market, and is often referred to as a "subscription" arrangement. *Retakāful* (and *Retrotakāful*) may also be written on a co-*Takāful* basis, with several RTUs each taking separate shares of a *Retakāful* cover. In some reinsurance markets, subscription arrangements are very common. Another form of arrangement consists of one entity, which may or may not be itself a TU or RTU, writing and managing a book of business on behalf of other TUs or RTUs under a delegated underwriting authority, with each TU or RTU taking a pre-agreed share of each risk so written.[9] Such arrangements also constitute co-*Takāful* rather than *Retakāful.*

II. Principal Structures in Use

17. In following the due process for standards development, the IFSB undertook a survey to attain an understanding of the various models used by RTUs to govern their relationship with the TUs. The following models proved to be popularly used by the RTUs.

(i) *Wakālah*

Under a *Wakālah* model, the RTO and the TUs form a principal–agent relationship whereby the RTO acts strictly as a *Wakil* (agent) on behalf of the TUs, to manage the ceded risks as well as the investment of the contributions. In return for the service rendered by the RTO as *Wakil*, the RTO receives a management fee, called a *Wakālah* fee, which is usually a percentage of the contributions paid. The *Wakālah* fee must be pre-agreed and expressly stated in the *Retakāful* contract. For the RTO, the *Wakālah* fee is intended to cover the total sum of: (a) management expenses; (b) distribution costs, including intermediaries' remuneration, where this is borne by the RTO; and (c) a margin of operational profit to the RTO. In this respect, an RTO will be profitable if the *Wakālah* fee it receives is greater than the management expenses incurred. It does not directly share in the risk borne by the RRF or any of its investment profit or surplus/deficit.

In addition, the *Wakālah* model may permit the RTO to receive part of its remuneration as *Wakil* in the form of a performance-related fee. A performance-related fee, as agreed in the *Retakāful* contract, is typically related to the result of the RRF. The underwriting result arising in the RRF, after payment of the *Wakālah* fee, including any performance-related element, and after crediting any investment income, is attributable to the cedant TUs collectively.

(ii) *Wakālah–Muḍārabah*

In a *Wakālah–Muḍārabah* model, as commonly practised, the RTO acts both as a *Wakil* and a *Mudarib* (entrepreneur) to the TUs: typically, as *Wakil* to manage the underwriting activities of the RRF, and as *Mudarib* to manage its investment activities, though the exact relationship and basis of remuneration in respect of these activities will be specified in the *Retakāful* contract. The RTO receives a *Wakālah* fee, which is usually

[8] The term "co-*Takāful*" is also sometimes used in other senses. It may be used to describe a situation where a participant insures only a proportion of his or her exposure, retaining the remainder; this is sometimes referred to as the participant's coinsurance, or co-*Takāful*. In addition, particularly in Family business, proportional treaty reinsurance (see below) is sometimes described as "coinsurance". These usages, both of which involve the participant (or cedant) sharing only a portion of the risk with the TU (or RTU), should not be confused with the co-*Takāful* described here, in which TUs or RTUs cover the whole risk but in agreed proportions.

[9] In this structure, the entity holding the delegated underwriting authority is sometimes referred to as a "coverholder" or managing general agent of the TUs and RTUs on whose behalf it writes cover.

a percentage of the contributions paid, as described above, and may (where the contract permits it) receive a performance fee based on the underwriting result. In addition, the RTO is remunerated by a predetermined percentage share in the investment profit.

Some RSAs permit extension of the *Muḍārabah* element of the model to cover also underwriting results of *Retakāful* operations.[10]

As with the *Wakālah* model, the residue in the RRF after payment of all contractual obligations, including profit shares due to the RTO, is attributable to the cedant TUs collectively.

(iii) *Wakālah–Waqf*

Under a *Wakālah–Waqf* model, the RTO's shareholders and potentially also cedant TUs contribute seed money to the establishment of the *Waqf* RRF. In addition to acting as a *Waqif* (trustee) to the *Waqf* RRF, the RTO also undertakes the role of a *Wakil* to manage both the investment and underwriting activities of the *Waqf* RRF. The *Wakālah* fee must be pre-agreed and expressly stated in the *Retakāful* contract.

The residue in the RRF after payment of all contractual obligations, including profit shares due to the RTO, is attributable to the *Waqf* fund. Subject to the terms of the *Waqf*, part or all of the residue may be carried forward as reserves in the RRF, donated to charity or returned to the cedants.

(iv) Cooperative

In a cooperative model, the RTO's shareholders and the TUs establish a cooperative RRF. All management expenses and acquisition costs are paid out of the cooperative RRF.[11]

A graphical presentation showing typical flows of funds under these *Retakāful* models is shown in the Appendix.

III. *Retakāful* Core Principles

18. The concept of *Retakāful* is founded on the same premises as the concept of *Takāful*, where risk sharing forms the basis of agreement among the TUs in a *Retakāful* contract. As was affirmed in 2013 by the International Islamic Fiqh Academy (IIFA), Islamic insurance looks after the welfare of its participants through participating in bearing and mitigating harm among themselves, by contrast with commercial insurance which aims for profit through compensation for risks.[12] The IIFA identified essential insurance principles that are shared by commercial and Islamic insurance, as well as three principles that are exclusive to Islamic

[10] Many scholars disagree with the RTO taking any percentage of an underwriting surplus under a *Mudārabah* contract, on the ground that an underwriting surplus is not a profit, though some consider that a performance fee may be permitted. In any event, none of the respondents to our survey claimed to be using a pure *Muḍārabah* model.

[11] There is, however, a difference between the Saudi and Sudan cooperative models. In the former, the RTO receives its remuneration via a predetermined share of underwriting surplus from the Cooperative RRF. The latter model does not allow the sharing of surplus between the RTO and the cedants; instead, all surplus belongs to the cedants. The RTO would be remunerated via a predetermined share of investment income for being a *Mudarib*.

[12] IIFA Resolution 200 (6/21), made at its 21st meeting in Riyadh, Saudi Arabia (18–20 November 2013), taking into consideration recommendations of the seminar in Jeddah earlier that year on *Sharī`ah* rules and regulations for the basis of cooperative insurance. The IIFA refers to "Cooperative insurance", which in the present paper is rendered as "Islamic insurance" to avoid confusion with the cooperative model described above.

insurance, being: (a) compliance with the *Sharī`ah* throughout transactions and contracts; (b) non-insurability of prohibited subject matter; and (c) not engaging in any transaction involving the payment or receipt of interest.

19. Core principles of *Takāful* and *Retakāful*, which are intended to adhere to the objective of *Sharī`ah* compliance, are *Tabarru'*, *Ta'awun* and the prohibition of *Riba* (usury).

(i) *Tabarru'*

Tabarru' is a type of Islamic contract that is fundamental to *Retakāful* and *Takāful schemes.*[13] It is the amount contributed by each cedant TU to fulfil obligations of mutual help and to pay claims submitted by eligible claimants among the contributing TUs.

(ii) *Ta'awun*

The concept of *Ta'awun*, or mutual assistance, is also core to the operation of *Retakāful*, as it involves the cedant TUs agreeing to cover each other (on behalf of their respective PRFs) mutually for the losses arising from specified risks. It is clearly stated in the Holy Quran, "help one another in goodness and piety, and do not help one another in sin and aggression" (Al Maidah:2).

(iii) Prohibition of *Riba* (Usury)

Conventional reinsurance business typically involves *Riba* (which is forbidden in *Sharī`ah*), particularly in the form of assets in which funds may be invested, and also potentially in contracts and indirectly in other ways. It is important that investments in both the RRF and the RTO's shareholders' funds should be *Riba*-free types of investment.

20. In a *Retakāful* undertaking, the underwriting of the RRF needs to conform to the principle of mutuality; that is, the RRF belongs[14] to the cedant TUs, who share the risk between them, and not with the shareholders of the RTO. Correspondingly, the shareholders do not take on any underwriting risk (though they do assume credit risk, if *Qard* is provided to the RRF but cannot be repaid). Management of the underwriting, investment and administration are performed by the RTO.

21. The IIFA resolved, in its resolution referred to above, that Islamic insurance companies should reinsure only with Islamic reinsurance companies except where that is not possible and "for other valid reasons". In the case of these exceptions, the IIFA indicates that Islamic insurers can reinsure with conventional reinsurers only within parameters set by the *Sharī`ah* committee, to minimise reliance on conventional reinsurance and to preserve compliance with *Sharī`ah* rules.

IV. Categorisation

22. *Retakāful* is commonly viewed as divided into two categories: Family *Retakāful and* General *Retakāful.* An RTU that carries on both forms is referred to as a Composite *Retakāful* undertaking.[15]

[13] The use of *Tabarru'* as the basis of the contributions renders acceptable the element of *Gharar* (lack of certainty in a contract, which would otherwise vitiate the contract) in *Retakāful*. Cooperation between group(s) of people in a society through participating in bearing the risk without aiming for profit from it enables the contract not to be defined as *Aqad al-mu'awdah* (exchange contract). Hence, *Gharar* arising from the contract is forgiven.

[14] Except in the case of a *Waqf*, which is a separate entity under *Sharī`ah* and is not owned by either the RTO or the cedants.

[15] The distinction between Family and General *Takāful* may vary between jurisdictions. In addition, many RSAs will allow certain types of business, such as medical, to be carried on under either a Family or a General licence.

(i) Family *Retakāful*

a. Family *Retakāful* covers the cedant TU for claims paid by it arising from *Takāful* contracts covering the death, disability, accident or illness of the TU's participants, or survival to an age specified or determined in the contract. The amount of cover provided by the RTU to the TU is determined based on the agreed-upon terms and conditions as stated in the contract between the two parties.

b. Funds relating to certain Family *Takāful* products are in some models segregated into two different funds: a Participants' Investment Fund (PIF) and a Participants' Risk Fund.[16] However, a Family *Retakāful* arrangement between an RTU and TU will not normally include a PIF, since the PIF is typically a pure investment fund, and the related investment risks are fully borne by the *Takāful* participants rather than being reinsured through *Retakāful* or otherwise.

c. In Family *Retakāful*, the *Retakāful* contribution will be made from the PRF of the TU to the RRF of the RTU on the basis of *Tabarru'*, to provide funds to meet claims falling within the scope of the contracts. Any *Wakālah* fee for the RTO is credited to the RTO.

d. As Family *Retakāful* exposures may be long-term in nature, investment activities in the RRF of Family *Retakāful* companies may be important for the solvency of the fund.

(ii) General *Retakāful*

a. General *Retakāful* covers the cedant TU for claims paid by it arising from *Takāful* contracts covering loss or damage inflicted upon real estate, assets, belongings or liability of the TUs' participants. The amount of cover provided by the RTU to the TU is determined based on the agreed-upon terms and conditions as stated in the contract between the two parties.

b. In General *Retakāful*, the *Retakāful* contribution will be pooled into the RRF of the RTU under the principle of *Tabarru'* to provide funds for claims falling within the scope of the contracts concerned. Any *Wakālah* fee for the RTO is credited to the RTO.

c. Although investment activities in the RRF of General *Retakāful* companies are secondary to the underwriting activities, they may be important for the solvency of the fund, especially in the case of longer-tailed risks.

23. Where a single RTU is permitted to undertake both Family and General *Retakāful* business, it is likely that it will be required to maintain separate operational frameworks and separate RRFs for Family and General *Retakāful* due to the nature and typical duration of the risks in Family *Retakāful*. Although it is arguable that the justification for separation of General and Family business is not necessarily as strong in *Retakāful* as it is in direct *Takāful*, supervisors may consider that separation is necessary. RSAs requiring separation need to take into consideration the international nature of *Retakāful* and the possibility, which also exists in conventional reinsurance, that cedants from other jurisdictions may be required to classify their business differently.

[16] PIF constitutes an investment fund for the purpose of capital formation, while PRF is a risk fund – that is, an element of business that is inherent in the underwriting activities, and the contributions to which are made on the basis of *Tabarru'*.

V. *Retakāful* Windows

24. In the course of developing these guiding principles, the IFSB carried out its own survey[17] to understand the nature of the existing *Retakāful* industry. This exercise confirmed that the *Retakāful* sector includes a number of window operations.[18] (The sector also includes some *Retakāful* operations that are subsidiaries of conventional reinsurance groups.) Among the key considerations for the establishment of both windows and subsidiaries is the high capital need of *Retakāful* in which the financial capacity of experienced conventional reinsurers is necessary in providing financial backing to the growing *Retakāful* business. In addition, technical expertise and ratings of conventional reinsurers are key in meeting the requirements of many RSAs.

25. The operation of *Retakāful* windows carries with it additional issues requiring attention by the RTO and by RSAs. Care may be needed to ensure that the close association with a conventional reinsurance operation does not impair the *Sharī`ah* compliance of the operation in the window, and the application of other principles set out in IFSB standards relevant to *Retakāful*. Assessing and demonstrating the window's compliance with applicable principles may require particular attention if the RRF is likely to be dependent, on more than an exceptional basis, on capital support from funds that are not invested in a *Sharī`ah*-compliant way.

VI. *Retakāful* Business of *Takāful* Undertakings

26. *Retakāful* business may be underwritten by *Takāful* undertakings. This position may arise where capacity for an individual risk is not available from specialist reinsurers or *Retakāful* undertakings, perhaps due to lack of either market access or expertise, and writing the business is attractive to a TU that does have capacity. This type of *Retakāful* contract between two TUs is usually organised on a per-risk basis under a facultative arrangement as described below. Acceptance of facultative *Retakāful* by TUs may be assessed as sufficiently similar to the underwriting of direct risks for RSAs to permit such arrangements; however, authorities may be less prepared to agree to proposals by TUs to underwrite treaty *Retakāful* due to the different skills required to assess treaty business and the risk of exposing direct *Takāful* participants to dissimilar business. Possible risk mitigation measures include requiring the establishment of separate PRFs for treaty business written by TUs, where an RSA is satisfied that the TO possesses the necessary skills.

