

# Takaful and poverty alleviation

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*“But those who before them had homes (in Medina) and had adopted the faith, show their affection to such as come to them for refuge, and entertain no desire in their hearts for things given to the (latter), but give them preference over themselves, even though poverty was their (own lot) and those saved from the covetousness of their own souls; they are the ones that achieve prosperity.”*

(AlQuran: Al Hashr 9.)

*“Serve Allah and join not any partners with him and do good to parents, kinsfolk, orphans, those in need, neighbours who are near, neighbours who are strangers, the companion by your side, the wayfarer (you meet) and what your right hands possess; for Allah loves not the arrogant, the conceited.”*

(AlQuran: An Nisaa 36.)

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# Income levels in the Muslim world

Worldwide the Muslim population in 2001 stood at 1,433.71 million or 23 per cent of the total population, of which 1,385.45 million are based in Asia and Africa. Muslims account for 47 per cent of the population in Africa, 27 per cent in Asia, 7 per cent in Europe, and 2 per cent in North America (Felahi 2001).

## The well-being of the Muslim population

| Continent                    | Muslim population (%) 2001 | Worldwide Muslim population (%) 2001 | HDI* value 1998 | GDP per capita (PPP USD) 1998 | GDI* value 1998 | Population without access to safe water (%) 1990–8 | Population without access to sanitation (%) 1990–8 | Underweight children under age five (%) 1990–8 |
|------------------------------|----------------------------|--------------------------------------|-----------------|-------------------------------|-----------------|--|--|--|
| South Asia                   | 36                         | 38                                   | 0.56            | 16,765                        | 0.542           | 18   | 65   | 49   |
| South Asia (excluding India) | 84                         | 28                                   | 0.55            | 25,314                        | 0.533           | 15   | 49   | 41   |
| Arab countries               | 94                         | 18                                   | 0.635           | 4,140                         | 0.612           | 17   | 23   | 19   |
| Sub-Saharan Africa           | 36                         | 16                                   | 0.464           | 1,607                         | 0.459           | 46   | 52   | 31   |
| South East Asia and Pacific  | 40                         | 14                                   | 0.691           | 13,111                        | 0.688           | 29   | —  | —  |
| East Asia                    | 3                          | 3                                    | 0.716           | 20,987                        | 0.710           | 32   | —  | —  |
| East Asia (excluding China)  | 0                          | 0                                    | 0.849           | 17,719                        | 0.846           | 8  | —  | —  |

\*HDI (Human Development Index): composite index based on life expectancy, educational attainment and standard of living. An HDI value equal to or more than 0.800 has high human development; 0.500–0.790 HDI has medium human development; and an HDI below 0.500 reflects low human development and well-being.

†GDI (Gender-related development index): composite index using same variables as HDI but adjusted in accordance with the disparity in achievement between women and men. A GDI of less than 0.500 show that women in these countries suffer the double deprivation of low overall achievement in human development than men.

Source: UNDP (2000), Felahi (2001).

There is a comparatively very low ratio of Muslims in developed countries, the majority reside in medium to low human development countries. From the thirty-five low human development countries as defined by the Human Development Report 2000, eighteen have a majority Muslim population and a further five have a Muslim population of over 20 per cent. Muslims around the world are commonly faced with low-income levels, and lack access to social security systems, healthcare, education, sanitation, and employment opportunities.

The UNDP 2002 Arab Human Development Report covers twenty-two countries from the Magreb to the Gulf. It states that over the last three decades improvements have been made: life expectancy has increased by fifteen years, mortality rates for children under five has decreased by two-thirds, and adult literacy has doubled. However there are still over sixty-five million adults who are illiterate and ten million children out of school (which is envisaged to increase by 40 per cent by 2015).

High population growth is adding six million labour force entrants every year but with average unemployment across Arab countries at 15 per cent, job creation is not matching the growth of the work force. While Arab countries do not have the lowest levels of dire poverty it is estimated that one in every five person is still living on less than USD 2 per day. Real GDP per capita of the average Arab citizen fell to 13.9 per cent in 1998, one-seventh of the average OECD citizen.

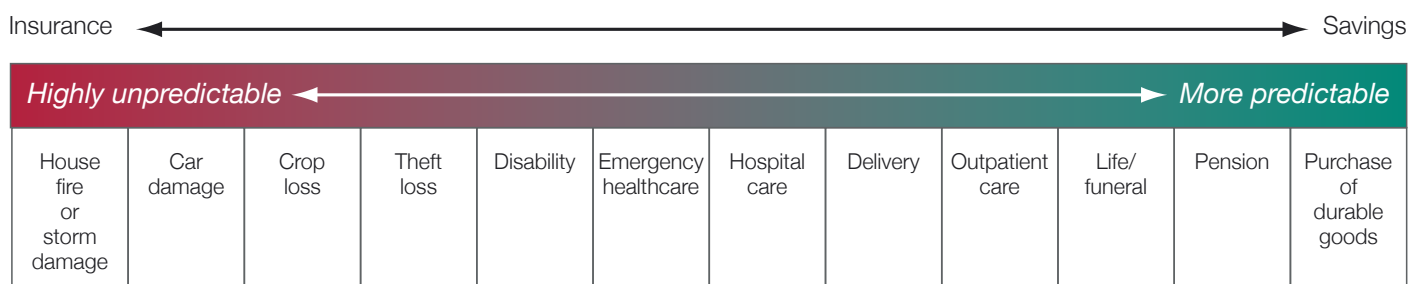
As well as a certain level of income poverty, the less well off in Arab countries have poor or unavailable healthcare, low quality education, poor living conditions, and weak social safety nets with per capita healthcare ranging from USD 11 to USD 1,105 between countries. The Human Development Index (HDI) value for Arab countries was lower than the global average between 1980 and 1999, better than Subsaharan Africa and South Asia but lower than Latin America and Caribbean countries.

