CAPTIVE INSURANCE FROM AN ISLAMIC VIEWPOINT: AN ANALYSIS

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Abstract
The purpose of this study is to examine the application of Captive Insurance in Takaful. The method used in this research was done by collecting information from the related websites, conversation and discussion among students, lecturer of Islamic Finance Program of UMSKAL and the Head of Islamic Financial Services Unit of LOFSA. As a result, this research shows that captive is relevant to be personified in takaful by using the Islamic terms as ‘Kafalah Arabah’. As a conclusion, this theory could be used in the established company who intended to use a full Islamic transaction in their risks management.

Keywords: Insurance; Financial management; Captive insurance; Wealth planning; Religion.

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1. Introduction
Captive insurance companies are insurance companies that are established with the specific objective and financing risk emanating from their parent group(s) also insures risks of the group’s customers as well. Captive insurance is a risks management technique where a business forms its own subsidiary insurance company to finance its affiliates insures group(s) which is called as a pure captive. Captive insurance or reinsurance is provided by a company that is formed primarily to cover the assets and the risks of its parent group(s). Captive insurance is essentially an “in house” insurance company with a limited purpose and is not available to the public. It is an alternative form of risks management that is becoming a more practical and more popular means through which the particular companies can protect them financially while having more control over how they are insured.

The main business of captive insurance company (captive) is to ensure or reinsurance the risks of its owners or other companies affiliated with its owners through common ownership, management, or control. It serves a limited pool of insured which is usually licensed in the domicile where it’s located. Captive is flexible entities that can accept many of the insurable risks facing any industry. They are commonly found among companies in the construction, distribution, financial services, manufacturing, and other services industries. Captive are also useful for professional services such as physician practice groups. Individuals may own captives, but only for the purpose of insuring other companies belong to them.

In most cases, captive are restricted to the business of providing insurance and investing their premium income. The Internal Revenue Services (IRS) defines an insurance company a company in which at least 50 percent of its business during a taxable year is restricted to the issuing underwritten by other insurance or the reinsurance of risks underwritten by other insurance companies. States are required to follow this IRS guidance. Captives are usually permitted to cover most insurable risk other than health and life. However, each domicile has the right to limit what a captive in its jurisdiction may ensure. Captives commonly insure property and casualty risks that include:

- Property damage
- Business interruption/extra expense
- Boiler and machinery

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• Commercial general liability
• Automobile liability and physical damage
• Excess / umbrella liability
• Workers compensation
• Professional liability
• Fiduciary liability
• Surety
• Environmental
• Employee benefits and
• Terrorism

2. What makes a captive attractive?
Companies form captives to gain benefit from internal risk financing or to strengthen their risk-management programs. That’s why the transfer of business risk is the single most important benefits that a captive offers. In this transaction, the insured assumes a contractual obligation to pay premiums to the captive for a specified type and level of insurance coverage. In turn, the captive assumes a contractual obligation to make the insured whole again if that insured suffers a covered loss.

Internal risk financing
Premium costs become stable and equitable for the captive’s owners overtime because a captive sets its own insurance rates. That means the captive can establish a premium rate that reflect its own expected losses. In addition, captive premiums are not directly subject to variable and often unpredictable commercial insurance markets. In contrast to commercial markets, the captive and its insured receive an immediate economic reward for controlling losses. By creating a Captive Insurance Company people will be able to directly access wholesale reinsurance markets which will enable them to reinsure risks at wholesale versus retail rates and receive lucrative reinsurance commissions and profits. In addition, the insurance premiums which their Captive charges their existing businesses will be calculated based on their favorable claims histories instead of less favorable industry loss cost estimates. A Captive Insurance Company will also allow them to reduce costs by eliminating broker and agent commissions, administrative charges, and insurer profits which account for 35% to 40% of the premiums they are currently paying to a traditional insurance company. Insurance industry experts estimate that a company with a favorable loss history can save up to 50% on its cost of business insurance with a Captive Insurance Company.