VII. Types of *Retakāful*

27. *Retakāful* arrangements between cedant TUs and RTUs may be classified in different ways. One basic distinction is that between treaty and facultative arrangements, though some contracts may have features of both.

(i) Treaty versus Facultative

a. A treaty *Retakāful* arrangement is a contract that covers all risks written by the cedant TU that fall within the terms of the *Retakāful* contract, subject to limits and exclusions specified in the contract. It is an automatic arrangement where, in most cases, risks that fit within the treaty terms must be ceded by the TU and cannot be rejected by the RTU.

[17] The survey, conducted during the period 10 July – 15 August 2014, received a total of 67 respondents (14 RTOs, 38 TOs and 15 RSAs).

[18] While most windows identified take the form of a segment of a conventional insurance operation, managed separately by the insurer, a refinement has also been observed where a managing general agent contracts with several conventional insurers to manage a ring-fenced window operation for each of them.

b. In a treaty arrangement, RTOs rely on the cedant's underwriting capabilities and expertise, and may undertake due diligence and audit to satisfy themselves as to these. Treaties are typically expressed as annual contracts, but the TU and RTU treaty relationship is in practice long-term in nature and treaties are often renewed with the same parties, updated only for necessary changes in the contract terms (e.g. to reflect a changing portfolio of the cedant).

c. A facultative *Retakāful* arrangement, on the other hand, is used to cover all or part of a single certificate of *Takāful* written by the cedant. Facultative contracts are commonly entered into for large or unusual risks which exceed or are excluded from the TU's treaty arrangements and cannot be wholly retained due to the TU's underwriting capacity. A facultative arrangement may cover only parts of the original (or "underlying") risk, as the cedant may wish only to cede or the RTU only to accept parts of the risk. The terms and conditions of the TU's contract with the RTU specify the proportion or aspects of the underlying risk that are covered.

d. A TU and RTU negotiate the terms for each facultative arrangement, with the RTU assessing the individual risk that it is being offered. The TU is not obliged to offer the risk to the RTU, and the RTU has the option to accept or decline it.

e. Both treaty and facultative *Retakāful* business may be written either on a proportional or a non-proportional basis.

(ii) Proportional versus Non-proportional

a. Under a proportional *Retakāful* arrangement, the RTU reimburses a predetermined proportion of all claims incurred by the cedant within the scope of the treaty, in consideration of a predetermined proportion of the contributions received by the cedant on that business. The two most common types of agreement are quota share and surplus. Under a quota share arrangement, the fixed proportion is the same for all claims and premiums within the scope of the contract. For example, under a 40% quota share *Retakāful* contract, the contribution payable to the RTU is based on 40% of the contribution received by the cedant (although in practice the actual agreed contribution is lower, the difference being negotiated and commonly described as a ceding commission), and 40% of the claims incurred are recovered.

   Under a surplus arrangement, the proportion of each risk ceded is determined by reference to the sum covered and to limits agreed upon by the parties to the contract. Surplus treaty is typically used as a mechanism for ceding only the larger risks within a portfolio, with smaller risks being wholly retained by the cedant. For example, a surplus treaty may be expressed as having a retention of $20 million and a limit of $100 million. A risk with sum assured of less than $20 million would not be ceded to the treaty at all. A risk with sum insured of between $20 million and $120 million would be ceded to the treaty, and for each the proportion ceded would be determined by the formula: (sum assured – $20 million)/sum assured. A risk with sum insured in excess of $120 million would be ceded and the proportion ceded would be $100 million/sum assured. Once the proportion is determined, the RTU reimburses that proportion of all claims, however small, relating to the risk. As with a quota-share arrangement, the contribution paid to the RTU is determined on the basis of the stipulated percentage of the contribution received by the cedant for the risk in question, less a negotiated "ceding commission".

b. Under a non-proportional arrangement, the TU is able to recover claims from the RTU only once the losses exceed an amount agreed upon in the contract between the TU and the RTU. Two common forms of non-proportional *Retakāful* arrangement are "excess-of-loss" (or "X/L") and "stop-loss". Under an excess-of-loss arrangement, the RTU reimburses the TU for the portion only of claims in excess of a deductible specified in the contract but capped to a maximum limit also specified in the contract. For example, a cover may be expressed as being for $30 million excess of $20 million. Under such an arrangement the cedant bears the initial $20 million, but once the claim has exceeded this level the cedant recovers up to $30 million from the RTU. Should the claim exceed $50 million, the cedant recovers no more than $30 million under this contract. A cedant may buy several "layers" of excess-of-loss cover to protect it against larger losses in a cost-efficient manner. The contribution to be paid to the RTU is negotiated and is typically expressed as a percentage of the cedant's contributions that are protected by the cover. Excess-of-loss cover may be for individual losses, or the aggregate of losses arising out of one event. (The latter is often referred to as "catastrophe cover".) A stop-loss arrangement is similar to excess-of-loss, except that it protects the TU's whole account rather than individual risks or event losses. Deductibles and limits on stop-loss contracts are typically expressed in terms of loss ratios.

(iii) Captives

a. A captive is an entity created and owned by large non-*Takāful*/non-insurance entities within a group. The purpose of a captive is to protect the group by assuming and managing insurable risks emanating from within their operations. It is a form of risk management that provides the group with greater control over how its insurance needs are managed, compared to arranging external *Takāful* or insurance.

b. Maintaining a captive allows the group to manage its risks by pooling and retaining them, and to obtain direct access to the reinsurance/*Retakāful* markets for individual or aggregate exposures that are beyond its capacity or wish to retain.

c. A captive may be managed by officers of the group to which it belongs, though many captives are managed on an outsourced basis by professional captive managers. In addition, some jurisdictions permit the formation of legal entities having internal ring-fenced segments insulated from each other. Such "protected cell companies", or "segregated account companies", are used to enable a group to capitalise a "cell" of the company to act as a captive, rather than establishing a separate legal entity. In the *Takāful* sector, the principle of segregation of funds may create the opportunity for separate PRFs to be established within an undertaking and operated as captives for different groups without pooling the risks of those groups with each other. The effectiveness of such a structure is dependent on national law – in particular, on insolvency.

d. Some captives are structured as RTUs.[19] This may be because regulation requires external cover of certain risks, and the group agrees with an external TU or insurer to "front" the business and retain a small portion, ceding the bulk to the group's captive.

e. Some conventional insurance groups maintain group reinsurance captives to enable them to pool their risks and obtain benefit from diversification. Similar arrangements may be established by large *Takāful* groups.

f. Although captives are common in the industry and may in some jurisdictions be regulated similarly to other insurers, whether conventional or Islamic, captives pool risk only within the same group, rather than with unrelated parties.

g. In some jurisdictions, captives may be allowed to accept unrelated business, or may have many independent clients (e.g. the members of an association). In a *Retakāful* context, these types of captives pose different issues from "pure"

[19] Rather than TUs.

captives, particularly in relation to risk sharing. Subsequent references to “captives” in this document should be taken to be to “pure” captives only.

(iv) Financial, or Finite Risk, *Retakāful*[20]

a. In an arrangement of financial, or finite risk, *Retakāful*, the relationship between the cedant and the RTU is effectively one of borrower and lender (or, in some forms, lender and borrower), although the contract is structured as *Retakāful*. The cedant’s risk is not pooled with that of other cedants, and contractual or connected arrangements ensure that the accumulated surplus or deficit on the ceded business reverts to the single cedant. The RTU receives in substance a fee for facilitating the transaction.

b. Arrangements of this nature may be used to relieve new business strain in life insurance operations, but have also been used in general insurance. It is possible for an insurer to obtain a timing benefit, by accelerating or deferring the recognition of surpluses or deficits, for regulatory or financial accounting purposes. In the conventional sector, RSAs have typically taken action when they consider that the impact of an arrangement of this nature on an insurer’s solvency position fails to reflect the economic substance of the transaction. Internationally, moves towards market-consistent balance sheets and risk transfer requirements have reduced the ability of market participants to obtain advantage in this way. Such arrangements are not generally regarded as *Sharī`ah* compliant due to the absence of pooling and potential lack of transparency.[21]

VIII. Special Issues in *Retakāful*

28. The following broad areas highlight distinctive features of *Retakāful* operations that differentiate them from *Takāful* operations and point to a need to treat some issues related to *Retakāful* distinctly from issues of *Takāful*.

(i) Nature of the Participants

a. An RTU’s participants are TUs who provide Family and/or General *Takāful* coverage to their own direct participants. In the case of *Retrotakāful*, the participants are other RTUs. This differs from the nature of a TU’s participants, which include individuals, groups, businesses, and various other commercial organisations.

b. The different nature of an RTU’s and a TU’s clients necessitates different treatment to address the respective participants’ interests. An RTU’s participants may be assumed to understand the nature of the *Retakāful* relationship, and to be able to manage their *Retakāful* needs. By contrast, most participants in PRFs of TUs are not financial professionals, and the direct *Takāful* relationship usually involves more asymmetry in terms of information and (in personal lines of *Takāful*) financial power.

(ii) International Nature of the Business

a. The *Retakāful* market has an international dimension that direct *Takāful* does not usually have. Although some RTUs operate on a national level, TUs may seek cover in international as well as domestic markets in order to avoid concentration of credit risk, and RTUs may seek cedants in different markets so as to obtain

[20] The survey conducted did not identify financial *Retakāful* as a prominent feature of the *Retakāful* market.
[21] The *Sharī`ah* Board of the Islamic Development Bank does not consider financial, or finite risk, *Retakāful* arrangements as *Sharī`ah*-compliant.

diversification of risks (e.g. a natural disaster in General business, and mortality or morbidity in Family business). Diversification is a strategy for efficient use of capital.

b. Because of the compelling economic logic, RSAs commonly allow TUs in their jurisdictions to cede business to RTUs outside, and do not attempt to regulate those RTUs directly. However, the supervisors of cedants need to consider the appropriateness of the RTUs with whom cedants propose to arrange *Retakāful* cover, and the stability of foreign RTUs accepting risks from their territory, while the supervisors of RTUs need to consider the prudential issues affecting those RTUs arising from overseas operations and incoming business.

c. The international nature of *Retakāful* business may lead to situations where the cedant and the RTU classify the same business differently, leading to potential mismatch between the scope of an RTU's authorisation to write business, and some of the business that is offered to it.

(iii) Large and Specialised Risks

a. RTUs provide coverage on large and specialised risks, and are expected to have the financial strength and technical underwriting ability to manage such risks. TOs frequently rely upon these attributes of RTUs when considering whether to underwrite such risks as primary providers, and indeed ensure that they have agreement on suitable *Retakāful* cover before accepting the underlying contract as TU. A capable *Retakāful* sector is essential to the writing of certain lines of business where individual risks often exceed the capacity of TUs, including marine (hull and cargo), aviation, and significant property risks.

b. RTOs are perceived as possessing technical expertise in writing large and specialised risks, from their experience in writing in international markets and the fact that such risks must necessarily be brought to the *Retakāful* or reinsurance sector. TUs often rely on RTOs' underwriting tools and experience to provide technical assistance in claims management as well as underwriting.

c. Paragraph 27 above referred to the specialised nature of treaty business. The underwriting of treaty business exposes the RRF to the underwriting standards of cedants on an aggregate basis. In addition to being able to analyse risks on an aggregate basis, and with understanding of the effects of treaty characteristics such as deductibles, aggregate deductibles and reinstatement provisions, RTOs need to be able to assess the quality of underwriting of proposed cedants.

(iv) Capital-intensive Nature of the Business

a. *Retakāful* is a capital-intensive business, because an RTU needs to hold capital to cope with the exposures that it assumes to events of low frequency but high severity, or to provide effective relief for new business strains of cedants. Capital needs can be optimised by maintaining a very well diversified book of business. However, in order to represent a realistic counterparty for *Retakāful*, an RTU needs to be capitalised to a level enabling it to accept and retain large tranches of exposures.

b. Initial capital in a *Takāful* or *Retakāful* operation is normally provided by investors or another external party. However, whereas a direct *Takāful* operation may reasonably plan to accumulate over time sufficient surplus within the PRF to make the PRF self-sufficient as to capital, an RTU is unlikely to be able to achieve this aim due to the size and volatility of its exposures. Similarly, if it is necessary for an RTO to provide capital support to its RRF by way of *Qarḍ*, as envisaged in IFSB-11, the time frame for repayment of that capital support is likely to be long. It must be assumed that shareholder capital will remain an important feature of the economics of a *Retakāful* operation in the long term, except possibly for some forms of Family *Retakāful*, where self-sufficiency of the RRF may be achievable.

c. Commitment of shareholders' funds to support the RRF in the long term may affect the ability of an RTO to remunerate shareholders, particularly where funds are transferred to the RRF rather than held in the SHF.

(v) *Sharī`ah* Compliance of Business Accepted

a. *Retakāful* operations may carry an enhanced risk of accepting business that is not *Sharī`ah* compliant. Because of the international nature of *Retakāful* business, and because many small risks may be bundled into a single treaty, it is ordinarily impracticable for RTUs to perform their own *Sharī`ah* assessment of each and every risk that is presented to them by cedants. RTUs must therefore place some reliance on *Sharī`ah* governance in cedants.

