

An Analysis of Takaful: The Potential and Role in Financial Inclusion and Challenges Ahead

Amela Trokic

* MA Islamic Banking Center for Islamic Banking, Finance and Economics University of Sarajevo; University of Bolton

† MSc Strategic Project Management Heriot-Watt University; Politecnico di Milano; Umea University

Abstract — This paper will look to analyze Takaful and the Takaful industry in existence today with regards to its potential for growth and the challenges associated with its development. The possibilities associated with Takaful are numerous primarily due to its widened market reach and adaptability; Takaful, unlike conventional insurance, is permissible to Muslims and non-Muslims alike providing more versatile offerings. The Takaful industry is also one of the fastest growing businesses, substantially contributing to the global insurance industry. However, despite the prospects of Takaful, the industry today faces many obstacles. Above all, the total value of the Takaful industry with regards to its combined total assets and contributions (premium) is negligible if we consider both the size of the Muslim population and the conventional insurance industry. Not to mention the challenges associated with monitoring and transparency, standardization and lack of knowledge. Therefore, this paper will analyze the economic potential and influence of the Takaful industry as well as investigate the role of Takaful in poverty alleviation, where some research has already proven successful. It will also consider the challenges faced by the industry, stalling its development and deterring it from reaching its full potential.

Keywords - Islamic insurance, poverty alleviation, financial inclusion, economic development

I. INTRODUCTION

Takaful, or Islamic insurance, emerged as an alternative to conventional insurance, primarily for Muslims who desired a Shari'ah compliant product offering the same services. The industry has since grown and developed, holding a significant share in the global insurance market. It has yet to surpass other products and services offered by the Islamic banking and finance industry, however, its sustainable growth year by year has shown just how vast the potential of the Takaful industry is.

This paper will look at the potential of Takaful which is primarily linked to it being a Shari'ah compliant alternative to conventional insurance. This means it caters to the ever-increasing Muslim population worldwide. Studies show that the Muslim population continues to grow at significantly faster rates than the non-Muslim population. Not to mention the growth in the Americas and Europe which will significantly help the Takaful industry penetrate these markets where its share is otherwise minimal. This paper will also discuss the economic potential of Takaful, primarily with regards to poverty alleviation.

The challenges currently being faced by the Takaful industry will also be highlighted to see where improvement is needed. It is necessary to highlight the obstacles being faced by the industry and Takaful operators to better understand what the steps are moving forward with regards to growth and development.

II. LITERATURE REVIEW

Many academics have begun to consider the link between the development of the financial sector and economic growth [13; 14; 15; 16; 17; 18]. There are multiple arguments for this albeit the type of relationship is a matter of debate. While some academics claim that economic growth is a result of the supply of financial products, others claim that the demand for such products is a result of growth. The supply argument states that a country needs to develop new financial instruments, spurring financial development which will eventually lead to overall economic development [19; 26]. In that respect, the institutions that offer these new instruments need to place the products on the market which requires increasing financial inclusion for maximum impact. Advocates of the demand argument believe that financial development does not lead to economic growth but rather growth in the economy creates demand for financial instruments and service providers, ergo leading to financial development [20; 25; 26]. They argue that financial inclusion is limited in underdeveloped economies because there is shortage of demand [19].

Alternatively, some authors believe it is a combination of the two whereby both supply and demand of financial products on the market eventually leads to economic development [23; 24]. Ultimately, there is no consensus in the literature on the direction of causality between financial development and economic growth [26]. While the majority of the literature considers the financial industry as a whole, none of the research considers the insurance sector, particularly related to Islamic finance. Abduh and Omar (2012) [21] analysed the development of the Islamic banking sector on the economic growth of Indonesia, however they did not look at the insurance sector. Chen et al. (2012) [22] investigated how life insurance affected economic development but only in terms of the conventional system. The role that Islamic insurance, or takaful, plays in contributing to economic growth, namely in terms of increasing financial inclusion, has yet to be investigated in the literature, to the best of our knowledge.