Historically, income inequality in Arab countries has been, on average, one of the lowest in the world due to a strong cohesive system of social responsibility and the practices of charity (*zakat* and *sadqua*). More recently, with growing populations and high unemployment, the gap between the rich and poor is expanding. Formal credit is often available to the wealthy but the less well-off remain asset deprived and cannot offer the collateral required. There is a lack of local capacity to deliver microfinance services efficiently to the low income sector and a need for a focused approach to expand outreach beyond the less than 2 per cent of poor households that currently have access to financial services. It is therefore important that some risk protection mechanism is available to lower the vulnerability of the Muslim population.

*“... the less well off in Arab countries have poor or unavailable healthcare, low quality education, poor living conditions, and weak social safety nets with per capita healthcare ranging from USD 11 to USD 1,105 between countries.”*

(World Bank, 2000.)

While both savings and credit facilities are integral in assisting the poor overcome unforeseen losses their benefits are limited to the capacity of the individual to save or make repayments. When bad conditions and their consequences persist for several years such as drought and flooding, then the use of savings as protection is constrained. In addition, high risks of illnesses, death and disability of the breadwinner means outstanding loans become difficult to pay.



Source: Atim, 1998.

It can be concluded that insurance is an effective mechanism for reducing the vulnerability of the poor from the impacts of disease, theft, disability, and other hazards as well as safeguarding the productive use of savings and credit facilities. Insurance protects against unexpected losses by pooling the resources of the many to compensate for the losses of the few, the more uncertain the event the more insurance becomes the most economical form of protection. Policyholders only pay the average loss suffered by the group rather than the actual costs of an individual event, insurance replaces the uncertain prospect of large losses with the certainty of making small, regular, affordable premium payments (Brown & McCord 2000, Brown & Churchill 1999). The primary function of insurance is to act as a risk transfer mechanism, to provide peace of mind and protect against losses.

Risk can be handled by either: assumption, combination, transfer, or loss prevention activities. Insurance schemes utilize the combination method by persuading a large number of individuals to pool their risks into a large group to minimize overall risk (Ali 2000). In the developed world insurance is part of society, such that some forms of cover are required by law. In developing countries the need for such a safety net is much greater, particular at the poorest levels where vulnerability to risks is much greater and there are fewer opportunities available to recover from a large loss.

*“... insurance is an effective mechanism for reducing the vulnerability of the poor from the impacts of disease, theft, disability, and other hazards as well as safeguarding the productive use of savings and credit facilities.”*

# Insurance in Muslim countries

Whilst “conventional” insurance companies do operate in Islamic countries these are limited to commercial needs and to the more affluent sector of the population. While population sizes indicate a large potential market, insurance penetration in Muslim countries is low, mainly due to underdeveloped financial systems, weak contract enforcement, consumer scepticism, corruption, lack of understanding of the benefits, and necessity of insurance, limited technical expertise, and low GDP per capita.

Another major reason for low insurance penetration is that conventional insurance contains elements contradictory to Islamic principles namely:

## *Gharar* (uncertainty)

The insurance contract contains uncertainty due to:

- Uncertainty whether the payment will be accepted as promised.
- The amount to be paid is not known.
- The time it will occur is not known.

(Any form of contract which is lopsided in favour of one party at the expense and unjust loss to the other is classified as *Gharar*.)

*Example:* When a claim is not made the insurance company may acquire all the profits whilst the participant may not obtain any profit whatsoever. The loss of premiums on cancellation of a life insurance policy by the policyholder, or the “double standard” condition of charging a customary short period in general insurance, whilst only a proportional refund is made if the insurance company terminates the cover is also considered as unjust.

## *Maisir* (gambling)

- The participant contributes a small amount of premium in hope to gain a large sum.
- The participant loses the money paid for the premium when the insured event does not occur.
- The company will be in deficit if claims are higher than contributions.

*Example:* When a life insurance policyholder dies after only paying part of the premium his dependants receive a certain sum of money which the policyholder has not been informed of and has no knowledge as to how and from where it has been derived.

## *Riba* (interests)

- An element of interest exists in conventional life insurance products—as the insured, on his death, is entitled to get much more than he has paid.
-

- ✦ Insurance funds invested in financial instruments such as bonds and stocks contain and element of Riba.

Muslim jurists have concluded that the system of insurance which falls within the framework of Islam should be founded on the concept of Al-Takaful. Therefore an Islamic insurance transaction would be a policy of mutual cooperation, solidarity, and brotherhood against unpredicted risk and catastrophe, where participants contribute (donate) to help one another other (Billah 2001).