Internal risk financing can potentially reduce operating expenses. That is because, the complex overhead costs of commercial insurers are often significantly higher than the straightforward overhead costs of running a captive. Captives are often able to create a new profit center. For instance, the level of underwriting profit on premiums paid by related parties is generally set by captive owners. As well many captives can earn investment income by investing the net premiums retained. By segregating specific risks in a Captive, company will be able to take advantage of a wide range of risk financing alternates including risk securitization programs. These financing alternatives are not available without a Captive.

Improved risk management
Financial self-management best practices at the most companies’ captive owners and their affiliates make continual and diligent efforts to improve their own risk practices because they have a direct impact on the size of their captive premiums and overall profitability.

a. Flexibility- Create a risk funding program that is tailored to the specific needs of an organization;
b. Coverage for risks not usually insurable - Accept risk that may otherwise be uninsurable (for example, strike insurance, environmental liability insurance);
c. Consistency of coverage- B.C. captives can be used to meet special requirements, fill gaps in claims-made policies, offer additional limits of liability and supplement any restricted forms obtained from the conventional insurance market;
d. Improved risk management control- As any cost savings flow directly back through the captive to the parent organization, there is incentive for: [1]obtaining better risk management information, [2] distributing loss costs equitably among profit centres, [3] designing more effective loss control
programs and [4] implementing loss control programs throughout all divisions or subsidiaries. For many companies, particularly those with geographically dispersed subsidiaries, a captive offers an effective means of ensuring centralized control of a diverse risk management program;

e. Capacity -Where capacity limitations are encountered in the conventional insurance markets, a captive can provide access to additional capacity, often at lower prices, either from the international reinsurance market or by retaining the risk itself;

f. Reduced need for commercial insurance -As the captive matures and its surplus grows, it becomes capable of retaining greater portions of an organization's risks, thereby reducing dependence on commercial insurance while improving the captive's position with reinsurance markets;

g. Stability of market -The insurance industry is subject to considerable changes in pricing and availability of coverage. A captive can create a stable base from which the insured can be confident of obtaining price stable coverage, irrespective of the commercial market offerings.

h. Claims administration -Control over claims administration allows for consistency in the philosophy and methodology of handling claims

3. Types of captives

**Single Parent**

Single parent captives are wholly owned subsidiaries of the parent company and are an insurance or reinsurance company formed primarily to insure the risks of its non-insurance parent or affiliates. As such, the lines of insurance and the structure of the program can be readily customized to meet individual company or corporate-wide needs. It can also insure related or unrelated (third party) risk at the discretion of management. Typically, at least $1.0 million of premium is required to achieve the desired cost benefit.

**Multiple Parents or Group Captive**

Multiple parent captives are jointly owned by a group of companies or persons in the same industry. They are also known as group, homogeneous, or joint venture captives. Group coverage allows for customizing your specific needs. It consists mainly of workers compensation, auto liability & damage, and general liability. Typically $500,000 of premium is required to make your participation financially attractive.

**Heterogeneous Captive or Association Captive**

For companies of similar size but from varying industries, heterogeneous captives provide them an opportunity to pool their resources and form a joint venture captive. Also known as an association captive. Participants in the heterogeneous captive share risks at a predetermined layer. Typically $500,000 of premium is required to achieve the desired cost benefit.

**Rent-a-Captive**

Rent-a-Captive defined as a company that provides 'captive' facilities to others for a fee, while protecting itself from losses under individual programs, which are also isolated from losses under other programs within the same company. This facility is often used for programs that are too small to justify establishing their own captive. For companies within the same industry not large enough to take advantage of forming their own captives, a rent-a-captive provides them an opportunity of obtaining similar benefits as owning a captive. There is generally no sharing of risk among the participants. The owner of the rent-a-captive charges the participants a fee. Over time, if the captive proves successful, the underwriting profits plus investment income may be returned to the participants. Rent-a-captives have higher fixed costs and minimal entry barrier expenses (legal, licensing). Typically as little as $250,000 of premium is required to achieve the desired cost benefit.

