In the Name of God

Takaful and Microtakaful: Islamic Instruments for protecting poor And Vulnerable Groups

Sadegh Bakhtiari

Professor of Economics, Islamic Azad University, Khorasgan, Isfahan, Iran

The First Annual Conference of Islamic Economics & Islamic Finance @ ECO-ENA, Inc., Canada

Venue: Toronto University: Chestnut Conference Center, Armoury suite
August 30th & 31st, 2013

Introduction (1)

- In the last 50 years, different development strategies have been used to assist the poor and vulnerable groups
- Most of these programs failed
- “Microfinance” initiated in the mid-1970s appears to be the ‘new paradigm’ to eradicate poverty

Introduction (2)

- lack of saving and limited access to finance are the key constraints for the poor and it is impossible for them to do any investment
- The poor are not qualify to get funds from formal institutional sources due to:
  - lack of collateral
  - too much risk
  - too costly

Basic Concepts

- **Microfinance** – provision of a range of the poor's financial service needs, including credit, savings, insurance, remittance management.
- **Microcredit** – provision of small-scale loans for the poor.
- **microinsurance -** The protection of low-income people against specific perils in exchange for monetary payments (premiums) proportionate to the likelihood and cost of the risk involved.
- **Takaful-** a kind of cooperative Insurance for enhancing social solidarity amongst policy holders. It is not purely profit oriented, but seeks protection against risks and absorb material consequences of any loss to insured person or his properties.

The Importance of Insurance for the poor

- Access to insurance, as part of a broad range of essential financial services, is especially important for poor households in order to smooth consumption, build assets, absorb shocks, and manage risks associated with unpredictable income.
- Without access to good formal insurance services, the poor depend on less reliable and often far more expensive informal sector mechanisms

Poverty Alleviation and MDGs

- Poverty is a social problem and affects every culture and society dimensions. Poverty involves limiting access to services on education, health, decision making and lack of community facilities such as water, sanitation, roads, transport and communications.
- The key to sustainable development and achieving the MDGs of the United Nations is poverty alleviation.
- So any strategy that alleviate poverty and assist vulnerable groups it could help achieving sustainable development and MDGs.

The Millennium Development Goals MDGs

1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria, and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development

Poverty Alleviation Is at the Center of the MDGs

- These goals set out to reduce poverty and hunger, and to tackle ill-health, gender inequity, lack of education, and environmental degradation at the first place by 2015.
- The ability to meet our nation's commitment to the Millennium Development Goals or a sustainable development, is contingent on poverty alleviation strategies.

Poverty, Risk and Insurance

- Risk and uncertainty are fundamental facts of life.

  All human activities are subject to risk, which may

  lead to financial or physical losses to him.
- Every individual try to protect himself against future potential losses.
- Risk causes poverty
- Insurance is a modern time device to cover the losses arise due to occurrence of some undesired event.
- Risk implies a possible ‘fear’ of bad outcomes

Strategies for risk management

- Individuals don't passively undergo risks, and use risk strategies to shape their consequences
- Economic agents uses two kind of strategies
- Ex-ante strategies: before the risk occurs, trying to *prevent* risk affecting the household or to *mitigate* the impact of risk
- Ex-post strategies: after the risky event occurs, reducing its impact (*coping*), while ex-ante is preparation for the risk.

Problems associated with insurance

- Information problems
  - adverse selection and
  - moral hazard
- Trust and credibility
- Administration costs

Information Problems

- **Adverse selection** describes a situation where the two parties to a transaction (i.e., the buyer and seller) have different pieces of knowledge about the quality of the good or service being traded

- **Moral hazard** refers to a situation where a transaction empowers one of the parties to take an *unobservable* action that is more beneficial to that party, and more harmful to the other party.

Trust and credibility

- Historically: insurance for poor spread through cooperatives, trade unions, etc.

- Work with local community groups to help bridge understanding and trust problems, especially those involved in mutual support already.