### Human development and insurance penetration in Muslim countries

| HDI rank 1998 | Country      | Muslim population (%) 2000 | HDI value 1998 | GDP per capita (PPP USD) 1998 | Insurance density: Premiums per capita 1998 (USD) | Insurance penetration: premiums as a share of GDP 1998 (%) | World population 1998 (%) | World insurance market 1998 (%) |
|---------------|--------------|----------------------------|----------------|-------------------------------|---|--|---------------------------|---------------------------------|
| 32            | Brunei       | 67                         | 0.848          | 16,765                        | —   | —  | 0.3                       | —                               |
| 36            | Kuwait       | 100                        | 0.836          | 25,314                        | 97.8  | 0.79   | 1.8                       | 0.01                            |
| 41            | Bahrain      | 100                        | 0.820          | 13,111                        | 191.8   | 1.95   | 0.6                       | 0.01                            |
| 42            | Qatar        | 95                         | 0.819          | 20,987                        | 271.9   | 1.66   | 0.6                       | 0.01                            |
| 45            | UAE          | 96                         | 0.810          | 17,719                        | 253.4   | 1.43   | 2.4                       | 0.03                            |
| 61            | Malaysia     | 59                         | 0.772          | 8,137                         | 133.4   | 4.02   | 21.4                      | 0.13                            |
| 72            | Libya        | 97                         | 0.760          | 6,697                         | 35.9  | 0.23   | 5.3                       | 0.01                            |
| 75            | Saudi Arabia | 100                        | 0.747          | 10,158                        | 39.1  | 0.52   | 20.2                      | 0.04                            |
| 82            | Lebanon      | 70                         | 0.735          | 4,326                         | 140.4   | 2.69   | 3.2                       | 0.02                            |
| 85            | Turkey       | 99.8                       | 0.732          | 6,422                         | 33.1  | 1.06   | 64.5                      | 0.10                            |
| 86            | Oman         | 99                         | 0.730          | 9,960                         | 58.5  | 0.87   | 2.4                       | 0.01                            |
| 89            | Maldives     | 100                        | 0.725          | 4,083                         | —   | —  | 0.3                       | —                               |
| 90            | Azerbaijan   | 93.4                       | 0.722          | 2,175                         | —   | —  | 7.7                       | —                               |
| 92            | Jordan       | 94                         | 0.721          | 3,347                         | 29.8  | 1.90   | 6.3                       | 0.01                            |
| 94            | Albania      | 70                         | 0.713          | 2,804                         | —   | —  | 3.1                       | —                               |
| 97            | Iran         | 99                         | 0.709          | 5,121                         | 18.6  | 0.67   | 65.8                      | 0.05                            |
| 98            | Kyrgyzstan   | 75                         | 0.706          | 2,317                         | —   | —  | 4.6                       | —                               |
| 100           | Turkmenistan | 89                         | 0.704          | 2,550                         | —   | —  | 4.3                       | —                               |
| 101           | Tunisia      | 98                         | 0.703          | 5,404                         | 35.4  | 1.65   | 9.3                       | 0.02                            |
| 106           | Uzbekistan   | 88                         | 0.686          | 2,053                         | —   | —  | 23.6                      | —                               |
| 107           | Algeria      | 99                         | 0.683          | 4,792                         | 9.1   | 0.54   | 30.1                      | 0.01                            |
| 109           | Indonesia    | 88                         | 0.670          | 2,651                         | 5.8   | 1.27   | 206.3                     | 0.06                            |
| 110           | Tajikistan   | 85                         | 0.663          | 1,041                         | —   | —  | 6.0                       | —                               |
| 111           | Syria        | 91                         | 0.660          | 2,892                         | 23.0  | 0.52   | 15.3                      | 0.02                            |
| 119           | Egypt        | 94                         | 0.623          | 3,041                         | 8.5   | 0.65   | 66.0                      | 0.02                            |
| 124           | Morocco      | 99                         | 0.589          | 3,305                         | 33.8  | 2.60   | 27.4                      | 0.04                            |
| 126           | Iraq         | 97                         | 0.583          | 3,197                         | —   | —  | 21.8                      | —                               |
| 135           | Pakistan     | 97                         | 0.522          | 1,715                         | 2.9   | 0.66   | 148.2                     | 0.02                            |
| 137           | Comoros      | 98                         | 0.510          | 1,398                         | —   | —  | 0.7                       | —                               |
| 143           | Sudan        | 73                         | 0.477          | 1,394                         | —   | —  | 28.3                      | —                               |
| 146           | Bangladesh   | 88.3                       | 0.461          | 1,361                         | —   | —  | 124.8                     | —                               |
| 147           | Mauritania   | 100                        | 0.451          | 1,563                         | —   | —  | 2.5                       | —                               |
| 148           | Yemen        | 99.9                       | 0.448          | 719                           | —   | —  | 16.9                      | —                               |



| HDI rank<br>1998 | Country       | Muslim<br>population<br>(%) 2000 | HDI value<br>1998 | GDP per<br>capita<br>(PPP USD)<br>1998 | Insurance<br>density:<br>Premiums<br>per capita<br>1998 (USD) | Insurance<br>penetration:<br>premiums<br>as a share of<br>GDP 1998<br>(%) | World<br>population<br>1998 (%) | World<br>insurance<br>market<br>1998 (%) |
|------------------|---------------|----------------------------------|-------------------|--|---|---|---------------------------------|--|
| 149              | Djibouti      | 94                               | 0.447             | 1,266                                  | —   | —   | 0.6                             | —  |
| 151              | Nigeria       | 50                               | 0.439             | 795                                    | 2.7   | 0.86  | 106.4                           | 0.02                                     |
| 154              | Côte d'Ivoire | 60                               | 0.420             | 1,598                                  | 12.0  | 1.53  | 14.3                            | 0.01                                     |
| 155              | Senegal       | 94                               | 0.416             | 1,307                                  | —   | —   | 9.0                             | —  |
| 156              | Tanzania      | 50                               | 0.415             | 480                                    | —   | —   | 32.1                            | —  |
| 159              | Eritrea       | 50                               | 0.408             | 833                                    | —   | —   | 3.6                             | —  |
| 161              | Gambia, The   | 90                               | 0.396             | 1,453                                  | —   | —   | 1.2                             | —  |
| 162              | Guinea        | 85                               | 0.394             | 1,782                                  | —   | —   | 7.3                             | —  |
| 165              | Mali          | 90                               | 0.380             | 681                                    | —   | —   | 10.7                            | —  |
| 167              | Chad          | 50                               | 0.367             | 856                                    | —   | —   | 7.3                             | —  |
| 171              | Ethiopia      | 50                               | 0.309             | 574                                    | —   | —   | 59.6                            | —  |
| 172              | Burkina Faso  | 50                               | 0.303             | 870                                    | —   | —   | 11.3                            | —  |
| 173              | Niger         | 97                               | 0.293             | 739                                    | —   | —   | 10.1                            | —  |
| 174              | Sierra Leone  | 60                               | 0.252             | 458                                    | —   | —   | 4.6                             | —  |

Source: UNDP (2000), Felahi (2001), Sigma (1999), Sigma (2000).