**Segregated Cell Captive**

Individual cells in a segregated cell captive enjoy legal insulation of assets and liabilities. Legislation has been approved in all major domiciles. Cell segregation varies by demographics, risk profile, and lines of coverage.
A captive insurance company is simply an insurance company owned by the parent that underwrites the insurance needs of the parent's subsidiaries. In general, most countries have an admitted insurer ruling, meaning that insurances have to be bought from insurance companies licensed in that country. Because of this requirement, most captive requires the services of a Fronting Insurer. In a typical arrangement, the parent company of the captive will insure with a local admitted insurer. The fronting insurer then either retains some share and reinsures the balance or reinsures everything to the captive.

4. Takaful

The Islamic way of insurance is widely accepted that insurance plays a very important part in commerce and personal finance. While most may take insurance for granted, many people of the Muslim faith find that conventional insurance is incompatible with their religious belief. In the late 1970s in Sudan, and the 1980s in Malaysia, the concept of Islamic insurance, or takaful, was introduced. Though its acceptance in the Muslim world was slow at first, the new millennium has seen a quickening in the pace. This has a lot to do with the emergence of a young generation of educated and affluent Muslims seeking a substitute for an important part of commerce and personal finance. For Muslims, Islam is not merely about how to go about worshiping God; it is also a way of living life.

Takaful is an Islamic insurance concept which is grounded in Islamic muamalat (banking transactions), observing the rules and regulations of Islamic law. This concept has been practiced in various forms for over 1400 years. It originates from Arabic word Kafalah, which means “guaranteeing each other” or “joint guarantee”. In principle, the Takaful system is based on mutual co-operation, responsibility, assurance, protection and assistance between groups of participants. It is a form of mutual insurance.

In Islam, the basic principle of investment is that reward must be accompanied by risk. On this basis, it’s permissible for a Muslim to invest in Shariah-approved stocks (meaning, for example, no gaming, brewery, tobacco, or highly leveraged companies) as prices of equities and dividends from equities command no certainty in value. A stock investor is subject to market risk. Investment in bonds, however, where there are capital protection and fixed returns, is not permissible.

Contrary to widely held beliefs, Islam does not reject the notion of the time value of money. Islamic scholars generally accept that goods sold on credit are priced higher than goods sold for cash. Islam, however, does prohibit the charging of interest (or riba) on loans. Specifically, in Islam, money cannot be treated as a commodity to be bought or sold but rather only as a medium of exchange. As an extension of this, financial assets can’t be sold or used as collateral. In Islam, therefore, an entity cannot refinance receivables because they’re not real assets. A hadith attributed to the Prophet Muhammad, “Every loan that attracts a benefit is riba”, defines the ban on interest in Islamic finance.

5. Principles of Takaful

The principles of Takaful are as follows:

a. Policyholders co-operate among themselves for their common good;
b. Every policyholder pays his subscription to help those that need assistance;
c. Losses are divided and liabilities spread according to the community pooling system;
d. Uncertainty is eliminated in respect of subscription and compensation; and
e. It does not derive advantage at the cost of others.
Theoretically, Takaful is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. The purpose of this system is not profits but to uphold the principle of “bear ye one another’s burden”. Commercial insurance is strictly not allowed for Muslim as agreed upon by most contemporary scholars because it contains the following elements: i) Al-Gharar (Uncertainty) ii) Al-Maisir (Gambling) iii) Riba (Interest).

There are three (3) models and several variations on how takaful can be implemented.