Risk as a cause of poverty:

Uninsured risk implies that it may be optimal to avoid

profitable opportunities. So, ***lower risk at the***

Expense of lower returns

E.g. low risk activities, low risk assets;

NOT due to 'risk averse preferences' but driven by

Lack of insurance Shocks result in **lost human,physical or social capital**, reducing access to profitable opportunities in the future.

Long-run impact of shocks and risk on Poverty

- Increasing evidence of long-run effects of shocks
- Destruction of human/physical capital, feeding into growth potential
- Closer to the core of the analysis of poverty
- Less attention to role of risk, but this is also *cause* of poverty and lower growth

Impact of risk on Poverty

- Increasing evidence of short run and long-run effects of shocks
- Destruction of human/physical capital
- Closer to the core of the analysis of poverty
- Less attention to role of risk, but this is also *cause* of poverty.

Muslim scholars and Insurance

Opinion of Muslim scholars is divided on insurance.

We can classify them into three major groups.

- Those who are in agreement with the present insurance and find nothing wrong in it.
- Those who accept the concept of insurance, but find prohibited elements in its present practice.
- Those who consider both the concept and practice of commercial insurance un-Islamic.

Takaful and Microtakaful

The word ‘**Takaful**’ has been derived from the Arabic root word ‘ **Kafala**’ meaning ‘**mutual protection and joint guarantee.**.

- It is **risk-sharing** instead of **risk-transfering**.
- Takaful is a practical manifestation of the Quranic injunction for mutual co-operation and assistance for the common good/benefit.
- It encompasses the predominant elements of social good, brotherhood and solidarity – founded on the core Shariah principles.
- By doing so, one gets benefited – from cradle to grave and even in the Hereafter!

Principles of Takaful

- Solidarity and joint guarantee
- Self reliance and self sustaining for community well being
- Assist those that need assistance
- Community pooling system
- Shari’ah approved investments and products

Takaful and Risk Reduction

- Takaful and microtakaful provides strategies of risk mitigation/reduction by virtue of collective risk taking that distributes risks and losses to a large number of participants.
- This mitigates the otherwise very damaging losses, if borne individually.

Major Arguments Against Insurance

According to many Shariah scholars, conventional Insurance is unlawful because of involvement of prohibited elements like,

- Riba (Interest)
- Qimar (Gambling)
- Gharar (Uncertainty, Doubt)

Islamic Substitute

- Based on Islamic principles the scheme based on the concept of mutual cooperation and Joint responsibility may be considered as Islamic Substitute for Conventional Insurance.

- This alternate is introduced under the title of Takaful and Microtakaful in the recent past.

The need in Muslim countries

- Social services inadequate or unavailable
- Large sectors of poverty in many Muslim countries
- Over half of world's lowest developed countries have a majority Muslim population
- Religious considerations are important in villages and small communities
- Takaful has been approved by All Islamic scholars' from different sects.

Benefits of MicroTakaful

- Helps people sustain their financial well being
- Creates feeling of togetherness & security
- Opens avenues for joint efforts for mutual benefits
- Cooperative approach and outlook
- Result s in migration of benefits at individual level.
- Ensures that Society benefits at large.

Takaful drivers

This movement is driven by:

- a strong demand from a public who would not insure otherwise (because of religious beliefs); and
- The successful development of Islamic banking institutions providing capital and Islamic financial instruments for asset management and investment.

Definition of Takaful and Microtakaful

- The word '**Takaful**' has been derived from the Arabic root word ' **Kafala**' meaning '**mutual protection and joint guarantee.**.
- It is **risk-sharing** instead of **risk-transfering**.
- Takaful is a practical manifestation of the Quranic injunction for mutual co-operation and assistance for the common good/benefit.
- It encompasses the predominant elements of social good, brotherhood and solidarity – founded on the core Shariah principles.
- By doing so, one gets benefited – from cradle to grave and even in the Hereafter.