III. METHODOLOGY

The methodology is based on a literature review approach, whereby the researcher mainly used secondary data. To determine the source of materials for review, a structured approach was implemented. Peer-reviewed literature was the primary information and data source. A limited amount of grey literature, or literature which is not necessarily considered to be of the highest quality academically speaking, was used. That is to say, sources outside the standard literature databases. Peer-reviewed articles and dissertations were found using databases such as science direct, jstor, emerald insight and university library databases, on the topic of takaful, Islamic insurance, Islamic finance, financial inclusion and poverty alleviation. More general searches were also conducted using Google Scholar as a generic search engine. Searches were limited to research conducted in English.

In the decision process, when choosing which sources/articles will be included or excluded, the researcher based the decision on key criteria. Namely, the abstract was first reviewed to search for key terms and concepts directly related to the concept of the paper. If the abstract proved to be interesting, or if it did not provide enough detail, the entire document was skimmed to determine if it met the inclusion criteria, that is if it was related to the theme of our paper. Inclusion criteria included sources which discuss takaful or Islamic insurance, its role in poverty alleviation, financial inclusion and/or economic development. Exclusion criteria included sources which only mentioned takaful within Islamic finance without discussing its role or demand. In other words, sources which only skimmed the surface of the takaful phenomenon without providing more in-depth information. Sources and articles were not excluded based on their publication date.

IV. GROWTH OF TAKAFUL IN THE GLOBAL MARKET

Takaful is the Shari'ah alternative to conventional insurance, or sometimes referred to as Islamic insurance. It is based on Islamic principles, primarily the concept of mutual care and fulfilment of one's needs. This means that Takaful should be void of all elements not permitted by the Shari'ah, including but not limited to, gharar (uncertainty), riba (interest), maysir (gambling) and so forth. Takaful has a responsibility towards all parties involved in the practice, encouraging brotherhood, solidarity and mutual financial security to protect Takaful participants against defined risks [1]. In this sense, the main aim of Takaful is not to earn profit but to provide aid to others facing risk and misfortune by sharing the responsibility

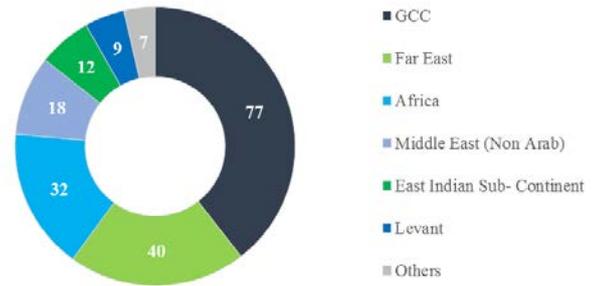


Figure 1 – Number of Takaful Operators in 2010 [2]

Takaful appeared as a result of fiqh rulings stating that conventional insurance practices were haram, or went against Islamic practices. Thus, a need for an Islamic alternative spurred the birth and development of Islamic insurance practices in the late 1980s in both Sudan and Malaysia [3]. The main difference between conventional and Islamic insurance, or takaful, is that conventional insurance is essentially a contract of risk transfer while takaful is a contract of risk transfer [12].

The Takaful industry is one of the fastest growing industries in the world today, contributing positively to the growth of the global economy. From year to year, its growth has remained in the double digits with forecasts predicting this to continue. The industry has now reached a level of sustainable growth with an expected increase of 17.114 percent in 2015 [4]. This translates to an average growth of 20 percent yearly [4].

The Takaful industry's growth can be noted by the increased number of Takaful operators worldwide. By the end of 2010, the number of Takaful operators reached 195 (Figure 1), 82 more than the 113 estimate in 2006.

As can be seen in Figure 1, most Takaful operators are located in the Gulf Cooperation Council (GCC) countries with nearly 40 percent of total Takaful business occurring there. South East Asia comes in a distant second to the GCC with only an 11.8 percent share in the Takaful market. With that said it is no surprise then that the GCC contributes more than 62 percent of the gross Takaful premiums globally [5].

In terms of the overall global financial industry, the Takaful market share makes up only about 5 percent, which is a relatively small segment. Similarly, its contribution to the global insurance industry remains minor despite its consistent growth. Even within the Islamic financial industry, it maintains the smallest market share. Nonetheless, it is continuously developing with substantial contributions to both the Islamic financial industry and the global industry with Moody estimating its full potential at nearly 5 trillion USD [6].