1. Mudharabah Model
2. Wakalah Model
3. Combination of both

The Mudharabah Model (Profit Sharing)
By this principle, the entrepreneur or al-Mudharib (takaful operator) will accept payment of the takaful instalments or takaful contributions (premium) termed as Ra's-ul-Mal from investors or providers of capital or fund (takaful participants) acting as Sahib-ul-Mal. The contract specifies how the profit (surplus) from the operations of takaful managed by the takaful operator is to be shared, in accordance with the principle of al-Mudharabah, between the participants as the providers of capital and the takaful operator as the entrepreneur. The sharing of such profit may be in a ratio 50:50, 60:40, 70:30, etc. as mutually agreed between the contracting parties. In order to eliminate the element of uncertainty in the takaful contract, the concept of tabarru (to donate, to contribute, to give away) is incorporated. In relation to this a participant shall agree to relinquish as tabarru, certain proportion of his takaful instalments or takaful contributions that he agrees or undertakes to pay thus enabling him to fulfill his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss.

In essence, tabarru would enable the participants to perform their deeds in sincerely assisting fellow participants who might suffer a loss or damage due to a catastrophe or disaster. The sharing of profit or surplus that may emerge from the operations of takaful, is made only after the obligation of assisting the fellow participants has been fulfilled. It is imperative, therefore, for a takaful operator to maintain adequate assets of the defined funds under its care whilst simultaneously striving prudently to ensure the funds are sufficiently protected against undue over-exposure. Therefore the provision of insurance cover as a form of business in conformity with Shariah is based on the Islamic principles of al-Takaful and al-Mudharabah.

Takaful is the pact among a group of people, called participants, reciprocally guaranteeing each other; while Al-Mudharabah is the commercial profit-sharing contract between the provider or providers of funds for a business venture and the entrepreneur who actually conducts the business. The operation of takaful may thus be envisaged as the profit-sharing business venture between the takaful operator and the individual members of a group of participants who desire to reciprocally guarantee each other against a certain loss or damage that may be inflicted upon any one of them.

The Wakalah model
This contract defines an agency. Simply put, under wakalah, one person represents the other as the latter’s agent. Therefore, exchange for compensation, which can be a certain percentage of the consideration of fixed amount, the agent performs a certain service. This contract would then also have to follow the three basic rules and principles set out earlier. In order to ensure wide acceptance among Muslims, however, the preferences is to use the existing Islamic contracts, in combination if necessary, to make Takaful work.

6. Objective of the study
The main objective of this study is to examine the appropriate of Captive Insurance in Takaful application. Captive Insurance Companies have been use traditionally as a means of insuring the property and liability loss exposures of their parent companies. In most cases, Captives are usually permitted to cover most insurable risk other than health and life.
7. Literature review
According to Elliott (2004) in the article “Captive Insurance Arrangements—A Comprehensive Update”, said that the insurance concept has been implemented using several organizational structures that serve the interests of constituents for a range of risk coverage and risk mitigations. One organizational structure is called a captive insurance company because it operates at the behest of, and for the benefit of, a noninsurance parent owner-company or group (a multiple-owner captive). Organizationally, these entities resemble mutual insurance companies working for a limited number of participants. Elliott (2005) also found that one organizational structure that has been called into question is referred to as a “captive insurance company” because it operates at the behest of and for the benefit of a non-insurance parent owner company or group. A captive insurance company is owned by those whose risks it insures. Ownership may be by a single parent or by a group of shareholders. The latter is referred to as a “multiple-owner captive.”. It is different with Schaller and Harshman (2008). They said in their article “Use of Captive Insurance Companies in Estate Planning”, a captive insurance company is a corporation formed either in a U.S. or foreign jurisdiction for the purpose of writing property and casualty insurance to a small, usually related group of insured. The captive must be formed as a C corporation and is subject to Chapter L and Chapter C of the Internal Revenue Code. There are many types of captive insurance companies, including pure captives, group captives, risk retention groups, and producer-owned reinsurance companies. However, in the article by Unger and Magyar (2007), “Captive Insurance Can Help Manage Risks”, had mentioned that captive are flexible entities that can accept many of the insurable risk facing any industry. They are commonly found among companies in the construction, distribution, financial services, manufacturing and other service industries. Captive are also useful for professional services like physician groups. Individuals may own captives but only for the purpose of insuring other companies that they also own. On the other hand, Lai and McNamara (2004) in their article “Employee Protection and Tax Deductibility Issues when Insuring Employee Benefits through a Captive Insurance Company” stated captive insurance company is a subsidiary created by a parent company for the purpose of insuring the parent company’s loss exposures. Captive insurance companies have been used traditionally as a means of insuring the property and liability loss exposures of their parent companies. The overall reviews bring into being the different definition of captive but still related to the risks.

