INNOVATION IN ISLAMIC FINANCE: THE WAY FORWARD

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Abstract

Developing modern Islamic financial products can be very challenging due to a number of constraints from different aspects, including the formation of regulatory, taxation and economic frameworks that are based on conventional principles. Much emphasis was given to replication of conventional instruments by restructuring conventional financial products according to the Islamic law of commercial contracts and eliminating prohibitory elements from these products. This paper aims to discuss the role of innovation in structuring contemporary Islamic financial products. A series of library research is conducted by reviewing both classical and contemporary texts in areas relevant to the present study. In addition, we conducted a field study of the practice of financial innovation made by the stakeholders of the Islamic finance industry. It was found that though replication is acceptable, its continuous application may not be suitable. Hence, it is important for shari'ah *scholars and industry experts to think beyond replication. The novelty of this paper lies in the proposed guidelines for innovating Islamic financial instruments.*

Keywords: Islamic finance, innovation, product development, *maqasid al-shari'ah*, Malaysia

Introduction

In the second half of the 20th century, one of the remarkable initiatives that took place in the Muslim world was the re-introduction of Islamic laws pertaining to commercial activities that mainly occurred in mainstream banking and finance sectors. Constant perseverance and efforts of *shari'ah* scholars have provided a strong foundation and friendly environment for the growth and development of Islamic finance around the world. Recent statistics has shown that over the period of fifty years the growth of Islamic banking and finance industry was remarkable. According to the Islamic Financial Services Board's (IFSB) The Islamic Financial Services Industry Stability Report, the size of the global Islamic financial services industry reached an overall total value of USD1.88 trillion as of year-end 2015, with an average growth rate approximately more than 15 per cent per annum.[1] There are approximately 600 Islamic financial institutions (IFIs) that have been established across 75 countries, offering a wide variety of *shari'ah*-compliant financial products and services. The fundamental motive behind this effort was to provide alternatives to Muslims, allowing them to conduct their commercial activities in the way that are in line with their belief and the teaching of the *shari'ah*. This includes the prohibition of interest and other non-compliant elements, imbedded in the practice of conventional banking such as uncertainty (*gharar*) and gambling (*maysi*r).

Nevertheless, finding suitable alternatives indeed was not an easy task as Islamic scholars and intellectuals had to come up with an appropriate *shari'ah*-compliant model that was compatible to the modern, but complex global financial system. In almost all countries, the Islamic banking framework needs to be introduced on a parallel basis, in which, in most circumstances, the regulatory, taxation and economic frameworks were not in favour of Islamic finance. Therefore, the chosen approach had to be taken in a flexible and an accommodative manner which was at the same time compliant to *shari'ah* rules. In fact, in order to make this innovative model

[1] Islamic Financial Services Board (2016), "Islamic Financial Services Industry: Stability Report," Exstracted on September 4, 2016 from http://ifsb.org/docs/lfl%20 stability%20Report%202016%20(final).pdf

appealing to the masses in terms of its financial and commercial effects, it was presumed that the model had to operate very closely, if not totally conforming, to the existing conventional banking framework. Although putting up the framework together with its several unique features was a very challenging task, as time passed by, various models were invented and proposed, some very idealistic, and others very accommodative. The current practice of modern Islamic banking and finance has somewhat settled with these models, comprising various Islamic contracts under the construction of *shariah*-compliant portfolios, be it from the asset or liability side. Despite criticism, either from theoretical or practical points of view, the current model has been able to lead the growth of the Islamic banking and finance industry to a very promising level.

