Microtakaful can thrive

Microtakaful is the confluence of Islamic finance and microfinance. As such, it addresses two of the largest groups on earth – the underfinanced and the Muslim population. There is obviously an overlap here as some people will come under both groups. **Mr David Piesse**, Global Head of Insurance, Sun Microsystems, examines how microtakaful could become workable in the months to come when applied in the insurance industry through modern mutuality.

Islamic economic goals of equality, fairness, social solidarity through risk sharing, property rights, sanctity of contracts, entrepreneurship, partnership and income generation through productive activity for poverty alleviation are consistent with the elements of microfinance. This is well-known to all, and a successful marriage of Islamic finance and microfinance embraces and reinforces these principles.

In the past, however, the Islamic financial services have shown little traction in microfinance with poverty alleviation aiming for Shariah compliance in form and not in spirit. Similarly the conventional microfinance industry has shown inadequate interest in religious and cultural sensitivities and also largely excludes the poorest of the poor.

It is now becoming a common belief that Islamic microfinance will enhance financial inclusion and requires products and strategies to be specifically designed for this market.

Key issues for microtakaful

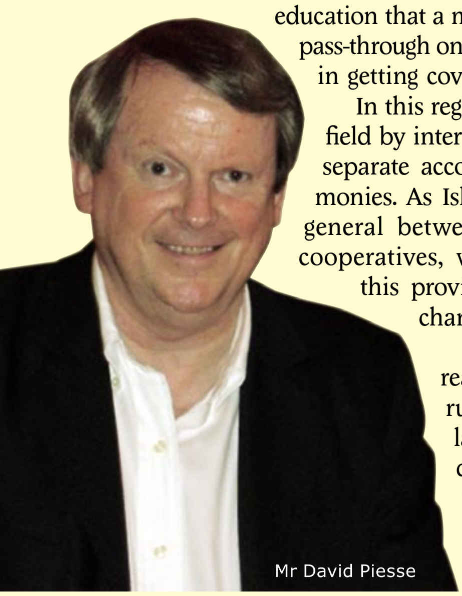
Takaful insurance or Shariah-compliant insurance products, by their very nature, will aid institutions which are trying to reach the low-income market. Local religious leaders are key for Shariah microfinance and microtakaful to be effective.

This concept has a large impact on the potential for microinsurance as most Shariah insurance has been focused on upper, middle and higher wealth sectors. In addition, the low income market in Muslim communities is most likely to resist non-Shariah-compliant products.

The intermediary involved in microtakaful must charge a fee and not a commission. Buyers must be made aware by education that a microtakaful intermediary is a pass-through only for the purpose of efficiency in getting cover quickly to the masses.

In this regard, all premiums held in the field by intermediaries need to be held in separate accounts for other intermediary monies. As Islamic law allows linkages in general between takaful companies and cooperatives, who understand mutuality, this provides a powerful distribution channel.

However, right now, the outreach of takaful penetration to rural areas may be limited by lack of trained personnel, and distribution alternatives need to be applied in order to create an Islamic alternative to traditional microfinancing.


Mr David Piesse

Distribution factors

There are three basic distribution alternatives in play here namely:

- Islamic Microfinance Institutions (MFIs)
- Islamic banks;
- Specialised Institutions (IMFI).

As can be seen from the following table. Overall, the Islamic banks are the best channel.

Channel	Credit Risk	Moral Hazard	Economic Cost
Conventional MFI	no	yes	yes
Islamic MFI	no	no	yes
Islamic bank	no	no	no
Specialised IMFI	no	no	somewhat

Islamic MFI's retain the basic operational format of MFIs in terms of going to the clients in rural/semi-urban areas, collecting weekly/monthly repayments but provide a social role to fulfil a social development requirement of Islamic Finance teachings.

Unlike traditional MFIs, the Islamic MFI has access to charitable funds in the general mode of financing in order to supplement transferring money to the poorest. The process is based on a group dynamic where co-operation is encouraged between the group members.

Women have proved to be the most effective way of protecting families as they disseminate the knowledge to their children and get a co-signature from their spouses. Should the loan fall into default, the collection process is not aggressive and Islamic teachings are used to recover the loan.

As can be seen from the table above, Islamic MFIs resolve credit risk through group lending and moral hazard through giving asset/goods instead of cash but still have high administrative costs to implement bring economic viability and sustainability into play. Often assets/goods are obtained from far away.

Islamic Banks, however, have the added advantage in that they can deploy existing branches for operation, leverage excess liquidity and do not require a hierarchy of senior management thus leading to lower administrative costs.

Islamic bank distribution appears to resolve the sustainability issue for microfinance and the existing client base can be expanded into the microfinance enterprise as part of the bancatakaful distribution.

Specialised IMFISs can leverage the many instruments of microtakaful elaborated below on the approach to microtakaful, eg remittances.

Risk-reducing reserves

Microtakaful is blessed with a reserve system that risk mitigates the whole process to act a risk-transfer mechanism. With the correct financial instruments in place, it would also be possible to create retakaful mechanisms to capital markets via the Islamic sukuk bond to protect the mass market. The reserve system works threefold to be use in case of negative shock:

- General takaful reserves – these are contributed by beneficiaries;
- Profit equalising reserves contributed by depositors from the profit-based mode;
- Economic capital reserves contributed from surplus of the microfinance programme.

Approach

To achieve microtakaful in practice, a composite approach is required of a market-based approach linked with a charity element existing in Islamic financial services. The following Islamic financial instruments are available to put together effective programmes.

Market-based or For-profit Modes

- Debt based finance (Murabahah, Bai-muajjal, Ijarah and Istisna;
- Equity based finance (Musharakah and Mudarabah);
- Remittance (Hawalah) and guarantee (Kafalah);
- Insurance (Takaful);
- Deposit products (Mudarabah and Qard).

Non-Profit Modes

- Mission based on charity (Zakah, Sadaqa, Awqaf);
- Zero return loans (Qard-hasan).

Adapting classical Islamic contracts to modern Islamic microfinance in the for-profit modes is much easier than for mainstream Islamic finance using a combination of the above instruments to meet the consumption needs of the underfinanced.

There is a need to establish more microtakaful providers and maintain sustainability and the permanence of assets using the non- profit modes working in conjunction with the market-based approach.

In the same way as for microfinance, where innovative technology is required to achieve outreach and distribution, microtakaful providers are required to create sustainability in order to get a profitable situation for all encompassed by credit guarantee providers adhering to Shariah principles.

Technology

Technology plays a major role in the outreach to the customers in rural areas. This means setting up allow transaction cost policy and claims administration system leveraging the Internet as a processing platform and prime use of the mobile phone.

Techniques need to be applied to ensure connectivity issues in rural areas are addressed by off-line technology so that services can be continued at a later time.