Even where the cedant's *Sharī`ah* governance is sound, there is also a risk, particularly in marginal cases, of different interpretations of the application of *Sharī`ah* between cedants and RTUs. A cedant might represent in good faith that a proposed arrangement is compliant based on the cedant's understanding of *Sharī`ah.* The RTO might rely on that representation and accept the arrangement, being unaware at the time that the arrangement is not in fact compliant based on its own understanding of *Sharī`ah*.

b. It is also possible, particularly in the case of treaty *Retakāful*, that non-compliant elements are inadvertently contained in aggregations of otherwise compliant risks bundled together for cession. If an RTU accepts business from conventional insurers, the cedant may not have performed *Sharī`ah* assessment.

c. RTUs need to consider the implications of accepting business that is not *Sharī`ah* compliant, and the mechanisms that are available to it for managing the risk of so doing and for identifying and purifying income that arises as a result.

(vi) Intragroup *Retakāful* and Reinsurance Business

a. Groups of TUs may find it advantageous to enter into *Retakāful* transactions between two group entities. This mechanism is typically used in the conventional insurance sector to aggregate exposures of different group companies to provide diversification benefit, optimise the level of risk that is retained, and improve the group's bargaining position when arranging retrocession cover for risk that cannot be retained.

b. The use of intragroup transactions may expose individual group entities to credit risk exposure concentration. Where intragroup business is conducted between two companies from different jurisdictions, RSAs may need to consider whether an arbitrage is involved such as to distort the capital position of the group as a whole.

c. In addition, RTOs need to consider implications where intragroup business involves a conventional entity and a *Sharī`ah*-compliant entity. Issues may arise if an RTU becomes perceived as merely a fronting operator for related conventional reinsurers sourcing business on a *Retakāful* basis and then converting it to conventional by internal retrocession. Possible procedures for preventing or dispelling such perceptions include contemplating the use of *Sharī`ah*-compliant contracts within a conventional group to address the *Sharī`ah* compliance perspective, and recovery and resolution planning to address the prudential risk perspective.

(vii) Ceding and Profit Commissions, and Brokerage

a. As noted above, it is common for cedants on proportional *Retakāful* and reinsurance contracts to receive a percentage discount on the contribution or premium paid, expressed as a ceding commission. Historically, ceding commissions have been regarded as compensation for the cedant for its acquisition and overhead costs. The contribution or premium paid, less the ceding commission, reflects the net price paid for the cover obtained.

b. The continuing practice of recognising a gross contribution as an outflow of the cedant, and a separate ceding commission as an inflow, rather than recording a single, lower amount of consideration[22] (as is the case typically for non-proportional covers), may reflect advantages available to cedants under some regulatory and accounting frameworks. *Retakāful* ceding commission can, under some frameworks, be treated immediately as income of the cedant, thus contributing to the profit in the year it accrues. In addition, because contribution has historically often been treated as a proxy for the ceded risk when determining regulatory capital requirements, recording the *Retakāful* contribution paid as gross of the ceding commission (so that net contribution retained by the cedant is lower) may lead to lower regulatory capital requirements. Evolving regulatory and accounting practices are likely to change both of these effects. Regulatory capital requirements increasingly depend upon more comprehensive assessments of risk, and accounting practice increasingly considers ceding commission to be a reduction in the amount of contribution rather than a separate item of revenue to the cedant and expense to the RTU.

c. Profit commission is a feature of some proportional *Retakāful* and reinsurance contracts, and represents an amount awarded to the TU based on the RTU's result under the *Retakāful* contract, calculated in accordance with the terms and conditions of the contract. The aim of a profit commission is to provide cedants with an incentive to manage the performance of the business that is ceded. A profit commission differs from a distribution of surplus in that it is a contractual entitlement, rather than a discretionary distribution, and is specific to the performance of a contract. The payment of profit commission[23] based upon the result of a single cedant's risks is considered by some to conflict with the principle of risk sharing.

d. Where commission is received by a TU (either ceding commission recognised as a separate inflow, or profit commission), it is necessary to consider which fund of the TU (PRF or SHF) such commission should be credited to.[24] A conflict of interest arises if commission may be credited to a fund other than that which bore the expense of the contribution to which it relates, since the TO may be incentivised to place *Retakāful* cover which is not optimal for its participants but which maximises the TO's remuneration. Conflict of interest may also arise if commission or other reward is paid from the RTO to the TO in consideration of entering into *Retakāful* arrangements.

e. In circumstances where TUs cede business to a conventional reinsurer, an issue may arise as to whether it is acceptable for the TUs to accept commission from a conventional reinsurer which is non-*Sharī`ah* compliant. In the case of ceding commission, this is in substance merely a means of arriving at the negotiated price for the cover obtained.[25] However, some bases of calculation of profit commission may involve elements of *Riba*, and TUs need to be alert to the risk of inadvertent *Sharī`ah* non-compliance.

f. *Retakāful* contracts may be negotiated between a cedant and an RTU through a broker or other intermediary, Although, in some cases, intermediaries are remunerated by a fee paid by the TU, the more common model has been that

[22] That is, a net contribution.
[23] Or a payment by any other name based on the experience of a single cedant's risks.
[24] See paragraph 127.
[25] This view of commission as a discount on the contribution is also consistent with the Accounting and Auditing Organization for Islamic Financial Institutions' *Sharī`ah* Standard 41: *Islamic Reinsurance* (in paragraph 7.2).

commission or "brokerage" is deducted by the broker from the amount paid to the RTU. Such brokerage, unlike ceding commission, represents an expense of the RTU rather than a rebate of the contribution, as it is paid to a third party. The *Retakāful* agreement should specify clearly whether brokerage is deducted from the *Tabarru'* from the cedant before it is credited to the RRF, or whether brokerage is to be borne by the RTO, out of *Wakālah* fees or other remuneration, in which case the *Tabarru'* is to be credited to the RRF without deduction.

(viii) *Riba* in Other Aspects of Contracts Assumed or Ceded

Cedants and RTUs need also to be alert to the potential presence of *Riba* in other aspects of reinsurance/*Retakāful* contracts that they enter into. For example, it is common practice under proportional treaties for cedants to retain a part of the premiums on account of possible future claims, and in the conventional insurance market such "retentions" are typically interest-bearing.[26]

(ix) Run-off

Like TUs, or conventional insurers or reinsurers, an RTU may go into run-off. That is, it may cease to accept new business while continuing to pay claims arising from existing contracts. Run-off may relate to part of the business or to the whole, and may in some circumstances be required by the RSA, usually in response to a deteriorating solvency position. Run-off, particularly complete run-off, creates a new set of risks and incentives, which may be exacerbated for an RTU by three factors:

a. The time taken to run off the business is likely to be long, because of the indirect relationship with ultimate participants.

b. Because the RRF is attributable to the participants, who will reduce in number as their claims are met, there may be a need to determine how any residual assets are allocated at the end of the period.

c. An unscrupulous RTO might seek to extract value from the RRF for the benefit of its SHF – for example, by manipulating the charges which it is entitled to make under the relevant contracts.

(x) Supplementary Services

As is also the case in the conventional reinsurance industry, RTUs may provide ancillary services to cedants and to other parties, that are connected with the business of *Retakāful* but which do not constitute *Retakāful* contracts themselves. Such services could, for example, include statistical or actuarial services, risk analysis or research. The provision of such services may be complementary to the *Retakāful* business of the RTU, but may also result in risks to the interests of cedants. The RTU's risk management procedures need to encompass risks arising from such activities, including any conflicts that may arise.

IX. Regulatory Standards and Practices Relevant to *Retakāful*

29. There has in the past been less commonality in international regulatory approaches to reinsurance than to direct insurance. On the prudential side, some in the industry have advanced arguments, which have been accepted by some RSAs, that because the failure of a reinsurer does not directly impact customers outside the industry (since the responsibility of the insurer towards the insured is unaffected), they should not be prudentially regulated. The counterargument is that, at least in some circumstances and for some kinds of risk, direct insurers are so dependent on their reinsurers that the failure of a major reinsurer would also

[26] Refer to paragraph 85(vii).

result in the failure of those insurers to meet their obligations. In addition, the fact that major reinsurers cede risk between themselves on a retrocession basis leads to the possibility of systemic risk, in which the failure of one reinsurer could also bring down others.[27] In recent years, the arguments against prudential regulation of reinsurers have been losing ground, most notably with the passing of the European Reinsurance Directive in 2005. European reinsurers are required to comply with the Solvency II regime. Where reinsurers are prudentially regulated, it is normally on a broadly similar basis to their direct insurance counterparts, though some parameters may be varied to recognise the generally greater volatility of reinsurance risks.

30. Even where reinsurers are prudentially regulated, they are normally subject only to minimal conduct of business requirements. This reflects the fact that reinsurance is interprofessional business. Cedants are themselves professional (and, in the vast majority of cases, regulated) insurers, who must be assumed to have a deep understanding of the business and of contract forms, even where these are highly technical. They will also in most cases have rough parity of negotiating power.

31. Against this background, the international standards for reinsurance are less highly developed than for direct insurance. The IAIS's Insurance Core Principle 13, entitled "Reinsurance and Other Forms of Risk Transfer", states:

> *The supervisor sets standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction.*

The ICP "provides guidance to supervisors on issues related to reinsurance and retrocession. It also provides guidance to supervisors on reinsurance matters in general, but does not provide guidance on the direct supervision of reinsurers." It thus focuses primarily on the role of the supervisor in supervising the reinsurance cessions of direct insurers.

32. The IFSB's standards relevant to *Takāful* have already been cited. IFSB-10, on *Sharī`ah* governance, applies to all firms undertaking Islamic financial business, and thus to all RTOs. The present standard therefore does not repeat any of its provisions, though it draws attention to some issues of particular relevance to the organs of *Sharī`ah* governance in RTOs, and in TOs that are placing *Retakāful* or reinsurance. Similarly, IFSB-11, on solvency of *Takāful* undertakings, and IFSB-14, on risk management in *Takāful,* are expressed to apply to RTUs also and their provisions are not repeated here, though attention is drawn to some particular issues affecting *Retakāful*.

33. Paragraph 10 of IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* states:

> *The Guiding Principles have been formulated for direct General and Family* Takāful *undertakings. The applicability to* Retakāful *operators is limited because their operating concepts differ in important respects: for example, the participants are direct* Takāful *undertakings (as cedants) rather than members of the public, so that the governance issues that arise are somewhat different. A thorough study of business models of* Retakāful *operators is required before good governance structures and processes can be recommended. Nevertheless,* Retakāful *operators and supervisory authorities are encouraged to consider the Guiding Principles in strengthening their governance framework, and to apply them where appropriate.*

[27] Although evidence indicates that reinsurers have in fact behaved prudently, dispersing risk rather than concentrating it. See, for example, the 2012 IAIS paper, "Reinsurance and Financial Stability".

In preparing this standard, the IFSB has reviewed the provisions of IFSB-8, and those considered relevant to *Retakāful* are included, with modifications as appropriate, in the guiding principles that follow.[28]

34. IFSB-9, on conduct of business, does not indicate unambiguously whether it is intended to apply to *Retakāful.* However, while some of the material in it is clearly as applicable to RTOs as to other institutions, other material does not appear appropriate to interprofessional business. In preparing the present standard, the same approach was taken as to IFSB-8; that is, the provisions of IFSB-9 were reviewed in detail and those relevant to *Retakāful* are included, with modifications, in the guiding principles that follow.

[28] Note also that some of the provisions of IFSB-8, even in their direct application to *Takāful*, have been modified or superseded by more detailed later standards.

C. THE GUIDING PRINCIPLES

I. Governance of *Retakāful* Undertakings

PRINCIPLE 1.1 Comprehensive Governance Framework

RTOs shall have in place in *Retakāful* undertakings that they manage a comprehensive governance framework appropriate for their *Retakāful* business models, in which the independence and integrity of each organ of governance shall be well defined and preserved, and the mechanisms for proper control and management of conflicts of interests shall be clearly set out.

Rationale

35. The role of an RTO is conceptually similar to that of a TO, in that management of the RRF is the responsibility of the RTO for which it receives remuneration in the form of fees reflecting its model of operation. The RTO is not responsible for any deficit suffered by the RRF unless the loss is proven to be attributable to an act of misconduct or negligence on the RTO's part.[29] The participants in the RRF (the cedants) are dependent on the RTO for proper management of their interests. At the same time, the shareholders are dependent on the RTO for proper management of their interests in the SHF. Both cedants and shareholders are principals with whom the RTO has a fiduciary relationship.

36. Potentially complex agency problems therefore arise, as the RTO has an incentive to engage in self-interested behaviour to the detriment of either or both of its principals (e.g. in the selection and remuneration of counterparties or service providers). Conflicts of interest may also arise between the two categories of principal, cedants and shareholders, creating a conflict of duties for the RTO. Conflicts of interest of all types need to be identified and managed in order to avoid inappropriate detriment to stakeholders.

37. Compared to the situation in a TU, the participants in an RRF are expected to have greater access to information and economic power to enable them to monitor the RTO and assert their interests if necessary. Consequently, RSAs may consider it is not as necessary for them to police the conduct of RTOs (in respect of the RTOs' interaction with their counterparties) to the same level as it is in the case of TOs.

38. However, the quality of governance in an RTU may indirectly affect participants of cedant TUs, through the risk that it poses to the stability of TUs relying upon the RTU for *Retakāful* cover. It is therefore appropriate for RTOs to cultivate an effective governance framework promoting a culture of accountability and transparency for the benefit of their cedant TUs and the indirect protection of underlying participants, and to help demonstrate to RSAs the ability of the RTU to withstand stressed circumstances.

39. In the context of *Retakāful*, the interests of cedants are not only economic but also relate to compliance with *Sharī`ah*. A governance framework is therefore needed to ensure that representations made to cedants as to the RTO's approach to *Sharī`ah*-related matters (including, for example, segregation of funds as envisaged in IFSB-8, the pooling inherent in the principle of *Ta'awun*, or mutual assistance, and the use of *Retrotakāful*) are reflected in the actual operations of the RTU.