*“While population sizes indicate a large potential market,  
insurance penetration in Muslim countries is low..”*

# Islamic insurance (Takaful)

***“Takaful is the second most important social institution in the Islamic community to counter poverty and deprivation.”***

(Omar Fisher, 1999.<sup>1</sup>)

Insurance in Islam has existed since the early second century of the Islamic era when Muslim Arabs expanding trade into Asia mutually agreed to contribute to a fund to cover mishaps or robberies along the numerous sea voyages. Muslim jurists concluded that insurance in Islam should be based on principles of mutuality and cooperation and encompass the elements of shared responsibility, joint indemnity, common interest and solidarity (Yusof 1999, Shakir 1999).

Principles of Takaful insurance:

- ♦ Policyholders cooperate among themselves for their common good.
- ♦ Every policyholder pays his subscription to help those that need assistance.
- ♦ Losses are divided and liabilities spread according to the community pooling system.
- ♦ Uncertainty is eliminated in respect of subscription and compensation.
- ♦ It does not derive advantage at the cost of others.

The basic fundamental underlying the Takaful concept are very similar to cooperative and mutual insurance principles, to the extent that the cooperative and mutual insurance scheme investing in Islamic-compliant products is one that is accepted under Islamic Law.

Takaful is the form of insurance deemed permissible for Muslims under *Shariah* Law (Islamic Law). The fundamental philosophy of Takaful is the same as that of the cooperative, with added restrictions on investments and more flexibility on capital formation. The Takaful is operated as an enterprise providing services on a self sustaining model rather than as a charity (Fisher 1999). Since the first Takaful insurer, the Islamic Insurance Company of Sudan, was established in 1979, there are now almost fifty Takaful companies around the world. However the growth of the Takaful movement has not been profound, in 2000 Takaful premiums represented approximately 0.02 per cent of world insurance premiums.<sup>2</sup>

## Estimated figures of Takaful business in 2000

| Country/region     | Takaful premium 2000 (USD million) | Percentage of total Takaful market |
|--------------------|------------------------------------|------------------------------------|
| Malaysia           | 143                                | 27                                 |
| Other Asia Pacific | 50                                 | 9                                  |
| Europe, USA        | 6                                  | 1                                  |
| Arab countries     | 340                                | 63                                 |
| Total              | 538                                | 100                                |

Source: Bhatti (2001).

## Takaful models in practice

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.” The role of this practice indicates that the policyholders are in fact the managers of the fund and the ones in ultimate control. However, the commercialization of Takaful has produced several types of Islamic insurance, each reflecting a different experience, environment and perhaps a different school of thought.

### Ta’awuni model (cooperative insurance)

The Ta’awuni model practices the concept of pure *Mudharabah* in the daily transactions where it encourages Islamic values such as brotherhood, unity, solidarity, and mutual cooperation. In the pure *Mudharabah* concept, the Takaful company and the policyholder will only share the direct investment income; the policyholder is entitled to a 100 per cent of the surplus with no deduction made prior to the distribution. This model is applicable to life family Takaful as the fund is entirely distributed to the participants.

### Non-profit model

This model includes social/governmental owned enterprises and programmes operated on a non-profit basis which utilize a contribution that is 100 per cent *Tabarru* (“donation”) from participants who willingly give to the less-fortunate members of their community.

### Al Mudharaba model

The surplus is shared between the policyholders and Takaful operator. The sharing of such profit (surplus) may be in a ratio of 5 : 5, 6 : 4, 7 : 3, etc., as mutually agreed between the contracting parties. Generally, these risk-sharing arrangements allow the Takaful operator to share in the underwriting results from operations as well as the favourable performance returns on invested premiums.

### Al Wakala model

Cooperative risk-sharing occurs among participants where a Takaful operator earns a fee for services (as a *Wakeel*, or “Agent”) and does not participate or a share in any underwriting results. As these belong to participants as surplus or deficit, under the Al Wakala model, the operator may also charge a fund management fee and a performance incentive fee.

# Challenges in providing insurance to the poor

Insurance is not as widespread in developing countries as in the developed world and in the poorest of countries it is virtually non-existent. Available figures show that only Nigeria has any officially recognisable form of insurance from the thirty-five countries identified as low in human development (HDI < 0.500). All developing countries, even those with large populations, have a very low proportion of the world insurance market. Of the forty-two medium human development countries for which information was available, despite population increases, twenty-nine had decreased their proportion of the world insurance market with only India, China, and South Africa increasing between 1998 and 2000. In 1998 the three largest insurance markets (USA, Japan, and UK) covered almost 64 per cent of the total world insurance market, but only 8 per cent of the world population—by 2000 this had grown to almost 69 per cent. Formal (legal) insurance is not being made available where it is needed the most, where human well-being is at the lowest and vulnerability at its highest.