Definition of Takaful and Microtakaful (Cont.)

Operationally, takaful refers to participants mutually contributing to a common fund with the purpose of having mutual indemnity in the case of peril or loss.

MicroTakaful refined:

"A mechanism to provide Shariah-based protection to the blue collared, under-privileged individuals at an affordable cost".

Takaful and Risk Reduction

- *"tie the camel first, then submit (tawakkal) to the will of Allah"*

  The hadith implied a strategy to mitigate risk.

- Takaful and microtakaful provides a strategy of risk mitigation by virtue of collective risk taking that distributes risks and losses to a large number of participants. This mitigates the otherwise very damaging losses, if borne individually.

Basic Elements of Takaful

- Mutuality and cooperation.
- Payments made with the intention of *contribution*
- Joint Guarantee / Indemnity amongst participants
- shared responsibility.
- Constitution of separate “Participants’ Takaful Fund”.
- Investments as per Shariah.

Benefits of MicroTakaful

- Helps people sustain their financial well being
- Creates feeling of togetherness & security
- Opens avenues for joint efforts for mutual benefits
- Cooperative approach and outlook
- Result s in migration of benefits at individual level.
- Ensures that Society benefits at large.

Comparing Takaful to Conventional Insurance

Issue	Conventional Insurance	Takaful
Organization Principle	Profit for shareholders	Mutual for participants
Basis	Risk Transfer	Co-operative risk sharing
Value Proposition	Profits maximization	Affordability and spiritual satisfaction
Laws	Secular/Regulations	Sharia plus regulations
Ownership	Shareholders	Participants
Management status	Company Management	Operator
Form of Contract	Contract of Sale	Cooperative, Islamic contracts of Wakala or Mudarbah with Tabar'ru (contributions)
Investments	Interest based	Sharia compliant, Riba-free
Surplus	Shareholders' account	Participants' account

Takaful models in practice

Takaful can be performed mainly in the following forms:

- Not for profit model
- Ta'awuni model – "cooperative insurance"
- Mudharabah model – profit sharing
- Wakala model – agency agreement
- Waqf Model and
- Modified *mudharabah* (*mudharabah* + *wakalah*)
- *Modified wakalah(wakalah + waqf)*

- It should be mentioned that the participation into a Takaful scheme must be performed with utmost sincerity in order to help those faced with difficulties.
- Every policy holder would pay his subscription in order to assist those who need assistance
- Any member or participant suffering a catastrophe or disaster would receive a certain sum of money or financial benefit from a fund, as also defined in the pact, to help him meet the loss or damage
- The Company involved in takaful business, as the operator, will accept payment of the takaful installments or takaful contributions (premium) from the participants (clients) and these fund may be used in profitable projects based on Islamic rules