40. Proper governance of operations is also important to enable smooth operations of key risk management functions. RTUs fulfil an important role in the risk management arrangements of TUs, and it is important that they are there when they are needed. Continuity of operations and effective operation, including of outsourced activities, are therefore within the scope of this principle.

[29] Though in some circumstances there may be a commitment to provide support to the RRF, normally in the form of *Qard*; see Principle 3.2.

Recommended Best Practices

41. RTOs should establish a comprehensive governance framework in the *Retakāful* undertakings they manage, with organs of governance given appropriate powers to oversee, control and review the administration of the SHF and the RRF, with a view to ensuring the RTO's adherence to the objective of protecting the interests of cedant TUs (and, indirectly, their participants), separately from the interests of shareholders. The framework of governance should be designed to ensure that the activities are subject to appropriate internal scrutiny and that those performing governance functions are functionally independent from the activities they oversee.

42. An RTO should thus establish a proper governance framework for the *Retakāful* undertaking(s) that it manages, covering the following areas:

    (i) a clear identification and segregation of strategic and operational roles and responsibilities for each organ of governance, including but not limited to the board of directors and its committees, the board of trustees (in the case of a *Waqf*), the management, the *Sharī`ah* governance function established in accordance with IFSB-10, as well as the internal and external audit functions;
    (ii) mechanisms for observing and addressing the rights and interests of all stakeholders;
    (iii) clearly documented and applied reporting lines and accountabilities of each organ of governance;
    (iv) a compliance mechanism covering all activities to monitor adherence with the legal and regulatory frameworks applicable in relevant jurisdictions; and
    (v) a documented and tested plan for ensuring continuity of service to cedants if normal operations are interrupted due to, for example, natural or operational events.

43. The governance framework should encompass the governance of any functions that are outsourced. In addition to continuous supervision of the performance of outsourced matters, the framework should provide that, prior to outsourcing any activities of an RTO, due diligence should be carried out to assess the service provider's capability and suitability to perform the activities to be outsourced. The assessment should be revisited periodically.

PRINCIPLE 1.2 Code of Ethics and Conduct

RTOs shall adopt an appropriate code of ethics and conduct to be complied with by their officials at all levels.

Rationale

44. Successful operation of a system of governance requires adherence to professional ethics and appropriate business conduct by officials of the company at all levels. An RTU is vulnerable to the possibility of loss arising from improper conduct – for example, acceptance of *Retakāful* contracts without proper consideration of underwriting standards, including considerations for contribution rate setting and the monitoring and control of aggregate exposures. The observation of Islamic ethical principles by the organisation as a whole also requires personal observation of such principles. Each RTO is responsible for ensuring that its officials (including persons to whom functions are outsourced) follow ethical standards that are commensurate with the levels and significance of responsibilities held by them.

45. In view of the business-to-business nature of the *Retakāful* arrangement, it is less important to have regard to information asymmetry between the provider and the cedant than it is in the case of direct *Takāful* business. Consequently, considerations relating to conduct of business of RTOs and their officials may be viewed in the context of contracts between knowledgeable professionals. However, it remains important that an RTO ensures that its representatives do not mislead potential cedant TOs (or brokers advising them) as to the nature of the contracts

offered – in particular, as to similarities with conventional reinsurance. Pressures of competition with conventional reinsurers should not lead RTOs to mis-describe the *Retakāful* products provided by them, as such compromise might lead to inadvertent non-compliance with *Sharī`ah* principles by cedants.

46. The RTO should observe *Sharī`ah* rulings and principles in all areas of its operation. Where the RTO outsources activities (e.g. information technology system, actuarial services, investment management or *Sharī`ah* governance function), the RTO remains responsible for the *Sharī`ah* compliance of the outsourced services.

Recommended Best Practices

47. An appropriate code of ethics and business conduct should be put in place by an RTO requiring its employees and representatives to observe high standards of integrity within the RTO and fair dealing between the RTU and its cedant TUs and other parties. Internal regular review mechanisms should be in place to verify and enforce compliance with the code. Breaches should be dealt with appropriately and identified conflicts addressed at an appropriate level.

48. The code should recognise the fiduciary role that an RTO has towards the participants in its RRF, and thus towards the relevant participants in the TUs with which it does business.

49. The code should require and incentivise the reporting of potential breaches, or potential conflicts of interest within the institution or any other material concerns arising in the course of their work, with appropriate protections for "whistle-blowing" disclosures properly made. A clear policy on "whistle-blowing" should guide employees on the reporting mechanism, type of actions to be taken by the management, and the RTO's obligations to ensure that measures are taken to prevent future breaches.

50. Wherever an official of an RTO finds himself or herself in a conflict of interest, he or she should be required to declare this conflict in writing to the immediate superior, and should be restrained from any position of decision making or influence in relation to it. In particular, an RTO's officials must do so in the case of related party transactions (i.e. involving members of their family, business associates, or companies in which they may have an interest).

51. RTOs should provide a mechanism for employees to report breaches of the code or other matters relating to ethics or business conduct that they have observed, on a confidential basis. Reports properly made should not expose the employee making the report to any detriment.

52. Compliance with the established code should be taken into consideration in determining performance of employees and representatives, and in the design of incentive programmes. Incentive programmes that do not take compliance with codes and standards into consideration may reward activity that places the RTU at risk of unmanaged risk exposures.

53. In addition to its own code, the RTO should require professional persons (including, without limitation, actuaries, chartered insurers, accountants and legal practitioners) employed or appointed by it to act in accordance with relevant professional codes of conduct and ethics established by the professional body of which the person is a member. The same professional should not act for both the RTU and a cedant TU on the same matter, to avoid the perception of conflict of interest.

54. An RTO should require outsourced service providers to observe similar standards as officers of the RTO. Due diligence on, and assessment of performance of, outsourced providers should include consideration of their ethical and compliance culture.

PRINCIPLE 1.3 Truthfulness, Honesty and Fairness

An RTO shall aspire to the highest standards of truthfulness, honesty and fairness in all its statements and dealings, and must treat its customers fairly.

Rationale

55. A *Retakāful* arrangement is a business transaction between professional entities in which concerns as to potential asymmetry of information and financial capacity between the participants are less relevant than in the case of direct *Takāful* business. Consequently, RSAs generally do not provide the same level of protection for cedant TUs as for the participants in a *Takāful* contract. This, however, does not relieve the RTOs from observing the highest standards of truthfulness, honesty and fairness in all business dealings with stakeholders, including cedant TUs. The integrity of RTOs and of their business dealings is important to the reputation of the *Retakāful* sector, and failings in this respect could damage the stability of the sector.

56. Indirectly, also, cedants' own participants may be affected by lapses in integrity of RTOs, as this may affect the *Sharī`ah* compliance of the chain of business in which they have an interest. The interest of participants in transactions, while indirect, may be perceived as more proximate than that of policyholders of a conventional insurer in a reinsurance transaction, as *Retakāful* contributions are typically paid from a PRF that is attributable to the participants.

57. For Islamic financial institutions, including TOs and RTOs, truthfulness, honesty and fairness are elements of ethical business conduct required by principles of *Sharī`ah* as set out in the Holy Quran and the Sunnah of the Prophet (peace be upon him). Accordingly, an RTO should not, either deliberately or through negligence, provide information that is misleading to its stakeholders or the market, nor should it seek to obtain commercial advantage by unethical means. This responsibility extends to information provided regarding the *Sharī`ah* compliance of its *Retakāful* products and activities, and providing information is also understood to include the withholding of material information. Similar obligations apply to TOs in their dealings with third parties.

58. There is a risk in the *Retakāful* sector that the contractual details of arrangements may not be finalised for some time after the parties to the agreement have agreed in principle that the cover is in place. Where this occurs, unethical behaviour by either party to the agreement – for example (on the grounds that the contract documentation is not complete), seeking to refuse a term previously agreed, following an unforeseen event, in order to gain an advantage – would undermine the confidence in good faith on which the effectiveness of the *Retakāful* function depends.

59. In the *Retakāful*/reinsurance sector, it is common for intermediaries (predominantly brokers) to play an important role in the communication of information between the parties, and in the development of contract documents. Intermediaries may be unfamiliar with the specificities of *Retakāful*. There is, consequently, a risk that information or contract wording will fail to comply with requirements that depend upon understanding those specificities.

Recommended Best Practices

60. An RTO should ensure that information that is material to concluding a *Retakāful* agreement is not withheld from its cedant TUs, and neither should misleading information be provided as to the terms offered or matters relating to *Sharī`ah* compliance. Cedants should similarly be under an obligation of disclosure of relevant material matters. Where an intermediary acts, by the nature of its services, as agent in some respect for either or both parties, the principals should ensure that information provided via an intermediary meets the same standard as that provided directly.

61. The *Retakāful* arrangements made between an RTU and its cedant TUs should aim to provide certainty of contract by containing clear and unambiguous terms and conditions, including matters relating to *Sharī`ah* compliance. The matters dealt with should include the *Retakāful*

model used for the arrangement, the treatment of the RRF surplus and the contract that forms the basis of the agreement, as well as the basis for any claimed benefits and any significant limitations in cover. The contract should also identify the expenses to be attributed in the RTU to the RRF and those to be attributed to the SHF, and specify the *Wakālah* fees or other remuneration by which the RTO is to be remunerated. Where an intermediary is involved in the drafting of the documentation, the principals should ensure that this documentation meets the requirements set out here and is consistent with the rulings provided by the undertakings' *Sharī`ah* advisers.

62. Contract documentation should be finalised prior to, or if that is not possible, as soon as possible after, inception. Where it is not possible for contract documentation to be in place prior to inception, RTOs and TOs should record matters agreed upon to facilitate execution of the contract in the meantime, in terms that will provide for enforceability of the commitment.

63. Communications relating to the arrangement following its completion should follow the practices referred to above in respect of communications prior to the contract.

64. RTOs should ensure that their employees and representatives are contractually obliged to carry out their duties and responsibilities in accordance with a code of business conduct that requires fairness and honesty.

65. RTOs should be aware of the potential for conflicts of interest arising from the activities of intermediaries with which they have dealings, and should seek to ensure that cedant interests are not adversely affected by such conflicts. They should satisfy themselves that any payments made to intermediaries reflect legitimate payment for activities that are in the best interests of cedants.

PRINCIPLE 1.4 Due Care and Diligence

An RTO shall exercise due care and diligence in all its operations, including the way it structures and offers its products and provides services, with particular regard to *Sharī`ah* compliance, and to the thoroughness of research and risk management.

Rationale

66. RTOs have fiduciary duties towards their shareholders and cedant TUs, and their products and services also indirectly affect participants of the TUs. In the best interests of all its stakeholders, this principle requires the RTOs to exercise due care and diligence in all its operations so as to manage the risks to which the RTU is exposed, including conflicts of interest. Failure to manage those risks can result in economic detriment to stakeholders. Where an RTO has not exercised due diligence in managing the RRF, the RTO may be liable for a share of responsibility for any resultant detriment.

67. RTOs carrying on supplementary business connected to *Retakāful* business but not constituting *Retakāful* arrangements should be aware of the potential for conflicts of interest arising as a consequence of those activities. Costs and profits arising from such activities should be segregated from transactions attributable to the RRF.

68. In offering *Sharī`ah*-compliant *Retakāful* products and services, an RTO aims to meet the interests of its cedant TUs in obtaining *Retakāful* coverage that is free from elements that do not comply with *Sharī`ah* in all respects, including the nature of the contract and the investment of contributions. Failure to exercise due care and diligence in ensuring *Sharī`ah* compliance may cause the RTU and, unintentionally, TUs to become non-compliant. Non-compliance may also affect, indirectly, the participants of the cedants. Due care and diligence helps protect the confidence of cedants and the insuring public in the *Sharī`ah* integrity of the *Retakāful* sector.

Recommended Best Practices

69. RTOs should exercise due care and diligence in managing the RRF in the interest of the cedant TUs, in providing *Retakāful* products and services, in accepting risks from the TUs, and in any other activities where a proper evaluation of risks, with the collection and analysis of the information necessary for this purpose, is called for. Due diligence also applies to the process of obtaining *Sharī`ah* approval and in maintaining *Sharī`ah* compliance of: (a) products; (b) services; (c) investment and underwriting activities of the RRF; and (d) the RTO's overall operational activities. Where an RTO makes use of the services of intermediaries, due diligence includes oversight of the activities performed by intermediaries and information provided via them.

70. RTOs should ensure that recruitment, training and incentive structures reinforce the requirement for due care and diligence on the part of their employees and representatives. Appropriate systems and controls should be enforced and monitored, to require behaviours conducive to due care and diligence.

PRINCIPLE 1.5 Systems and Procedures

An RTO shall ensure that it has in place the necessary systems and procedures, and that its employees have the necessary knowledge and skills, to comply with these principles and other IFSB standards.

Rationale

71. Lack of necessary knowledge and skills in key areas of the organisational structure of RTOs may result in flawed products and services, defective contracts, poor and costly underwriting decisions, and products that do not meet legal or regulatory requirements. These shortcomings may lead to misrepresentation of the nature of the contracts entered into, even if not intended. Consequently, it is essential that RTOs ensure that operational and governance functions are undertaken by persons whose fitness and propriety to undertake those functions are assessed prior to commencement and are periodically reassessed.

72. The requirement for appropriate knowledge and skills extends also to those responsible for assessing *Sharī`ah* compliance of products and operations, as failure to give proper and informed consideration to *Sharī`ah* compliance matters in RTUs may undermine the confidence of cedants and the insuring public in the *Sharī`ah* integrity of the *Retakāful* sector.