Availability of insurance in countries with low human development compared to those with high human development

| HDI rank (from 174) 1998 | Insurance* rank by volume from 88 1998 | Country  | HDI value 1998 | GDP per capita (PPP USD) 1998 | Insurance density: premiums per capita 1998 (USD) | Insurance penetration: premiums as a share of GDP 1998 (%) | World population 1998 (%) | World* insurance market 1998 (%) | World* insurance market 2000 (%) |
|--------------------------|--|----------|----------------|-------------------------------|---|--|---------------------------|----------------------------------|----------------------------------|
| 3                        | 1                                      | USA      | 0.929          | 29,605                        | 2,722.7   | 8.65   | 4.71                      | 34.17                            | 30.61                            |
| 9                        | 2                                      | Japan    | 0.924          | 23,257                        | 3,584.3   | 11.73  | 2.17                      | 21.02                            | 26.39                            |
| 10                       | 3                                      | U.K.     | 0.918          | 20,336                        | 2858.9  | 12.09  | 1.01                      | 8.40                             | 11.82                            |
| 135                      | 58                                     | Pakistan | 0.522          | 1,715                         | 2.9   | 0.66   | 2.55                      | 0.02                             | 0.01                             |
| 138                      | 65                                     | Kenya    | 0.508          | 980                           | 9.5   | 3.48   | 0.50                      | 0.01                             | 0.00                             |
| 151                      | 61                                     | Nigeria  | 0.439          | 795                           | 2.7   | 0.86   | 1.83                      | 0.02                             | 0.00                             |

\*Only those eighty-eight countries with premium volumes more than USD 150 million have statistical data provided in Sigma.

Sources: UNDP (2000), Sigma (1999), and Sigma (2001).

The lack of interest by the formal sector to serve the poor is due to low collateral, higher transaction costs, interest rate restrictions, corruption, uncertain profitability, high risks, lack of pro-poor values, and inability to serve the specific needs of the poor (Matin *et al* 1999). Insurance is a capital-intensive industry requiring large start up costs and financial commitments, modern technology, and a well-educated workforce. Additionally, monetary stability, opportunity for investments, a politically and economically stable environment, and a sound consistent, favourable, and fair regulatory system is not available in developing countries (Ripoll 1996). Consequently, the provision of insurance to the

poor has been left to the informal sector through existing microfinance institutes, NGOs, credit unions, and cooperatives without overwhelming success. These organizations are faced with a multitude of problems and issues that prevent them from providing adequate, affordable and secure insurance products.

- ♦ Coverage: protection has to be restricted to maintain affordable premiums and solvency of the scheme.
- ♦ Regulation: high capital requirements make servicing low-income markets uneconomical.
- ♦ Informal market environment: uneducated consumers are regularly defrauded.
- ♦ Morale hazard: there is greater probability that the poor insured will change his/her behaviour.
- ♦ Education: the poor find it difficult to understand and accept the risk pooling concept.
- ♦ Technical expertise: micro-insurance programme requires a greater level of technical expertise and actuarial support.
- ♦ Fraud: opportunities for fraud in an informal environment are greater than elsewhere.
- ♦ Adverse selection: a sufficiently large pool size of the right mix of risks is critical.
- ♦ Flexibility: it is important to verify claims and process payments quickly.
- ♦ Affordability: there is a clear correlation between the socio-economic level and the ability to purchase insurance.
- ♦ Retention: dropouts are high for various reasons (for example, changes in prices, misunderstanding of policies, lack of effective and focused marketing, and other more pressing demands on clients' income).
- ♦ Sustainability: in the initial years most insurers incur a loss from acquiring and servicing customers which can constrain future growth and endanger solvency.

## Specific difficulties providing Takaful

There are a number of specific issues obstructing the spread of Takaful to the Muslim population. Firstly, there is a shortage of adequately trained and qualified insurance personnel in Islamic countries and, in particular, on the Takaful concept. Secondly, there is a lack of knowledge on the principles of Takaful by the general public and scepticism on its permissibility (particularly on life insurance). Thirdly, there is no existing insurance culture in many Islamic countries, in fact there is an indifference towards risks reflected by their low insurance density and penetration. Fourth, there are few regulatory models in place that governments can use to monitor and encourage Takafuls.<sup>3</sup> Fifth, the demand for Takaful products, both life and non-life, has been huge; however Takaful providers have had difficulty in managing the explosive growth and are unable to fulfil its potential.<sup>4</sup> The lack of distribution channels is a major difficulty in ensuring that access can be provided to the needy. With so few players and with such small capital bases there is also a lack of available reinsurance from within the Takaful movement, limiting the coverage available to policyholders.

# The advantages of the cooperative structure

*“The United Nations Conference on Trade and Development (UNCTAD) endorses that cooperative insurance, complimenting other forms of insurance, has a special role to play in the overall development process.”*  
(UNCTAD, 1977.)

Organizing the poor to access necessary services has been done effectively and efficiently for centuries using the cooperative structure. Agricultural cooperatives satisfy the supply, processing, and marketing of goods. Housing cooperatives give low-income people the opportunity to own their own homes. Cooperative banks and credits unions serve people of limited incomes and extend credit to micro-entrepreneurs. In 2001, membership of the International Cooperative Alliance (ICA), the apex body of the world cooperative movement, covered 230 organizations serving more than 720 million individuals in over ninety countries. In the financial services sector alone, the World Council of Credit Unions Inc (WOCCU) represents over 36,000 credit unions which provide 108 million members access to safe savings and affordable credit. The apparent success of the cooperative structure in satisfying the needs of the poor in an effective and flexible manner makes it a good candidate for channelling insurance products to the poor.