V. THE NEED AND DEMAND FOR TAKAFUL

As discussed earlier, the need for a Takaful market became evident in the late 1970s when it was apparent that

conventional insurance practices were not Shari'ah compatible. For those who follow the faith of Islam, the desire to adhere by the religion's principles rendered conventional insurance non-compatible with their lifestyle choices and beliefs. Thus, it was necessary to produce an Islamic equivalent which would provide the same or similar service as conventional insurance, while adhering to the principles of Shari'ah.

After emerging onto the market, it was clear that the demand for Takaful only increased, as can be seen by its consistent 20 percent yearly growth. Innovations in the industry also helped push the demand for Islamic insurance, increasing the scope and breadth of the Takaful industry. The main factors contributing to the demand and need for Takaful can be summarized as follows [7]:

1. *Demand for Shari'ah compliant products* – There is a growing need for products that are Shari'ah compliant where demand rather than supply is fueling the development of such products, including Takaful. There are an increasing number of Islamic banking clients who are constantly looking for new Islamic financial instruments to meet all their financial needs.
2. *Liquidity* – Oil-producing nations have experienced an increase in liquidity due to sustained high oil prices over the years. Individuals involved in the industry have prospered and as a result became more concerned with protecting their investments, particularly in the form of Takaful coverage.
3. *Re-Takaful* – The emergence of international re-insurers entering the re-Takaful business has helped push the demand and growth of the Takaful industry.
4. *Improved Takaful distribution channels* – Takaful operators have improved their cooperation with other financial institutions, increasing the Takaful penetration rate and, consequently, demand.
5. *Micro-Takaful* – The introduction of micro-Takaful products has helped increase the demand among the poor.
6. *Muslim population size* – The ever-increasing size of the Muslim population globally has continuously contributed to the demand for Takaful. We will discuss this factor in detail below.

A. Takaful Demand and Population Size

Takaful, as a Shari'ah compliant alternative to conventional insurance, is a product made for everyone. However, it cannot be denied that although non-Muslims can benefit from Takaful products, the primary target is the Muslim market. As such, the growth and demand in the Takaful industry is expected to increase with the Muslim population; and the global Muslim population has significantly increased over the years with further projections of growth. Population projections estimate that the Muslim population will increase by 35 percent from 2010 to 2030. That is a rise from 1.6 billion to 2.2 billion Muslim (Figure 2) worldwide, or an expected 26.4 percent of the world's total population in 2030 [2]. Although the Muslim population is expected to grow, it will increase at a smaller rate

than in previous years. Nonetheless, the growth rate will still far surpass that of the non-Muslim population.

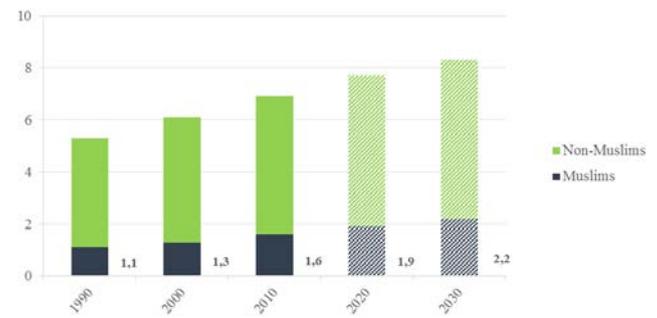


Figure 2 – Muslim Population Projections (Pew Research Center's Forum on Religion & Public Life, 2011)

What is interesting to note is the increase in the Muslim population in the Americas and Europe. In the United States of America, the Muslim population is expected to more than double from 2.6 million in 2010 to 6.2 million in 2030 [2]. In this same period, the Muslim population is expected to increase in Europe as a whole by nearly one-third. That brings the European Muslim population to 53.2 million from 44.1 million; in other words, Muslims will comprise 8 percent of Europe's total population by 2030 [2].