Recommended Best Practices

73. All persons with responsibility for carrying out operational or governance functions in an RTO should be subject to "fit and proper" requirements relevant to their position, prior to being allowed to take on their responsibilities. Fitness should be assessed by reference to factors such as skills and experience relevant to the duties performed, and propriety by reference to factors such as integrity and independence. Continuing suitability and training needs should be assessed periodically and addressed by providing training and development opportunities and, where necessary, modifying responsibilities. The responsibilities of the RTO in this respect are not restricted to those roles for which the regulatory framework may require specific approval by the RSA as a condition of appointment.

74. All officers and representatives of the RTO, including those performing outsourced services for the RTU, should be provided with a level of technical and *Sharī`ah* knowledge on *Retakāful* that is appropriate to the duties they perform. Professional persons (e.g. actuaries and accountants) should be encouraged to remain in good standing with their professional bodies regarding compliance with continuing professional education requirements.

75. RTOs should, when selecting persons to provide advice on *Sharī`ah* compliance of contracts or operations, whether officers of the RTO or external advisers, assess candidates' technical knowledge on the nature of the business. Those appointed should be provided with sufficient technical information on *Retakāful* to enable them to make informed decisions as to the application of *Sharī`ah* to that business. Technical training should be provided if *Sharī`ah* advisers request it or if those responsible for governance functions consider it necessary.

II. Compliance with *Sharī`ah* Principles

PRINCIPLE 2.1 Business is *Sharī`ah*-Compliant

An RTO should ensure that all the business it undertakes is compliant with *Sharī`ah* principles, both contractually and in terms of the underlying risks accepted. It should have measures in place to identify and purify any tainted income.

Rationale

76. IFSB-10: *Guiding Principles on Sharī`ah Governance Systems for Institutions offering Islamic Financial Services* emphasises the importance of having a *Sharī`ah* governance system in place for every Islamic finance institution. Although the standard does not mention *Retakāful* specifically, the inclusive nature of its application makes it suitable to be applied by all RTOs and the principles and rationales set out in that standard are not repeated here.[30]

77. It may, however, be noted that the application of *Sharī`ah* principles within the operational framework of a *Retakāful* operation is likely to require specialist technical knowledge as to the nature of that operation and the practical implications of decisions as to *Sharī`ah* application. If this specialist technical knowledge is lacking, *Sharī`ah* advice may lead to practical consequences not foreseen or intended by the advisers in reaching their conclusions, potentially including unintended outcomes in respect of *Sharī`ah*. There is therefore a need for *Sharī`ah* advisers to be provided with technical knowledge on the nature of the business of an RTU, in order to enable informed advice (see Principle 1.5 above). This observation is relevant to a range of areas on which *Sharī`ah* advisers' advice is required, including approval of the business model, attribution and distribution of underwriting surplus, contract wordings, placement of *Retrotakāful* arrangements, payment of profit commissions, and acceptance of business from conventional insurers.

78. The nature of the business of an RTU may expose it to the risk of *Sharī`ah* non-compliance due to unjustified reliance on assertions made by counterparties (or by intermediaries acting for counterparties) as to the *Sharī`ah* compatibility of business entered into or ceded by the RTU. The RTO is responsible for taking appropriate steps to check its compliance with *Sharī`ah* principles, including where the risk of non-compliance arises from actions taken by counterparties rather than the RTO itself. In addition, even where a cedant has proper *Sharī`ah* governance arrangements in place, there remains a risk that it will inadvertently accept, and cede to the RTU, a non-compliant risk.

79. Where an RTU accepts business from a conventional insurer (or reinsurer), it will not be able to rely on that conventional insurer to assess the *Sharī`ah* compliance of the underlying risk, and will need to have arrangements in place to do so itself.

80. An RTU that is a member of a group may face pressure to accept business from fellow subsidiaries or parent entities that are conventional insurance or reinsurance undertakings. An RTU that is a member of a group may also come under pressure to retrocede risk to group members that are conventional reinsurers. This risk is discussed further in Principle 5 below.

[30] IFSB-10 sets out nine principles, grouped into five parts. Part I: General Approach to the *Sharī`ah* Governance System; Part II: Competence; Part III: Independence; Part IV: Confidentiality; and Part V: Consistency.

81. Where an RTU operates as a window, the need for *Sharī`ah* compliance applies equally for the protection of those ceding business to the window. Further considerations also exist in this structure. These include the need for asset segregation and for *Sharī`ah* compliance of assets supporting the solvency or liquidity of the window.

Recommended Best Practices

82. An RTO should ensure that it has ready access to timely advice on matters pertaining to *Sharī`ah* and that its *Sharī`ah* advisers are provided with sufficient resources to enable them to carry out their duties. IFSB-10 requires it to have a *Sharī`ah* governance structure commensurate with the size, complexity and nature of its business.[31]

83. An RTO should have in place a system to provide its *Sharī`ah* advisers with such technical knowledge of *Retakāful* as they require to enable them to provide informed advice. The RTO should ensure that its *Sharī`ah* advisers are kept abreast of industry practices and developments, and assisted in assessing the impact of potential decisions on the RTU and its cedants.

84. The *Sharī`ah* advisers of RTOs should also make such enquiries of management as they consider necessary for the purpose of satisfying themselves that they have sufficient information on *Retakāful* matters relevant to *Sharī`ah* to enable them to apply *Sharī`ah* principles in an appropriate business context.

85. RTOs' *Sharī`ah* advisers should, in their capacity as a governance function of the institution, ensure the following:

(i) The operations of the RTU follow the *Retakāful* model approved by *Sharī`ah* advisers, and remain compliant with *Sharī`ah* principles at all times. This objective requires periodic review by the *Sharī`ah* advisers of the operations of the RTU.[32]

(ii) Policy and procedures are in place with regards to the treatment of surplus arising in the RRF. The presumption should be that underwriting surplus arising in the RRF is attributable to cedants, and that if any of the surplus is distributed rather than being retained within the RRF, it should be distributed to the cedants' PRFs.[33] Exceptions to these presumptions should be justified based on *Sharī`ah*.

(iii) Should the RRF go into run-off, there is a policy in place governing the distribution of any residual surplus once all valid claims have been met.

(iv) There is a procedure in place for *Sharī`ah* assessment of proposed *Retrotakāful* arrangements – in particular, where it is proposed that such arrangements are made on a conventional reinsurance basis or with a conventional reinsurer.

(v) There is a procedure in place for *Sharī`ah* assessment of any proposed profit commission arrangements in inward or outward *Retakāful* contracts.

(vi) There is a procedure in place for *Sharī`ah* assessment of any proposed ceding commission arrangements in inward or outward *Retakāful* contracts.

[31] Principle 1.1 of IFSB-10, which is fully applicable to RTUs.

[32] Paragraph 74 of IFSB-14 states: "A TU's *Sharī`ah* Board has a duty to advise the governing body and management of the TU on matters relating to *Sharī`ah*." This requirement is equally applicable to RTUs.

[33] At its 21st meeting in Riyadh, Saudi Arabia, the IIFA resolved, in relation to *Takāful*: "The insurance fund surplus is the financial amount that remains from the collected contributions, the revenues of investing them, and any other revenues after paying the compensations after deducting the provisions and reserves needed and paying all the expenses and liabilities due to the fund. The insurance surplus can be kept in the fund; or it can be distributed; or a part of it could be justly apportioned to the policyholders (participants) in accordance with the fund regulations." This principle applies by analogy to *Retakāful*.

(vii) There is a procedure in place to ensure, prior to accepting risks from conventional insurers, that the risk, the contract and any other pre-agreed arrangement, such as contribution retention by the conventional insurer (and the way it is invested), are *Sharī`ah*-compliant.

(viii) There is a procedure in place to review and assess the *Sharī`ah*-compliant status of contracts that are written on a coinsurance basis together with conventional reinsurers.

(ix) There is a procedure in place to review and assess the *Sharī`ah*-compliant status of activities carried out on a supplementary basis in addition to *Retakāful* business.

(x) There is a procedure in place to identify any tainted income, and to purify it as appropriate.

86. *Sharī`ah* advisers of RTOs should assist the RTO to preserve its integrity and independence when making *Sharī`ah*-related decisions, in situations where counterparties make assertions as to *Sharī`ah* compliance upon which the RTO is asked to rely. Such situations are likely to arise in the case of business offered to the RTU by prospective cedants, in the case of business on which the RTU is invited to participate as a follower on a co-*Takāful* basis, and in the case of potential *Retrotakāful* arrangements. In many such circumstances, detailed *Sharī`ah* compliance verification is likely to be impracticable. However, RTOs should still assess the systems of counterparties in order to determine the reliance that may be placed on assertions. Therefore:

(i) Before relying on assertions of *Sharī`ah* compliance by prospective cedants or intermediaries acting on their behalf, RTOs should conduct due diligence procedures approved by their *Sharī`ah* advisers to satisfy themselves that the prospective cedants have systems in place to provide assurance that business proposed to be ceded is *Sharī`ah* compliant, and that the prospective cedants' understanding of *Sharī`ah* compliance is compatible with the RTO's. Depending on the results of this due diligence, and on the nature of the business, checks on *Sharī`ah* compliance may be desirable within the lifetime of a treaty.

(ii) A similar approach should be adopted where an RTU is approached to participate as a following participant on a cover that is placed on a co-*Takāful* basis. In this case, the RTO has also to consider the procedures performed by the leader to satisfy itself as to *Sharī`ah* compliance.

(iii) Similar due diligence should be performed where an RTO proposes to place *Retrotakāful* arrangements with other RTUs or conventional reinsurers.

87. An RTU operating as a window should ensure that the practices recommended here are applied to the window, as though that window were a separate undertaking. In addition, the RTO needs to ensure that assets of the window are clearly segregated from those of the conventional operation, such that assets backing cedant entitlements are not commingled with those backing liabilities of the conventional operation. This segregation should be robust, including under conditions of insolvency. Where the solvency or liquidity of the window is supported by assets of the conventional operation, the RTO needs to ensure that the assets in question are identified and are *Sharī`ah*-compliant. The RTO also needs to ensure that the contracts issued by the window are *Sharī`ah*-compliant and are not unduly influenced by the forms of contract used in the conventional operation.

III. Prudential Framework

PRINCIPLE 3.1 Adequate Risk Management Framework

RTOs shall ensure that the RTU has in place an adequate risk management framework, with an appropriate scope and embedded within an appropriate governance structure.

Rationale

88. IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* is stated to be applicable to RTUs, and sets out minimum standards for the development of a risk management framework to facilitate management, and supervision by the RSA. IFSB-11: *Solvency Requirements for Takāful (Islamic Insurance) Undertakings* also requires a sound risk management framework to support the adequacy of the undertaking's solvency resources, and regards assessment of risk management arrangements as an essential part of the supervisory review process relating to solvency.

89. A risk management framework is intended to ensure that the RTO has processes in place to identify and manage the risks to which the RTU is exposed that may affect its ability to achieve its objectives or even its continuing existence. In addition to considerations that apply to conventional reinsurance providers in this respect, RTOs must also consider the impact of the additional fiduciary duty that they bear towards their cedant TUs, who share risks through an RRF that is managed by the RTO on their behalf.

90. IFSB-14 describes a basic structure for an effective risk management framework that is intended for adaptation to the circumstances of a particular TU or RTU.

Recommended Best Practices

91. An RTO should ensure that it has in place and documented an effective risk management framework, compliant with IFSB-14, dealing at least with:

    (i) the setting of risk policies and strategies;
    (ii) procedures for risk identification, assessment and decision on response;
    (iii) a control framework covering key activities;
    (iv) procedures for monitoring the status of risks; and
    (v) internal reporting procedures for risk.

92. The risk management framework should include all risks to which the RTU is exposed, including any to which it and its component parts are exposed by reason of the carrying on of supplementary services in addition to *Retrotakāful* arrangements.

93. An RTO should ensure that its risk management framework is overseen by persons of appropriate skills, resources and objectivity, such that those persons are able to carry out their functions without restriction or conflict of interest.

94. An RTO should carry out an own risk and solvency assessment (ORSA) to assess its financial strength on the basis of its planned level of business and risk management framework, on a forward-looking basis. The ORSA should be reviewed periodically and in any event when the circumstances of the RTU change significantly. The results of the ORSA and of periodic or ad hoc review should be communicated to the governing body of the RTU and to the RSA.

PRINCIPLE 3.2 Solvency of *Retakāful* Undertakings

RTOs shall ensure that they have in place appropriate mechanisms properly to sustain the solvency of *Retakāful* undertakings.

Rationale

95. IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* is stated to be applicable to RTUs. This standard envisaged solvency tests at the level of each segregated fund attributable to cedant interests (in the context of an RTU, the RRF or RRFs), at the level of the SHF, and at the level of the undertaking as a whole.

96. The rationale of requirements for capital adequacy and other prudential mechanisms is to ensure that an undertaking has sufficient resilience to absorb losses arising from its business that are foreseeable but unpredictable, such that it can continue to meet its obligations as they fall due. *Retakāful* is a capital-intensive business, because an RTU needs to hold capital to cope with the exposures that it assumes to events of low frequency but high severity, or to provide effective relief for the new business strain of cedants.

97. RTUs that are dominant providers of *Retakāful* for a specific sector could not only cause severe difficulty to individual cedants reliant on them, but also systemically affect the industry should failure occur, heightening the need for RTUs to ensure that they maintain adequate capital buffers.