## The cooperative values and principles

| Values              | Member ethics         | Principles                           |
|---------------------|-----------------------|--------------------------------------|
| Self-help           | Honesty               | Voluntary and open membership        |
| Self-responsibility | Openness              | Democratic member control            |
| Democracy           | Social responsibility | Member economic participation        |
| Equality            | Caring for others     | Autonomy and independence            |
| Equity              |                       | Education, training, and information |
| Solidarity          |                       | Cooperation among cooperatives       |
|                     |                       | Concern for the community            |

Source: ICA (1995)

Cooperative insurers are in a better position than others to serve the poor. Cooperative insurers dedicate substantial resources to research, health promotion, and loss prevention as the policyholders’ best interest is served by preventing losses. The cooperative structure makes it easier to win the trust of the members, particular in the face of market failure and is better placed to tap into member’s know-how, loyalty, and ideas. The strong community relationship, good user networks, member involvement, and democratic process encourage a growing feeling of trust and building of social capital to develop a better society. Peer pressure from within established

social groups can encourage members to avoid morally hazardous behaviour, particularly in small groupings and communities. Membership-based organizations thrive when the members come from a specific loyalty or occupation, as fear of future exclusion from the scheme and the accompanying social network keeps participation high. As members are owners of the scheme and ultimate beneficiaries of its success they have a strong incentive to educate themselves and learn about their own business. Cooperatives empower individuals by providing them with the opportunity to participate in decisions that impact their livelihoods. It gives the poor a voice, a choice, and a chance to find solutions to their specific social and economic needs. Community involvement reduces the costs of labour and resources needed for information collecting, educating, marketing, and monitoring policyholders.

The cooperative appears to have greater benefits over other type of institutions in delivering services to the poor—however, there are some limitations. Cooperatives principally rely on retained earnings to expand their capital base, they are unable to raise capital by issuing equity. At or near the subsistence level, the poor have little available for saving and whilst these can be mobilised, to depend on them to provide the required capital is unrealistic in the short term. In developing countries, insurance is offered through cooperatives or credit unions as member-benefit schemes to surpass regulatory requirements. Without the legal requirement of audited financial statements and performance reports, there is a greater need for internal mechanisms and transparency to ensure sufficient controls and checks are in place. There is no incentive through stock options or high salaries to guide managers' objectives and with insufficient board control and expertise there is greater opportunity of fraud by company officers. Lack of control on managers also leads to members' needs being ignored in product development and a lack of motivation to open membership to other groups. Many cooperatives in developing countries have become inward-looking and stagnant organizations. They are seen as a tool for government manipulation and propaganda. Access to services requires permission from group leaders, who are able to abuse their privileged position to favour certain parties, be tempted to steal funds, and exclude the poorest in the community. For these reasons many cooperatives in developing countries have lost the trust of the people they serve, they have earned the reputation as organizations that are riddled with corruption and cronyism.

While microinsurance can be provided through any type of institution that practices good corporate governance and financial transparency; the well run or *genuine* cooperative is in a better position to provide affordable and sustainable cover. The cooperative philosophy, if followed, enables a lot of the problems outlined above to be overcome. In addition, any surpluses from the scheme are returned to the members in the form of dividends, lower premiums, loss prevention activities, and additional coverage. Many observers say that the advantages of the cooperative structure in servicing the poor diminish as the organization grows larger. Solidarity, member participation, member driven services, flexibility, and concern for the community are not as evident once the organization expands beyond the local village. Nevertheless, some of the world's largest insurance organizations have remained as cooperatives and have continued to provide insurance products within their social objectives.

The cooperative can be one of the most effective distribution systems to provide insurance to the poor but only on strict adherence to the following principles:

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- ✦ Good corporate governance.
- ✦ Proper form of accounting and transparency.
- ✦ An open, voluntary and non-discriminating membership.
- ✦ A high degree of autonomy and self-reliance.
- ✦ Clear focus or objective to hold members together, such as access to affordable insurance products.
- ✦ Ensure that everybody has access to and can afford to join the cooperative.

Cooperative-based insurance schemes, if provided correctly, can provide the individual with the capability to secure a better livelihood for themselves and future generations. Insurance can ensure that the foundation on which poverty alleviation is built is strong enough to keep the individual out of poverty. Products such as loan protection, life savings, and health insurance should be introduced at an early stage into the services of a microfinance programme instead of much further down the line. The role of insurance needs to be given an importance equal to that of loans and savings. The success of loan and savings schemes towards poverty alleviation depends on the availability of complimentary insurance products.

*“The basic fundamental underlying the Takaful concept are very similar to cooperative and mutual insurance principles, to the extent that the cooperative and mutual insurance scheme investing in Islamic-compliant products is one that is accepted under Islamic Law.”*



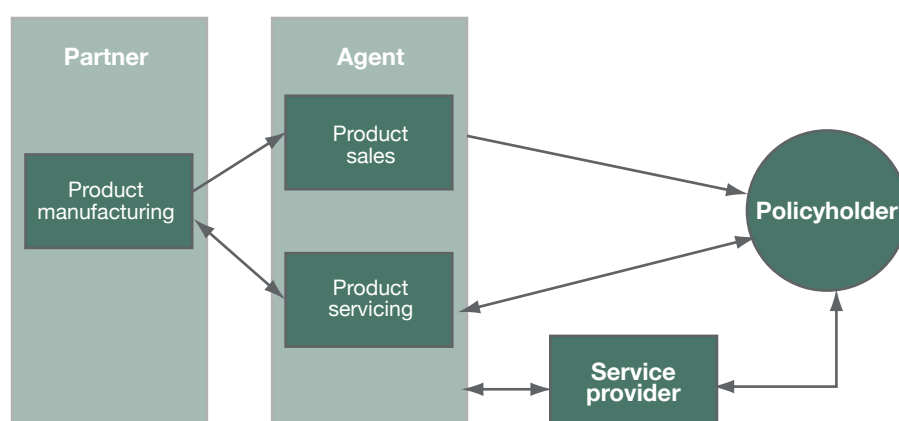
# Lessons from the microinsurance experience