In terms of the Takaful industry and its products, this means that demand will increase in the Americas and Europe [8]. Considering that the Takaful market share in these regions is currently minimal, with most contributions coming from the GCC and Asian regions, this is a significant factor to explore. This is especially important seeing as the US is a preferred market primarily due to it being the third most populous country in the world [8]. The increasing Muslim population will make it easier to penetrate the American and European markets, initially by offering services to Muslims and eventually to non-Muslims in search of alternatives.

VI. TAKAFUL IN POVERTY ALLEVIATION AND FINANCIAL INCLUSION

Despite the size of the Muslim population, a very small percentage of Muslims live in developed countries. Of the 35 least human developed countries, according to the Human Development Report 2000, 18 of them have a majority Muslim population while the rest have Muslim populations above 20 percent [9]. It is clear, that a significant number of Muslims live in poverty and are unable to receive the same benefits, be they educational, economic or similar.

In terms of insurance, it has increasingly become recognized for its potential and contribution to poverty alleviation. Studies have shown that individuals living in poverty have a desire to save and safeguard themselves against possible future risk but often lack the opportunity or support to do so. Insurance can provide the poor with coverage, reducing their vulnerability in terms of disease, theft, disability and other threats [8]. Yet, providing insurance to the poor is a difficult feat particularly due to the unfavorable circumstances associated with it such as high costs, corruption, low collateral,

uncertain profitability and similar. Not to mention the high start-up costs and need for an economically and politically stable environment [8]. Consequently, the responsibility of providing insurance to the poor has been left to the informal sector with minimal success.

The cooperative insurance structure is perhaps the best option for providing insurance to the poor. A cooperative is an autonomous association of individuals who voluntarily cooperate to achieve mutual benefit whether of a social, economic or cultural nature [8]. Takaful is very similar to the cooperative and mutual insurance schemes and can, therefore, be effective in contributing to poverty alleviation [10]. This can primarily be conducted through the creation of micro-Takaful products as a part of a larger poverty alleviation strategy, as Takaful alone cannot solve the poverty problem.

VII. THE CHALLENGES AHEAD

Despite significant development and the growing demand and potential of the Takaful industry, there are many challenges faced by Takaful operators. These challenges affect the supply of Takaful products as they are often associated with structural issues. The challenges faced by the Takaful industry can be divided into five categories which each have their individual challenges that need to be addressed by Takaful operators to strengthen the supply of Takaful products [5].

1. Governance and regulatory compliance [11]:
 - More consistency of regulatory frameworks
 - Optimizing capital adequacy through consolidation
2. Risk management and internal controls:
 - Risk-based business a priority unified with strategic planning
 - Improve risk and Shari'ah disclosures and governance excellence
3. Operational and business excellence
 - Improved technology capabilities to achieve cost efficiency and productivity
 - New business models accommodating for new market niches
4. Product governance and strategy
 - Improve product governance and product development process
 - Emphasis on target markets, sales and distribution
5. Capacity building: talent and leadership development
 - Switching emphasis to internal development to build specialized knowledge
 - Refocus on competency-based training and leadership program

CONCLUSION

The Takaful industry has significant potential for growth and further market penetration to continue contributing to the global insurance industry. From its emergence, it has continuously grown year by year, offering new products and services worldwide. This paper showed both the development and potential for further progress particularly on the back of a growing Muslim population. Particularly the increasing Muslim population in the Americas and Europe have shown to be significant indicators for the potential market penetration in terms of Takaful products. Taking advantage of the change in demographics should be one of the Takaful industry's main strategies. Yet, it is shown that the Takaful industry is still not performing to its maximum potential despite its sustainable growth rate. It holds a very small market share in both the global insurance market and the Islamic banking and finance market alike.

The potential role of Takaful in poverty alleviation was also presented and showed a significant potential. Takaful can be effective in providing strategies for bettering the economic situation of poorer populations, when used in partnership with other mechanisms. This is mainly because Takaful is similar to mutual funds and cooperatives. As was also shown, despite the increased growth of the Takaful industry, there are many challenges still left to face. Many of these challenges are associated with governance, regulation, operation, capacity building and risk management. Takaful operators need to work on alleviating these obstacles and challenges to better compete on the global insurance market. Therefore, significant work is still needed to ensure that the Takaful industry operates at its full potential.

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