98. IFSB-11 described the mechanism of *Qarḍ*, whereby assets of the SHF are lent to the RRF to cover deficiency in capital or liquidity to be repaid out of future surpluses of the RRF. The standard discussed the possibility that, rather than requiring immediate transfer of resources to an RRF, the regulatory framework might permit a sum to be earmarked within the SHF for a possible future *Qarḍ* to demonstrate the capital adequacy of the RRF. The earmarked sum would then, if permitted by the regulatory framework, count fully for the purposes of determining the solvency of the RRF. Such an arrangement is referred to in IFSB-11 as a *Qarḍ* facility.

99. The possible use of *Qarḍ* as a mechanism for providing capital support to an RRF has implications for an RTU that are potentially more severe than in the case of a TU. The time frame for repayment of *Qarḍ* is likely to be long, reflecting the capital-intensive nature of an RTU's business due to the potential size of losses when they do occur compared to the surpluses out of which capital must subsequently be rebuilt. As the SHF is not in general entitled to investment earnings on funds transferred into the RRF, large and long-term capital support for the RRF has implications for the RTO's ability to remunerate the shareholders' capital. In addition, the use of multiple RRFs could result in separate pots of inaccessible capital (i.e. inaccessible to shareholders) being required. As capital optimisation depends to some extent on diversification benefits, segregation of funds potentially places RTUs at a competitive disadvantage compared to conventional reinsurers. However, whereas a TU may be required to maintain separate PRFs to insulate different groups of participants, the wholesale nature of *Retakāful* means that the imperative to maintain separate RRFs for different classes of business is less strong, enabling greater access to diversification benefits.

100. RTUs need also to be aware of the risk of unplanned calls on liquid assets. In addition to contractual obligations to pay claims, RTUs may be exposed to contractual obligations to accelerate payments or post collateral on the occurrence of certain events, including external triggers such as ratings downgrades.

101. Where an RTU operates as a window, reliance on capital or liquidity support from its conventional reinsurance host company raises further questions as to *Sharī`ah* compliance. Where assets of the conventional operation support the solvency or liquidity of the window,

the RTO needs to ensure that the assets in question are identified and ring-fenced for the purpose of support of the window, and that they, and the support arrangement itself, are *Sharī`ah* compliant.

Recommended Best Practices

102. An RTO should evaluate the contractual arrangements relating to business that is attributed to the RRF or RRFs that it maintains, and determine whether each RRF represents a ring-fenced fund whose assets are available only to meet liabilities arising in that RRF. In reaching its view, the RTO must consider, as well as the contractual terms, the reasonable expectations of cedants whose business is attributed to an RRF, having regard to any representations made to them prior to or at the time of entering into the arrangement relating to the legal or *Sharī`ah* status of the arrangement.

103. Where the assets of an RRF are not, in legal form or in economic substance, fungible (i.e. cannot be appropriated to meet liabilities arising in other RRFs without breach of legal, *Sharī`ah* or other effective constraints), the RTO must evaluate the capital adequacy of that RRF on a segregated basis, with no recognition of surplus assets in other RRFs as available own funds, and no allowance for diversification by reference to exposures of other RRFs. Diversification should only be taken into account between RRFs where assets are freely transferable between RRFs.

104. An RTU should have in place a solvency mechanism for its SHF, as well as for each RRF that it maintains as a segregated fund attributable to cedants (whether accepting new business or in run-off). In each case the RTO should assess the capital needed to enable the fund to meet its obligations on an ongoing basis, and satisfy itself that the capital is available for that purpose without encumbrance. In circumstances where the amount of assets in an RRF is insufficient to meet liabilities for cedant TUs' claims and other liabilities, plus a solvency margin requirement determined in accordance with the principles of IFSB-11, RTOs should have in place a financial assistance mechanism enabling the RRF to demonstrate its capital adequacy.

105. An RTU should also undertake liquidity planning and have in place mechanisms to ensure that adequate liquidity can be supplied to each RRF as it is needed, having regard to liquidity needs of different parts of the business and the restricted fungibility that exists between different funds within the RTU. RTUs should be aware of and monitor the existence and status of triggers that could lead to unplanned calls on the liquid assets of the RTU.

106. Where *Qarḍ* is used as a financial assistance mechanism by the SHF of the RTU to the RRFs, to manage solvency or liquidity risk, RTOs and RSAs need to consider the following:

(i) Prior to actually transferring assets from the SHF by way of *Qarḍ*, an RTO can maintain assets in the SHF that it holds out as available for transfer as *Qarḍ* to the RRF, in the event that the position of the RRF requires such a transfer. Such assets, notwithstanding that they are located in the SHF, may qualify to be counted towards the eligible capital of the RRF, if local regulation permits the arrangement, and depending on the terms under which the assets are maintained and would be transferred.

(ii) The RTO should be required to give its consent to its RSA that:

a. a *Qarḍ* facility provided to an RRF cannot be withdrawn by the RTO before the RRF is considered to meet solvency requirements independently of any *Qarḍ* facility; and

b. in a run-off or winding-up situation, it will treat any part of the *Qarḍ* facility that has been drawn down as a *Qarḍ* as being donated to the RRF to the extent that is necessary in order for cedant TUs' claims to be met.

(iii) Any drawdown of a *Qarḍ* facility into an RRF should in principle be repaid from future surpluses of the RRF.

(iv) Where a *Retakāful* window requires *Qarḍ* (whether contributed or earmarked) from its conventional parent, the RSA should satisfy itself that the assets provided or earmarked fulfil the requirements of the RTO's *Sharī`ah* advisers with respect to *Sharī`ah* compliance.

(v) Where the RTU is regulated in more than one jurisdiction, the RTO's processes for approval of *Qarḍ* mechanisms must comply with the requirements of all involved RSAs.

(vi) SHF assets representing a *Qarḍ* facility, and any *Qarḍ* asset in the SHF, should not be double-counted for solvency purposes. No value should be attributed, for the purposes of determining SHF solvency, to a *Qarḍ* asset in the SHF or to assets in the SHF but representing a *Qarḍ* facility. If multiple RRFs are supported by the SHF through the same *Qarḍ* facility, the assets in the SHF representing the facility should be of value at least equivalent to the sum of the amounts recognised in each RRF as *Qarḍ* facility support, when determining the solvency of each RRF.

107. The legal and regulatory framework should provide for the determination of the point at which it is no longer permissible for a *Retakāful* undertaking to continue its business. The framework should also provide for the continuing supervision of an RTU or any part thereof which goes into run-off, and should pay particular attention to the adequacy of the assets of the RRF in that circumstance.

108. An RTU operating as a window should ensure that the practices recommended here are applied to the window, as though that window were a separate undertaking.

PRINCIPLE 3.3 Investment Strategy

RTOs shall adopt and implement a sound investment strategy and prudently manage the assets and liabilities of *Retakāful* undertakings.

Rationale

109. IFSB-8: *Governance for Takāful (Islamic Insurance) Undertakings* requires a TO to have in place a sound investment strategy, considering each PRF separately by reference to the interests of those who bear the risks of that fund. This principle is readily transferable to an RTO. In addition, IFSB-14: *Risk Management in Takāful (Islamic Insurance) Undertakings* requires consideration of investment-related risks and of the need to ensure that the profile of an undertaking's *Sharī`ah*-compliant assets is commensurate with its liabilities and liquidity needs, such that liabilities and solvency requirements are met without undue expectation of reliance on future capital support between funds or externally.

110. The types of *Sharī`ah*-compliant investment instruments that RTUs invest in need to be commensurate with the types of liabilities they hold. Certain liabilities are sensitive to market factors, particularly technical provisions subject to measurement by reference to market rates that may fluctuate. Volatility in both assets and liabilities can, if not managed, result in solvency difficulties for an RTU. An aspect of prudent investment management is seeking to hold different assets, or assets and liabilities, that act to dampen fluctuations overall by acting as a hedge.

Recommended Best Practices

111. An RTU should have in place a sound investment strategy, determined with due regard to the risk and return expectations of its stakeholders (its shareholders in the case of SHF investments, and its cedant TUs in the case of investments of RRFs), and policies and

procedures to implement that strategy. An appropriate process should be put in place to ensure that its investment activities are in compliance with *Sharī`ah*, including processes for assessing investments (initially and ongoing) for *Sharī`ah* compliance, and for identifying and purifying any tainted/non-halal income.

112. RTUs should also, in compliance with IFSB-14, have in place a risk management framework to manage all material risks relating to investment activity, including those specific to the nature of their business. Such risks include, without limitation, the risk of *Sharī`ah* non-compliance and risks arising from segregation of funds, as well as more generally applicable categories of investment risk, such as market risk, credit risk and liquidity risk.

113. An RTO should develop and apply asset–liability management policies to ensure that the profile of its *Sharī`ah*-compliant assets is commensurate with its liabilities and liquidity needs, taking into consideration the different constitutent parts of the RTU and the environment in which it operates.

114. RTUs should observe segregation of funds between those attributable to cedants of different types – in particular:

(i) Where an RTU operates two or more different operating models, issuing some *Retakāful* contracts under one model and others under a different model,, segregation of funds should be observed as between contracts issued under different operating models, in order to observe *Sharī`ah* compliance and to preserve the integrity of the pooling relationship between cedants ceding business under the same type of contract. Such an RTU should therefore operate separate RRFs for different operating models.

(ii) Assets of a *Retakāful* window should be segregated from assets of the host undertaking, and ring-fenced for application only to liabilities arising from the RRF of the window. This segregation should be robust, including under conditions of insolvency.

IV. Transparency and Disclosure

PRINCIPLE 4.1 Appropriate Disclosures

RTOs shall adopt and implement procedures for appropriate disclosures that provide market participants with fair access to material and relevant information.

Rationale

115. IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* states that "information regarding the solvency requirements for a *Takāful* undertaking that is material and relevant to the market participants should be publicly disclosed to enhance market discipline and the accountability of the TO".[34] IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* similarly requires TOs to "disclose, in their regular public reporting or on request, information to enable participants, investors, creditors and other stakeholders to understand the nature of the risk management framework" and that "information disclosed should be derived from systems and processes that are properly controlled and regularly assessed by the TO for effective operation".[35] Both standards are applicable to RTOs.

[34] Key Feature 7.
[35] Paragraphs 98 and 99, respectively.

Recommended Best Practices

116. An RTO should aim to disclose information pertaining to its operations that may be of use to the public, including cedants and potential cedants, their advisers (such as brokers) and their participants, in forming views as to the RTU's financial strength, resilience and compliance with *Sharī`ah* principles. An RTO should disclose the type or types of *Retakāful* model used.

117. An RTU should, prior to entering into a *Retakāful* arrangement, disclose to the intending cedant whether it proposes to enter into *Retrotakāful* or conventional retrocession arrangements in respect of the business ceded, and should provide to the potential cedant information on the arrangement that pertains to *Sharī`ah* compliance. RTOs should be transparent as to the types of arrangement and be prepared to explain the reasons for such arrangements, particularly if conventional reinsurance counterparties are involved. Similar disclosures should be made to cedants with whom an RTU has arrangements in force, if the RTO proposes to enter into new *Retrotakāful* or conventional retrocession arrangements that differ from those previously disclosed.

118. Because an RTO acts in a fiduciary capacity for the members of its RRF, it should disclose to those members, on request, any payments made to intermediaries in respect of the business that it accepts from those members.

V. Supervisory Review of *Retakāful*/Reinsurance Arrangements

PRINCIPLE 5.1 Supervision of *Retakāful*/Reinsurance Programmes

RSAs should supervise the *Retakāful*/reinsurance programmes of *Takāful* undertakings and *Retrotakāful*/retrocession programmes of *Retakāful* undertakings not only from a prudential standpoint but with the aim of ensuring that *Sharī`ah* compliance is not compromised. In doing so, an RSA may place substantive reliance on the TO's or RTO's *Sharī`ah* advisers, where it is satisfied that appropriate governance arrangements exist to enable the advisers to discharge this responsibility.

Rationale

119. IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* refers to the use of *Retakāful* as a part of the risk management framework for a TU, and the need for supervisory review of the *Retakāful* programmes of cedants. It also refers to issues that arise in respect of the use of conventional reinsurance rather than *Retakāful* – in particular, in the context of *Sharī`ah* compliance.[36] Like a TU, an RTU will manage its underwriting risk by using *Retrotakāful*, assuming in the process an element of credit risk exposure. The correct determination of the RTU's *Retrotakāful* needs is critical to its ability to withstand foreseeable losses, and the management of the consequent credit risk exposure is important to ensure that the *Retrotakāful* recoveries are there when they are needed. Again like TUs, only to arguably a greater degree, RTOs may need to turn to conventional retrocession markets due to a perceived shortage of *Retrotakāful* capacity of the appropriate quality. The use of conventional retrocession has implications for the undertaking's ability to ensure that its operational activities are *Sharī`ah* compliant. The interplay of underwriting risk, credit risk and *Sharī`ah* compliance risk creates the rationale for supervision of the *Retakāful*/reinsurance and *Retrotakāful*/retrocession programmes of TUs and RTUs, respectively.

[36] IFSB-14 defines *Sharī`ah* non-compliance risk as "an operational risk which requires processes and controls to prevent non-compliance and to detect and correct any instances that do occur. This risk is pervasive in the operations of a TU."

120. The specificities of *Retakāful* raise a number of issues of relevance to the supervision of the *Retakāful*/reinsurance and *Retrotakāful*/retrocession programmes of TUs and RTUs, including the following:

(i) In conventional reinsurance, RSAs consider whether an arrangement effectively transfers risk. In the context of *Retakāful*, risk is shared rather than transferred according to the principle of *Ta'awun* and an analogous consideration arises, since if risk is not shared by pooling with risks ceded by other cedants, the undiversified risk remains attributed to the cedant. The 2013 Fiqh Academy Resolution[37] clearly envisages pooling of some kind. (An exception might appropriately apply in the case of captive management activity, which effectively provides the originator of the risk with a structured form of risk retention, rather than either *Retakāful* cover or risk transfer.)