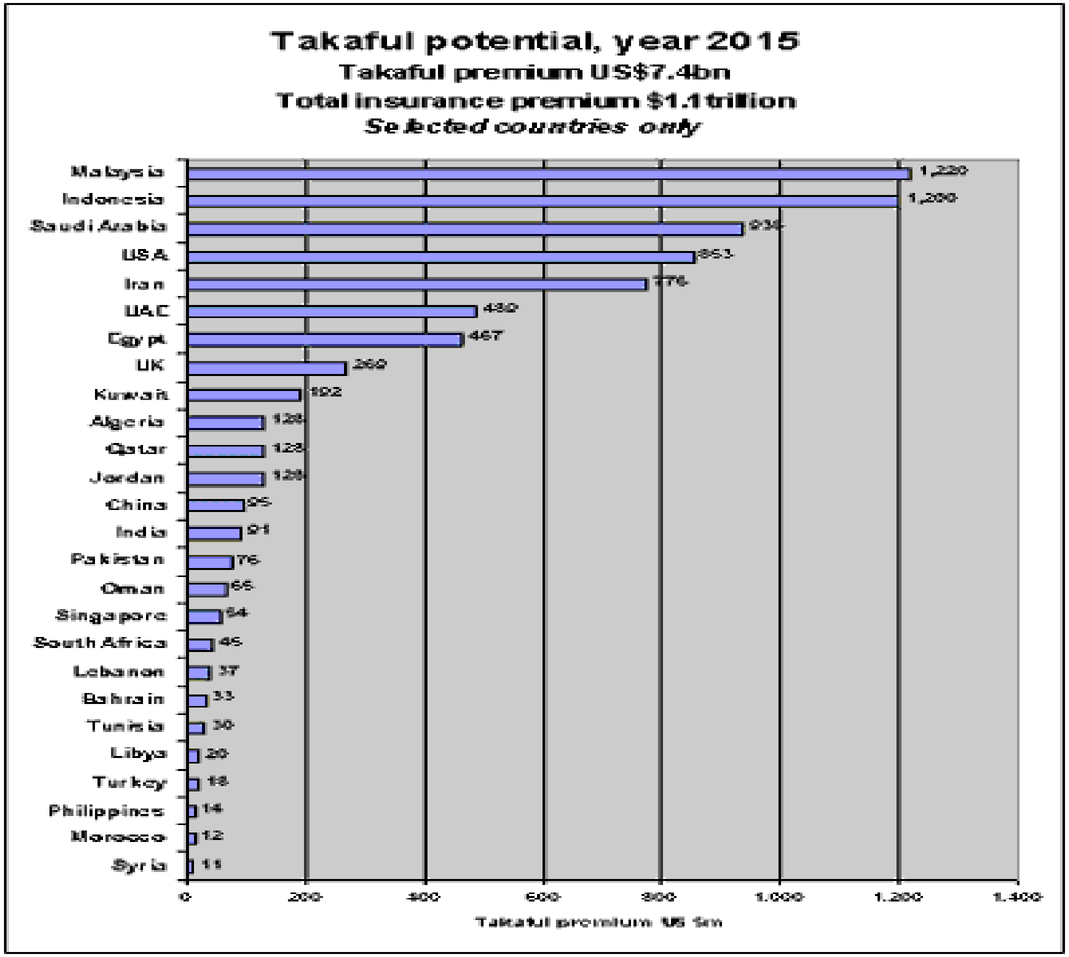
Future Outlook

- This study shows that takaful industry is one of the fastest growing segments in insurance.
- According to World Takaful Report 2012, Global Takaful contributions grew by 19% and reach a total of around $12bn.
- Despite the remarkable growth rate recorded by the Takaful industry, penetration is still far below the enormous market potential offered by the Muslim community worldwide (more than 25% of the total world population).
- Despite a remarkable breakthrough and a dynamic and sustained growth, there are challenges facing the Takaful industry.

New Takaful Frontiers

- Markets like Europe, North and Latin America, Central Asia, Australia where large Muslim communities live are huge untapped reservoirs;
- The recent opening towards "Islamic windows" in the banking sector in Europe is likely to be followed by "Takaful windows" initiatives.
- Takaful Products are not exclusive to Muslims.
- Competitively priced and sold through the right channel it could attract any consumer irrespective of their origin or faith (case of SriLanka and Malaysia).

Future Outlook



The Challenges ahead

- The existence of three business models:
  - Mudharabah (Profit & Loss sharing)
  - Wakala (agency contract with a performance fee element to replace surplus sharing)
  - Wakala with Waqf model
- Could create an uneven / unfair business environment to operate
- Need to reach a consensus internationally on a common and standard Takaful business model

Conclusions

- Insurance has an important role to play in poverty alleviation
- There is a need for microinsurance to be provided to low income sectors in Muslim countries and communities.
- Takaful and microtakaful scheme based on cooperative/mutual principles are acceptable under Islamic Law
- Takaful based microinsurance schemes are an effective vehicle to provide insurance to the poor.
- The success of Takaful largely depends on that of Islamic Financial institutions on a global basis.

Thank You for your attention.