Once a basic insurance scheme is introduced at the local level, whether it is a cooperative or not, the provider faces three key challenges that prevent the expansion of the scheme to a wider community and a wider range of products:

- **Technical expertise:** the microinsurance provider does not possess the necessary insurance expertise to provide a wider range of products on a prudent and sustainable basis.
- **Regulations:** high capital requirements mean that insurance schemes remain in the informal sector. Without a license, insurance schemes are unable to obtain reinsurance cover and are limited to the coverage they provide.
- **Reinsurance:** reinsurance cover is either not available or affordable to the microinsurance provider due to the high risks nature of its portfolio.

## Accessing technical expertise

A microinsurance provider may become an agent for an established insurance company to have access to technical expertise. Any arrangement should allow the microinsurance provider to receive a no-risk fee for administrating the business and access the technical expertise, reinsurance, and capital capacity of the partner. The partner would be ultimately responsible for maintaining reserves, setting the price, paying claims, dealing with external service providers, and complying with legal requirements. The policyholder benefits by increased access to a wider range of products with increased coverage and greater sustainability; and the partnering insurance company has access into a new market without taking extensive marketing, distribution, or administration costs. More importantly the partner–agent model facilitates the pooling of risks between the formal and informal sectors.



Source: Brown and Churchill (2000).

Where a partner is not available, the microinsurance provider may consider approaching donor agencies to sponsor training programs and facilitate the transfer of knowledge from developed markets to overcome their technical deficiencies and strengthen local competence. The International Cooperative and Mutual Insurance Federation (ICMIF), as well providing potential partnerships through its 126 member organizations, can itself be a training partner for the microinsurance provider. Since 1963, the development function of ICMIF has a long and successful history of providing technical assistance and supporting popularly-based organizations to set up their own insurance programs in Asia, Africa, and Latin America. There are numerous experts available from member organizations that can provide advice through short-term and long-term assignments and moderate educational workshops.

## Overcoming regulation

There are various ways that a microinsurance provider may formalize its operations. Some aid agencies are subsidizing premiums or donating capital to microinsurance providers to become legal entities. However these opportunities are few and far between. Many cooperative-based insurers have raised the necessary capital from their members by collecting small contributions over a number of years. Partnerships between established and semi-formal providers on a national and regional basis through fronting arrangements and partner–agent models have been discussed earlier. Collaboration between various microinsurance schemes under a national common holding structure can also achieve the necessary scale required.

Whilst some microinsurance schemes have managed to achieve formal status through these means, there is still a need for more enabling legislation to be in place to allow more microinsurance providers into the formal sector. Practical solutions need to be investigated to how the sustainability of the insurance provider can be maintained whilst lowering capital requirements. Experts from organizations such as ICMIF and its members, should actively discuss and lobby with insurance regulators on how an appropriate form of microinsurance regulation could be structured which would protect the rights of the consumer and support the development of the industry.

## Obtaining reinsurance

In the first years of operation the solvency of the microinsurer is at most risk. Reinsurance allows claims to be paid quickly and underwriting experience to be achieved, while maintaining premium levels and enhancing the credibility of the scheme. In developing countries domestic reinsurers are only able to provide minimal capacity. There is a need to transfer this risk onto the international insurance and reinsurance markets. International reinsurers are more diversified than local reinsurers, but here, too, the frequency of global catastrophes mean that available reinsurance is in short supply and quite expensive.

Cooperative insurers in developing countries can obtain favourable coverage from cooperative reinsurers in developed countries due to the principle of collaboration for mutual advantage. ICMIF has been facilitating reinsurance cover between its members since 1949. As well as assisting larger members, ICMIF has been instrumental in providing flexible and affordable *microreinsurance* for a number of newly-registered and small start-up companies in developing countries. The unique spirit of cooperation of ICMIF members has enabled cover to be provided to these companies where none was available from the market.

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## Establishing microtakaful products

With large populations of Muslims in many developing countries and an increasing level of unemployment in the MENA region, it is important that steps are taken to assist low-income communities and prevent greater destitution. There is growing disparity between the rich and poor in many of the Muslim countries and increasing inequality between high-income economies (e.g. Kuwait, UAE, Qatar, and Brunei) and low-income economies (e.g. Pakistan, Egypt, and Bangladesh). The one common bond between all of these countries is their faith; the principle of *Zakat* (charity) is at the heart of Islam and is one of the five pillars which constitute the foundation of the religion. There needs to be a greater concerted effort from the wealthy in Muslim countries to help support the plight of the less well-off.

In all countries, Muslim or non-Muslim, poverty can provide a breeding ground for misunderstanding, manipulation, discontent, and hatred. The poor are usually ignored and suppressed by corrupt and dictatorial regimes, and frustrations stemming from the concern of the welfare of one's family and a sense of injustice can lead to criminal activity, civil unrest, acts of genocide, and terrorism. In an ever-shrinking world and an increasing gap between the *haves* and *have-nots* it is also the responsibility of the Western, developed, world to provide assistance to the needs of individuals and communities in these countries. This support has to be provided with genuine intentions and transparency, development support coupled with foreign policy agendas serves only to stimulate the frustrations of the poor and provides local governments an excuse to obstruct their delivery.