(ii) The cession of risks to conventional reinsurers or retrocessionnaires is often defended by reference to the precept of *Dharurah* (necessity), the contention being that without such use of conventional markets, TUs and RTUs would be unable to maintain or to expand the level of their business. Reasons commonly advanced include a lack of capacity of appropriate quality in the *Retakāful* sector. The desired qualities cited include financial strength, credit rating, expertise in handling the type of risk, ability to assist in managing claims, and diversification – that is, the availability of a sufficient spread of capacity of the desired quality such that a cedant does not assume an unacceptable concentration of exposure to a small number of RTUs. The *Sharī`ah* justification of *Dharurah*, either generally or in any particular case, is outside the scope of this document. However, the observance of *Sharī`ah* governance surrounding the use of conventional reinsurance/retrocession, if not the decision itself, is of relevance to the supervisory concerns of RSAs supervising TUs and RTUs.

The conditions considered by *Sharī`ah* advisers to justify a finding of *Dharurah* may change over time, creating a need for periodic review of decisions in this area. Decisions should specify clearly a term within which review is required, or conditions that would trigger a review. Review should take place at least annually.

(iii) An RTU that retrocedes a very high proportion of its risks could be perceived as effectively acting as a "front" for conventional reinsurance operations, retroceding on a conventional basis business that it had accepted on a *Sharī`ah*-compliant basis. Such activity would carry reputational risk for the *Retakāful* sector. This may be particularly a risk for an RTU that is a member of a group, which may come under pressure to retrocede risk to group members that are conventional reinsurers in order to comply with group risk management policies involving pooling of group risks for onwards retrocession, or to utilise retrocession capacity risk within the group in preference to retroceding outside.

(iv) Design and placement of *Retakāful*/reinsurance programmes often involves the engagement of reinsurance brokers as advisers and intermediaries, acting on the cedant's behalf. The use of an intermediary does not relieve the cedant from its obligations regarding risk governance, including *Sharī`ah* governance, relating to the design and placement of the programme.

(v) The practice of financial or finite *Retakāful*/reinsurance (FinRe) in the conventional insurance sector has demonstrated a capacity to enable a misleading presentation of the financial strength of a party to the contract, to the detriment of effective supervision, and could have a similar impact if used in the *Retakāful* sector. In addition, the absence of pooling and the misalignment of form and substance render such arrangements non-*Shari'ah* compliant. Usage of FinRe in the *Retakāful* sector appears limited, and the increased adoption of risk-based capital, market-consistent valuations and risk transfer arrangements by supervisors makes it more difficult for FinRe to be used in this way. Supervisors may need to be alert if FinRe becomes widely used by RTUs and cedants.

[37] See footnote 122.

(vi) RSAs may also consider the appropriateness of the attribution in the cedant (or retrocedant) of amounts received from the counterparties to whom risks are ceded. If the *Retakāful*/reinsurance contract allows for the payment of ceding commission or profit commission or the distribution of surplus, it is relevant to the interests of the participants of the cedant whether such amounts are credited to the PRF and so attributed to participants, or to the SHF and so attributed to shareholders. Attribution in a manner that the supervisor considers unfair to the participants raises questions of ethical conduct of business, fairness of treatment of customers, reputational risk and *Sharī`ah* non-compliance risk.

Recommended Best Practices

121. RSAs should require RTOs to inform potential cedants clearly about how a proposed arrangement involves pooling of the cedant's risks with those of other cedants. RSAs should also require TOs and RTOs to have in place a process for subjecting proposed *Retakāful* agreements (where they will be the cedant) to analysis as to whether the risk is shared or not, and in the latter case to take no credit for potential recoveries under the contract when determining their solvency position, except for amounts demonstrably due without encumbrance.

122. RSAs responsible for supervising TUs and RTUs should require TUs and RTUs proposing to cede or retrocede risks to a conventional reinsurer, or to engage in *Retakāful* agreements that do not involve pooling of risk, or to engage in *Retakāful* agreements involving profit commission arrangements, to have in place a process for subjecting the proposed transaction to appropriate *Sharī`ah* governance. This is crucial since the payment of profit commission based upon the result of a single cedant's risks is considered by some to conflict with the principle of risk sharing. As part of its supervisory activity, the authority should consider whether the process has been followed (and the advice received followed) and if necessary assess the effectiveness of the process with regard to the information provided to *Sharī`ah* advisers, the resources available to them to carry out their duties and the nature of the advice given.

123. The *Sharī`ah* governance process referred to in paragraph 122 should include provision for consideration of all factors relevant to the decision, and for periodic review of decisions to allow arrangements of the types described, in case conditions have changed such that the decision requires modification.

124. RSAs should require TOs, prior to entering into a *Retakāful* cover, to ensure that the terms of the arrangement are sufficiently clear to permit identification of the contract on which the arrangement is based, and a proper assessment by the cedant and its *Shari'ah* advisers as to the effectiveness of the arrangement in sharing risk in accordance with *Shari'ah.*

125. RSAs should consider whether the use of conventional reinsurance risks compromising the integrity of the claim to *Sharī`ah* compliance made by the cedant. In particular, if the business model of a TU or RTU relies heavily on cessions (or retrocessions) to conventional reinsurers, RSAs should consider whether such a business model affects, having regard to all the circumstances, the licensee's suitability to hold a licence to operate as a TU or RTU.

126. RSAs should consider whether the use of intermediaries by cedants when designing and placing *Retakāful*/reinsurance programmes is adequately overseen by the governance functions, including *Sharī`ah* governance.

127. RSAs should require TOs and RTOs to document their policy regarding the attribution of cash flows under *Retakāful*/reinsurance contracts entered into by them as cedant or retrocedant, including justification of that policy by reference to fairness as between participants and shareholders, and *Sharī`ah* compliance (following consultation with their *Sharī`ah* advisers). At a minimum, the policy should cover the attribution of outflows in the form of contributions

and *Wakālah* fees or other remuneration to the RTO, and inflows in the form of ceding commissions, profit commissions, brokerage, recoveries and distributions of surplus. RSAs should require TOs and RTOs to have in place systems and controls to ensure implementation of the documented policy. RSAs should consider specifying default actions in respect of attribution of cash flows, based on the principle that participants (in the form of the cedant's PRF or RRF) should receive the benefit associated with costs charged to the PRF or RRF, requiring cedants to justify any departure from the default.

D. DEFINITIONS

The following definitions explain the terms used in this document. It is not an exhaustive list.

Captives	A *Takāful* or *Retakāful* entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide *Takāful* or *Retakāful* cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part, if any, of its risk exposure is related to providing *Takāful* or *Retakāful* cover to other parties.
Cedant	The participant in the *Retakāful* contract or in the conventional reinsurance contract, whereby part of the risks are ceded in accordance with the *Retakāful* or reinsurance contract.
Corporate governance	(i) A defined set of relationships between a company's management, its board of directors, shareholders and other stakeholders that provides the structure through which relationships are organised in accordance with the laws, regulations and by-laws of the

	institution and requirements of the regulatory and supervisory authorities.
Credit risk	The risk that a counterparty fails to meet its obligations in accordance with agreed terms. Credit risk in a *Takāful* or *Retakāful* undertaking may arise from operational, financing and investment activities of the funds. A similar risk may arise from *Retakāful* or *Retrotakāful* activities of the funds.
Deficiency	The situation where the liabilities of the fund exceed its assets, so that the fund has a debit balance.
Deficit	The situation where claims and other expenses exceed contributions for a financial period.
Facultative	A *Retakāful* arrangement that is specific to a single contract (or part of such a contract) written by a *Takāful* undertaking.
Liquidity risk	The risk of potential loss to the institution arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.
Market risk	The risk of losses in on- and off-balance sheet positions arising from movements in market prices – that is, fluctuations in values in tradable, marketable or leasable assets (including *ṣukūk*) and in off-balance sheet individual portfolios (for example, restricted investment accounts).
Muḍārabah	A partnership contract between the capital provider (*rabb al-māl*) and an entrepreneur (*muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
Operational risk	The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. For *Takāful* or *Retakāful* undertakings, this also includes risk of loss resulting from *Sharī`ah* non-compliance and failure in a *Takāful* or *Retakāful* Operator's fiduciary responsibilities.
Participants' Investment Fund	A fund to which a portion of contributions paid by *Takāful* participants is allocated for the purpose of investment and/or savings.
Participants' Risk Fund	A fund to which a portion of contributions paid by *Takāful* participants is allocated for the purpose of meeting claims by *Takāful* participants on the basis of mutual assistance or protection.

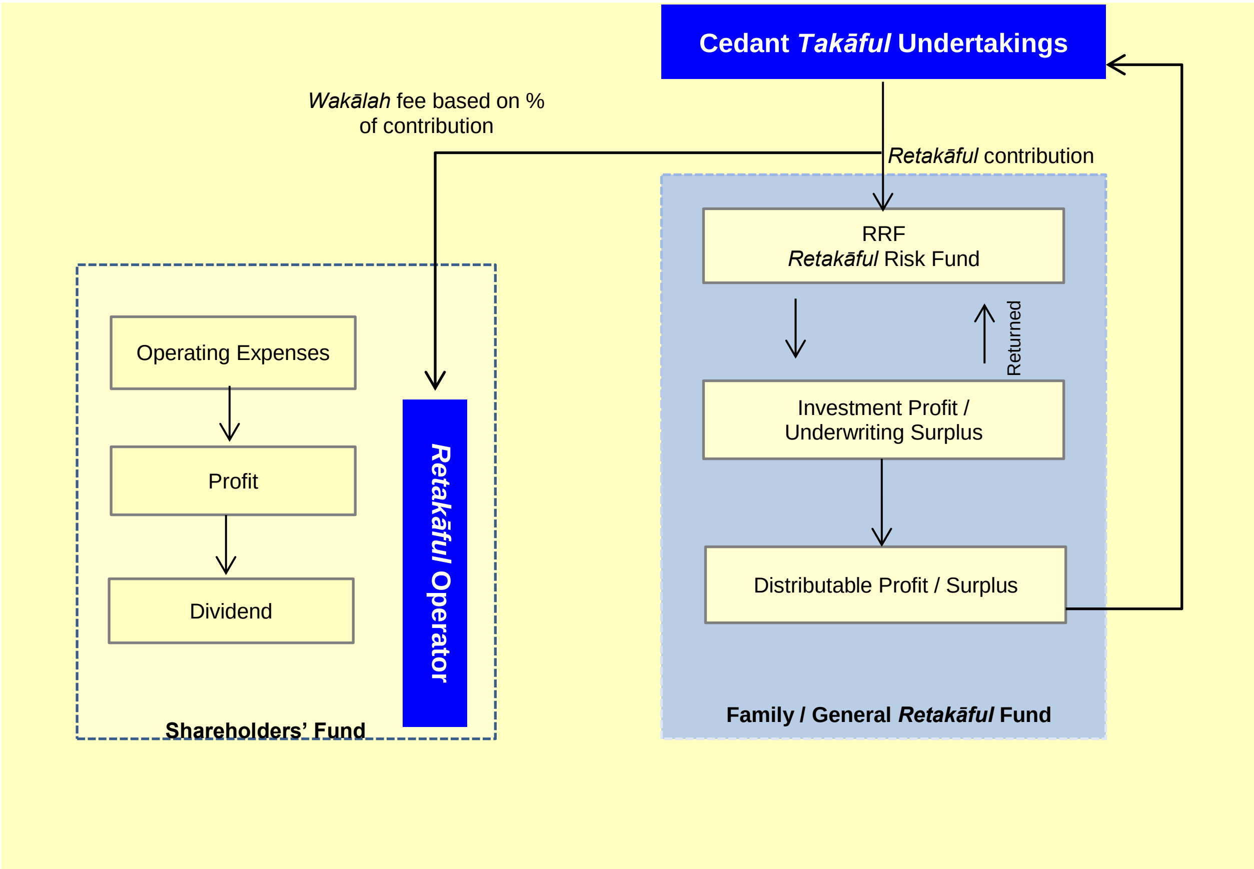
Qarḍ	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.
Retakāful	An arrangement whereby a *takāful* undertaking cedes a portion of its risks on the basis of treaty or facultative *retakāful* as a representative of participants under a *takāful* contract, whereby it would contribute a portion of the contribution as *tabarru'* into a common fund to cover against specified loss or damage.
Retakāful Operator	Any establishment or entity that manages a *Retakāful* business, usually, though not necessarily, a part of the legal entity in which the participants' interests are held.
Retakāful participant	A party that participates in a *retakāful* arrangement with the *retakāful* operator and has the right to benefit under a *retakāful* contract.
Retakāful Risk Fund	A fund to which a proportion of contributions paid by cedants to *Retakāful* Operators is allocated for the purpose of meeting claims by cedants on the basis of mutual assistance or protection.
Risk management	The process whereby the *Takāful* or *Retakāful* undertaking's management takes action to assess and control the impact of past and potential future events that could be detrimental to the undertaking.
Shareholders' Fund	A fund that represents the assets and liabilities of a *Takāful* or *Retakāful* operator that is not attributable to participants.
Solvency requirements	The financial requirements that are set as part of the solvency regime and relate to the determination of amounts of solvency resources that a *Takāful* or *Retakāful* undertaking must have in addition to the assets covering its technical provisions and other liabilities.
Stakeholders	Those with a vested interest in the well-being of *Takāful* or *Retakāful* undertakings, including: (i) employees; (ii) *Takāful* participants or cedants under *Retakāful arrangements*; (iii) suppliers; (iv) the community (particularly the Muslim ummah); and (v) supervisors and governments, based on the unique role of *Takāful* undertakings and *Retakāful* undertakings in national and local economies and financial systems.
Tabarru'	The amount of contribution that the *Takāful* / R*etakāful* participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.
Takāful	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the Participants' Risk Fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
Takāful Operator	Any establishment or entity that manages a *Takāful* business – usually, though not necessarily, a part of the legal entity in which the participants' interests are held.
Takāful participant	A party that participates in the *Takāful* product with the *Takāful* undertaking and has the right to benefit under a *Takāful* contract
Technical provisions	The value set aside to cover expected obligations arising on *Takāful* or *Retakāful* contracts. For solvency purposes, technical provisions comprise two components: a) the current central best estimate of the costs of meeting the *takāful* or *retakāful* underwriting obligations, discounted to the net present value (current estimate); and b) a margin for risk over the current estimate.