8. Methodology
Most of information was collected by using the website and also conversation among students, lecturer and Head Islamic Financial Services Unit of LOFSA Mdm.Norazua Mohd Marzuki. The conversations were conducted on Friday, September 5, 2008 at 2.30pm at 17th Floor, Main Office Tower, Financial Park Complex, Labuan, Malaysia.

9. Result
Captives are usually permitted to cover most insurable risks other than health and life. Captives also allow firms to retain risk and still satisfy insurance regulatory requirements and demands from third parties. For some lines of business a captive can operate without restriction. In other cases, such as workers’ compensation in the U.S., for example, a captive often must go through a fronting process. They pay a fee, usually somewhere between 5 and 15 percent, to participate in the risk. The fronting insurer issues the required policy using its insurance licenses and then the company “cedes” (sends some or all of the risk and some of the premium) to the captive. If there is a loss, the captive provides the funding to pay the loss even though the contractually responsible party from the injured parties’ perspective is the commercial "front". Captive insurance is essentially an “in-house” insurance company with a limited purpose and is not available to the general public. It is an alternative form of risk management that is becoming a more practical and popular means through which companies can protect them financially while having more control over how they are insured.

Companies both large and small are having an increasingly difficult time finding and affording traditional insurance policies to cover their risks and assets. Premiums are increasing at a steady clip, making insurance coverage nearly cost prohibitive for most companies, leaving them vulnerable to catastrophic loss. Some companies have risks that are difficult or impossible to cover. Increasingly, traditional insurance companies are setting up their credit rating structures without considering actual loss experience, but rather, trends in the market, making it difficult for many companies to qualify for coverage. Another stumbling
block for companies is that they might have insufficient credit for deductibles and exercise poor loss control, which in turn makes them ineligible for coverage.

Like traditional insurance, captive insurance can cover several types of risk. Captive insurance can underwrite public and product liability, physical property damage, professional indemnity, employee benefits such as medical aid and employer’s liability. As a result, what we found is captive can be a part of Islamic Finance through the Wakalah concept between parent and captive. The other concept is Takaful between subsidiary and captive where all the concepts using the aqad in the transaction. Then, we can call captives as a ‘kafalah arahab’.

10. Conclusion
The result shows the financial benefits of captive insurance. In a hard market, capacity is limited thus driving up premiums. Coverage will also be restrictive and in extreme cases not available at all such as war risk. Under such conditions the captive can drive down the overall cost of insurance through retaining a position of its own risk whether through assuming a larger policy deductible or assuming a share of the overall reinsurance program. The Captive idea can also lead to a part of tax exemptions. The Captive also provides you with a platform to undertake alternative risk financing methods which provide you with a host of alternatives to conventional insurance.

As mentioned before, captive is highly versatile and is only restricted in use by the insurance laws of its domestic parents. The examples on using the captive mentioned above are by no means exhaustive. Since that, Labuan IBFC comply targeting 500 best conglomerate in Asia to set up insurance company captive in the island and until first half of this year, two company already so do. So, there no issues arise if the captive insurances apply in Takaful application.

Besides, we can use this captive in Zakat system where this captive can help in the effort of upgrading the poor peoples in Malaysia. For instance, with the existence of captive, zakat distribution internally is more effective and systematic. On the other hand, this will avoid zakat oozing without particular purpose and approved by certain parties.

References