Among the challenges faced in the early stage of the modern Islamic finance industry was the availability of limited Islamic banking products and services provided by Islamic financial institutions (IFIs). The existing Islamic products are deemed insufficient to cater the various needs of the potential customers and investors. Moreover, it is argued that Islamic product development is directed toward replicating conventional financial products by re-structuring them according to the Islamic law of commercial contracts and eliminating prohibitory elements, hence advertising them as *shari'ah*-compliant products. However, over the past couple of years, there has been some urgency to instigate a paradigm shift in the approach taken in developing Islamic financial products from replication to fresh innovation. As the Islamic finance industry has managed to gain vast popularity and recognition in the global arena, it is vital for the industry to develop new products to meet various financial needs, without looking at how it is practiced by its conventional counterparts. Referring to Islamic derivatives, Iqbal asserted that the highly liquid derivative products currently offered in the market are structured based on a simple and basic set of conventional instruments.[2] Thus, today's *shari'ah* scholars and

[2] Zamir Iqbal, "Financial Engineering in Islamic Finance", In *The Proceeding of 1999 Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century*, (Cambridge, Massachusetts: Harvard University, 1999).

industry experts must now shift their focus towards innovating new products that are based on the general rules deduced from the *Qur'an* and *sunnah* rather than merely replicating any conventional product. Unlike the conventional products whose concerns are mainly on bringing economic benefits to certain segments of the society, the development of Islamic products should look at benefiting the society at large. This is highly essential for the sustenance and flourishing of the Islamic finance industry.

The primary objective of this paper is to discuss the role of innovation in structuring Islamic financial products and its importance for the development of the Islamic finance industry. A series of library research is conducted by reviewing both classical and contemporary texts on areas relevant to the present study. In addition, we conducted a field study of the practice of financial innovation made by the stakeholders of the Islamic finance industry. This study may have several practical implications. First, it provides some suggestions for the policy-makers and market players on future improvements needed in innovating Islamic financial products. Second, it discusses the possibility of adopting non-conventional methods in structuring Islamic financial products. The novelty of this paper lies in the proposed guidelines for innovating Islamic financial instruments.

2.0 Developing the Contemporary Islamic Products: To Replicate or Innovate?

2.1 Replication of Conventional Products

The inception of modern Islamic banking and finance took place with the establishment of Mit Ghamr in Egypt in 1963. It was well known as a social bank as its establishment was due to social motives back then. In the same period, another early Islamic financial institution was also established in Malaysia, namely Tabung Haji. The main purpose of the establishment of Tabung Haji was to provide depository facilities for Haj pilgrims. However, since the 1970s, with the advancement of commercial banking, its organizational objective has shifted towards commercial purposes. It is worthwhile to mention that the operation of these Islamic banks was established within the predominant conventional banking framework, with the availability of pure Islamic financial instruments that were very limited at that time. In building up their competitive advantage, the industry pioneers, with the help of *shari'ah* scholars, adopted a strategy of replicating conventional financial instruments. This was done by re-structuring the conventional products in ways that were compliant to *shari'ah* principles and were free from prohibited elements. Despite being the subject of scrutiny and doubts in respect to its *shari'ah* legitimacy, the proponents of this approach may argue that there was no harm in adopting this approach as long as it did not involve any element that was prohibited by the Islamic law. As a matter of fact, not all Islamic contracts were originated after the advent of Islam. Most of them existed and were implemented during the pre-Islamic era. The Prophet Mohammad (ﷺ) had permitted the use of these contracts after eliminating all prohibitory elements. Therefore, it was concluded that it was not wrong to adopt the replication approach as the act of restructuring "conventional" instruments and making them *shari'ah*-compliant could be traced back to the practice of Prophet Mohammad (ﷺ)

Besides, there are other arguments for making the act of replicating conventional products justifiable. First, the Islamic finance industry was initially formed under the conventional framework in which the Islamic financial products were given no option except to be benchmarked with its conventional counterparts. This is due to the absence of independent benchmarks in the Islamic finance industry. For instance, in the case of pricing Islamic instruments, the profit rates used by Islamic products seem to move in tandem with the interest rates. Second, the conventional financial system has existed over a period of more than four centuries; hence there is no doubt that the markets are more developed and sophisticated. Due to this, the existing and potential customers are more comfortable subscribing to the financial products offered by conventional banks; thus having products with similar features (without violating the *shari'ah* principles) is definitely a wise thing to do for the IFIs. Lastly, the IFIs need to comply with the existing financial regulatory and taxation framework which may be biased towards the conventional banking practice.