Treaty	A *Retakāful* arrangement that covers the whole or part of all contracts written by a *Takāful* undertaking, of a nature specified in the arrangement.
Underwriting	The process of evaluating new applications, carried out by a *Takāful* or *Retakāful* Operator on behalf of the *Takāful* or *Retakāful* participants, based on an established set of guidelines to determine the risk associated with an application. The *Takāful* or *Retakāful* Operator could accept the application, assign the appropriate rating class, or decline the application.
Underwriting risk	The risk of loss due to underwriting activities relating to the *Takāful* Participants' Risk Fund or *Retakāful* Risk Fund. Sources of this risk include assumptions used in pricing or assessment that are subsequently shown to be incorrect by experience of, for example, claims.
Underwriting surplus or deficit	The Participants' Risk Fund's or *Retakāful* Risk Fund's financial result from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contributions income and adding the investment returns (income and gains on investment assets).
Wakālah	An agency contract where the *Takāful* or *Retakāful* participants (as principal) appoint the *Takāful* or *Retakāful* Operator (as agent) to carry out the underwriting and investment activities of the *Takāful* or *Retakāful* funds on their behalf in return for a known fee.

E. APPENDIX

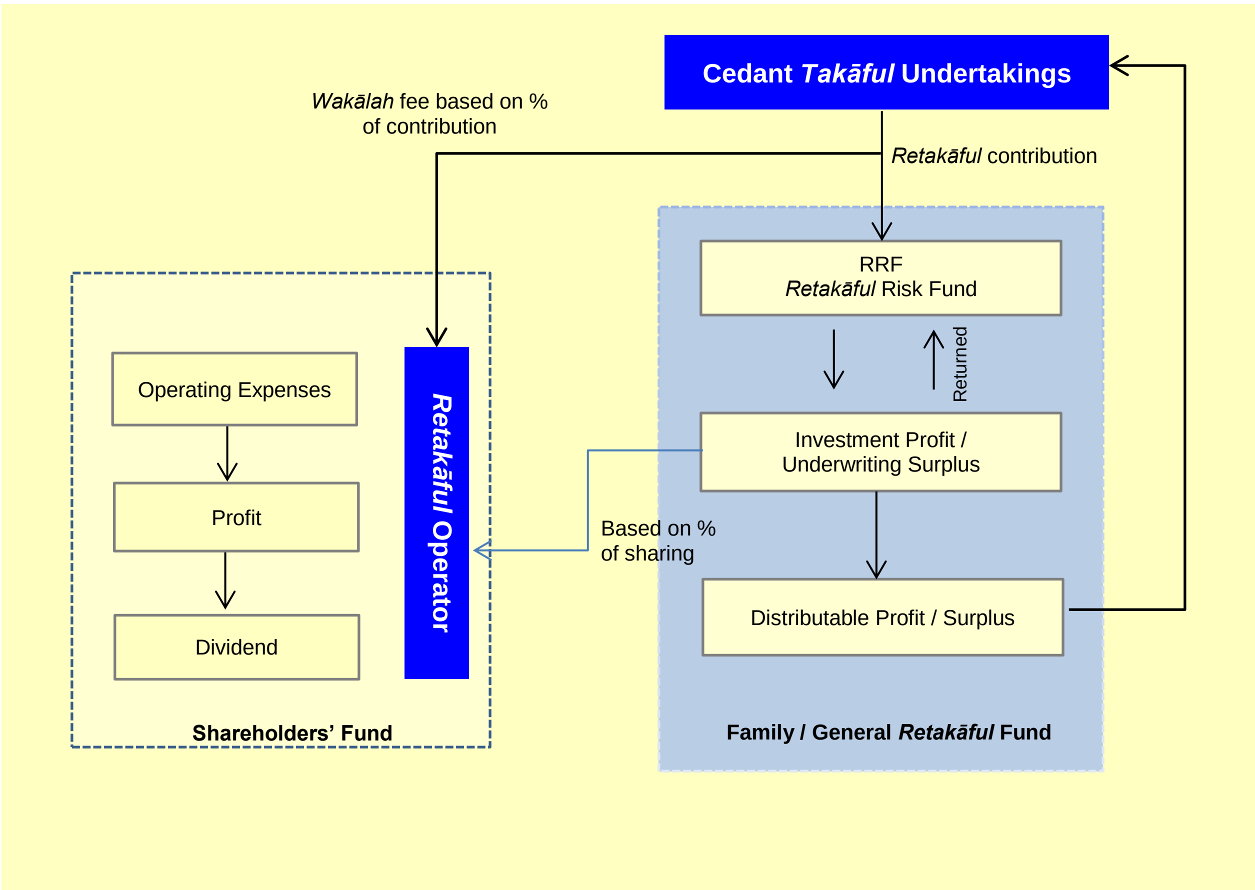
The Generic Flow of Funds within *Retakāful* Undertakings

(i) *Wakālah*-based *Retakāful* Contract – Family/General *Retakāful*



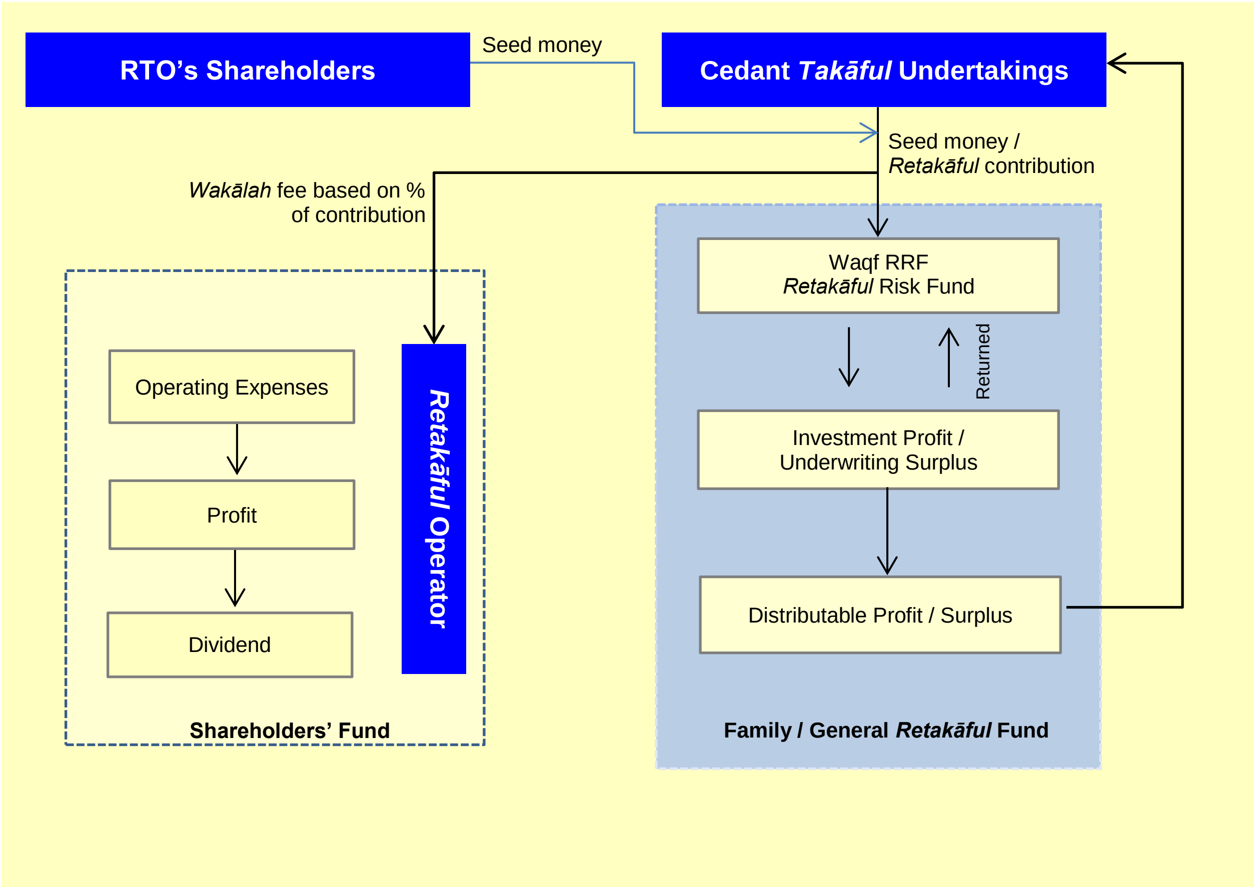
The Generic Flow of Funds within *Retakāful* Undertakings

(ii) *Wakālah–Muḍārabah*-based *Retakāful* Contract – Family/General *Retakāful*



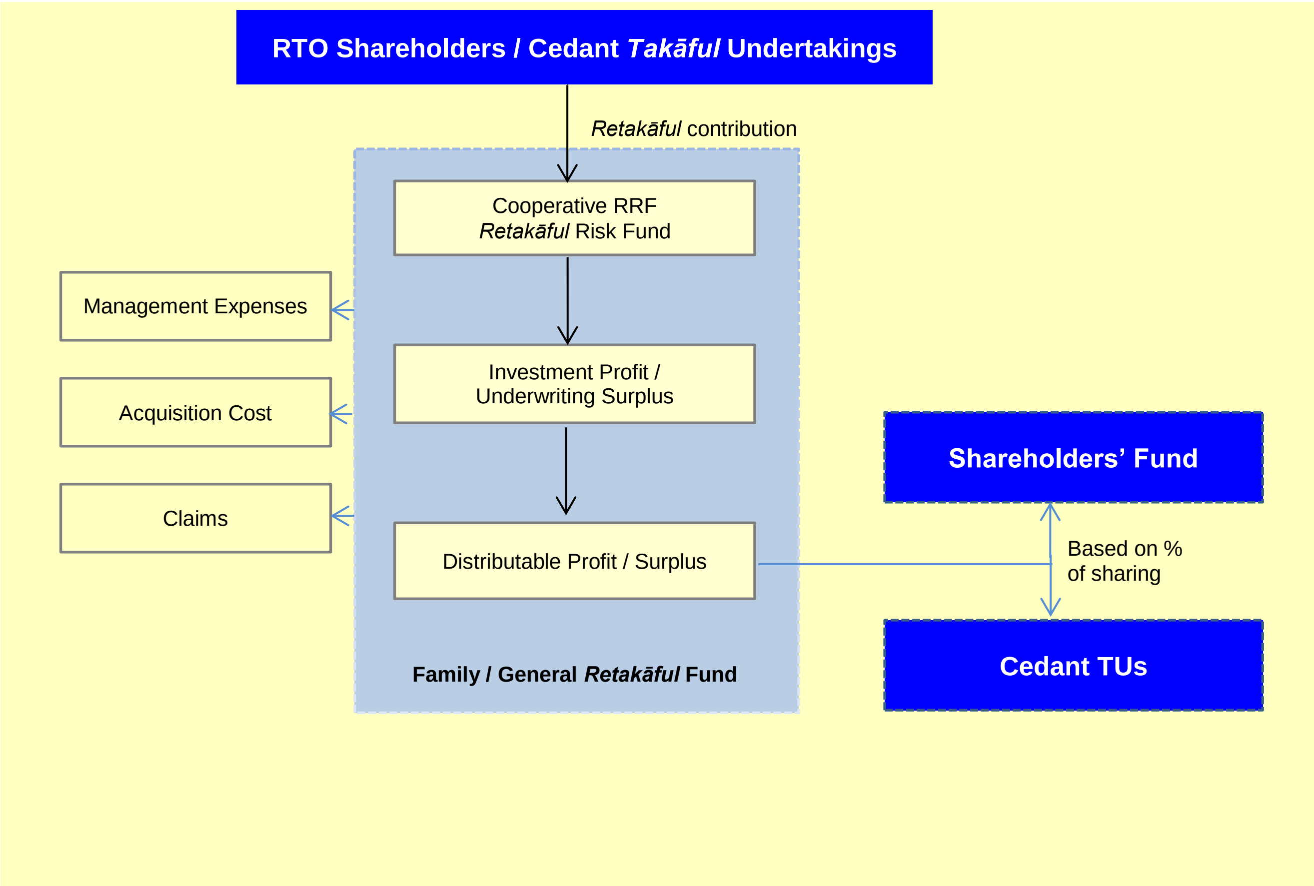
The Generic Flow of Funds within *Retakāful* Undertakings

(iii) *Wakālah–Waqf*-based *Retakāful* Contract – Family/General *Retakāful*



The Generic Flow of Funds within *Retakāful* Undertakings

(iv) Saudi Cooperative-based *Retakāful* Contract – Family/General *Retakāful*



The Generic Flow of Funds within *Retakāful* Undertakings

(v) Sudan Cooperative-based *Retakāful* Contract – Family/General *Retakāful*