The experiences of the cooperative and mutual movement in working with low-income sectors and providing services to the socially-excluded can be of great benefit to the Muslim world. Unfortunately, there is limited presence of the cooperative and mutual movement in the Arab World, it is the responsibility of organizations such as the ICA and ICMIF to increase awareness and promote the benefits of popular-based institutions. More locally-based member-owned organizations need to be established on the ground, to provide the poor with the tools to become self-sufficient and help themselves out of poverty.

While Takaful on its own is not the solution to the poverty problem, it has to be recognized as an important component of any poverty alleviation strategy. Without protection against losses and natural perils many individuals find themselves regularly falling back into poverty, which is not only disheartening but also renders development assistance ineffective in the long term. Takaful can provide the safety net for communities to achieve sustainable development of their standard of living, providing a basis for families to look to the future with a sense of security and optimism.

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As the Takaful and cooperative insurance concepts are so similar, there is no real obstacle for the more established cooperative movement to assist the Takaful movement to provide insurance products to low-income communities. The linkage between the two movements is such that where there are no Takaful schemes in place, Muslims are obliged to purchase their compulsory insurance needs from cooperative and mutual insurers.

“Commercial insurance is originally *haram* as agreed upon by most contemporary scholars. It is well known that in most non-Islamic countries there are cooperative and mutual insurance companies. There is no harm from the *Shari’ah* point of view to participate in these services. So, it is unlawful for a Muslim living in a country where there is such a cooperative insurance company to make an agreement with a commercial insurance company. But, if a cooperative insurance company is not found one may enter into a contract with a commercial insurance company only by way of necessity. If a person is forced by law to insurance or by way of need, it is obligatory for him to be content with the minimum proportion of insurance that covers his need or to the minimum of such transaction he’s being forced to carry out.”

Sheikh Faysal Mawlawi,  
Deputy chairman of the European Council for Fatwa and Research

Over the last year, ICMIF has held discussions with key players in the Takaful movement and has initiated support by providing technical expertise, partnerships with existing cooperatives, training, and reinsurance. A seminar bringing together the two movements was held in Tunisia in May 2004, which reiterated the benefits and need for closer collaboration. The ICMIF development function has assisted the establishment of twenty-five popular-based schemes in the last forty years, the goodwill of member organizations in providing the expertise of their staff has been critical in developing these schemes. ICMIF is now receiving membership applications from Takaful companies and building cooperation with Takaful experts, this expertise can be utilized in the same way to establish new Takaful schemes for excluded sectors of society. Discussions are already ongoing on projects in Tunisia, South Africa, Bosnia, and Trinidad and Tobago.

There is a need for more involvement from organizations that provide assistance and services to the poor in Muslim countries to stimulate savings and organize individuals into groups. Governments and donor agencies need to be educated and engaged, a lot more can be achieved with their financial resources and support. And more importantly the established Takaful operators need to share a burden of the responsibility by providing technical expertise, financial assistance and building partnerships with microfinance providers.

Takaful products in Muslim countries will protect the middle and working classes from falling into poverty in the event of a large or sustained loss and microtakaful schemes based on cooperative and mutual principles will provide the poor the protection they need to achieve sustainable poverty alleviation.

*“The experiences of the cooperative and mutual movement in working with low-income sectors and providing services to the socially excluded can be of great benefit to the Muslim world.”*

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## Case study: The first microtakaful scheme is established

Established in 1997, the Agricultural Mutual Fund of Lebanon provides health insurance coverage for costs not covered by the government social security fund (the government covers 85 per cent of hospital fees). It is provided in the spirit of Takaful where protection is provided to the needy sectors of society. The fund covers 5,000 families and provides for 23,000 beneficiaries, it is open to all sects and all religions. The fund has preferential agreements with healthcare providers which give discounts of up to 50 per cent. The premium per family is ten dollars per month per family and the target population are the “economically weak” (about 80 per cent of the total population of 800,000 in the South). The fund is operating in 180 villages in southern Lebanon and is under the Health Mutual Law. The board are comprised of nine policyholders; there is one general manager and thirteen regional officers. In addition to health protection products, the fund provides scholarships to schools. The fund is now advertising its services in Beirut and hopes to expand membership to other parts of Lebanon.

Some of the members, for whom the size of premiums is a problem, are sponsored by local villages or other policyholders. One of the main difficulties facing the fund is the possibility of the government withdrawing its subsidization of health costs. Currently for three months in the year the government provides no support and the fund covers all costs in this period.

The scheme would not have the financial capacity to support all of the costs throughout the year and continue to maintain affordable premiums. The scheme has managed to survive through difficult times thanks to the goodwill of the community and dedication of the employees. However, they do need outside technical support to increase coverage, provide additional products, and access reinsurance.

*Source:* Informal meeting through translation between scheme providers and Sabbir Patel (May 2004).

*“This is the only Takaful scheme in the world which is focused on serving the needs of the poor, the use of the mutual structure to provide adequate and affordable coverage emphasizes the spirit of Takaful inherent in this unique scheme.”*

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2. In 2000 Takaful premiums were estimated at USD 538 million, whilst world premiums amounted to USD 2,443.7 billion (Sigma 2001).
3. Malaysia is the only country with a specific Takaful Law.
4. In Malaysia since 1994 the annualized average growth was 92 per cent life (Family Takaful) and 34 per cent general. Since 1998 this slowed to 30 per cent life and 17 per cent general (Bhatti 2001).
5. A Takaful insurer is allowed to purchase reinsurance cover from a conventional company if there is insufficient capacity in the Takaful market, therefore the cooperative would be a more religiously acceptable alternative than the conventional reinsurer.

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