Financial Innovation and Islamic Shari'ah

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الحمد لله والصلاة والسلام على نبيا محمد وعلى آله وصحبه وسلم وبعد :-

What gives rise to innovation in finance in general? Studies show that the most important reason is to

Lessen the constraints of regulation.

Things are not very different in Islamic finance.

Innovation in Islamic finance comes as a response to another type of constraints: Shari'ah constraints:

These constraints are basically:

- The non-permissibility of profiting from lending money.

As we all know banks are commercial entities they are there to make money. And they have to make it out of their core business which is financial intermediation.

This is the objective. But they are faced with a constraint that is if they want to be Islamic, they must not lend money.

The original mode of Islamic bank envisaged by the pioneers in 1940's & 1950's was based on the idea of a two tier Mudarabah, i.e. bank receives money on profit and loss sharing basis and create assets on profit and loss sharing basis.

From risk point of view this is simply not doable, not in commercial banking any way.

It was not possible to create a viable Islamic bank on these principles. It is when Islamic banks moved to the area of sale based finance.

Even though, Islamic banking was almost stagnant until the innovation machine was put in full gear when conventional banks entered Islamic finance starting the 1990's.

But how does the process of innovation actually works in Islamic finance.

Innovation in Islamic banking is a "running" between the minds of bankers and Shari'ah scholars. It is a process where each party at one point says to the other: no on my dead body forcing the other to "race the circuits in their heads" strong enough to find an exit and an exit is always found.

Murabaha gives us a good example for how the process of innovation in Islamic finance really works.

Because they are forced away from lending money, and they can’t do partnerships the only alternative is sales based finance and Murabaha is a sale contract.

Banking Murabaha as we know it today is a far cry from the original Murabaha in the books of jurisprudence.

That one is simply a sale contract. The only difference is that what is negotiated between seller and buyer is the rate of profit not the sale price. It is cost plus.

Everything else in the same i.e. it is spot there is no price deferment, the subject of the contract is a commodity owned at the time of sale by seller.

The first attraction of Murabaha to bankers is the fact that it is cost-plus. Shari'ah people initially insisted that banks doing Murabaha must own commodities and run warehouses and showrooms…etc like merchants but bankers said: on my dead body. A financial intermediary can’t do that.

Bankers on the other hand wished to sell goods to customers and once price becomes a receivable, they go and purchase the same and deliver, but Shari'ah people said: on my dead body.

Hence a solution must be found. We want it to be within the boundaries of Shari'ah and at the same time create something that is “Bankable”.

The first innovation was simple but very effective. It is introducing order to purchase.

Banks need not purchase goods unless a desire has been expressed by a customer to purchase the same from the bank. But this is still very risky. Bank may purchase but customers may not go through with their purchase thus forcing the bank to take price risk and commodity risks.

Can we commit him to purchase as we fulfill his order? The problem is that a reciprocal commitment creates a contract hence it is sale of non-owned. This will never be Shari'ah acceptable.

Shari'ah is not rigid nevertheless, what we need to always do is live up to the challenge.

The OIC figh academy resolved the problem by adopting the position of the Maliki school of jurisprudence vis the enforcement of a promise.

If the promisee was put in a predicament because of the promise, the promisor is obliged to either honor his commitment or suffer the consequences by compensating the promisee for any actual loss. By adopting this juristic stance, the promise becomes effective.

Certainly, this made Murabaha close to the boundaries of “Bankability” but not completely in.

One more innovation was needed to manage the risk of failing to meet the commitment and this is what is called “earnest margin”, where a sum of money is deposited at customers bank account so that if the promisor failed to honor his commitment, and actual loss incurred by the bank as it sells the goods to a third party then, bank can compensate itself from the margin and need not go through the courts to force customer to pay that.

Now Murabaha is completely bankable. But innovation didn’t stop there. It is a relentless effort to make Islamic banking as efficient as the alternative. Even banking Murabaha today is different from the same at the early days of Islamic banking.

Nothing manifests the resilience of Shari'ah and the exceptional courage of Shari'ah scholars today, than what is now a standard in all finance contracts; that is penalties imposed on delinquent debtors. This is something new, unprecedented in jurisprudence, has no clear basis in the rules of Shari'ah. But without a question it was a must from “banking point of view”.

No bank can survive without having available to it a deterrence against defaulters. Shari'ah scholars actually invoked the principles of Shari'ah that unless a tool is available, no Islamic banking will ever be able to replace riba based banking. These penalties are very novel because, while they are “penalties” a cost for delinquency they are kept at distance from the definition of riba by not allowing the creditor to take them as income, rather they are paid to charity.

This is only an example, but if we want to examine Islamic finance in full we will find dozens of significant innovations in structure and in procedures of Islamic finance.

This directs our attention to one important conclusion: that Shari'ah is not against the “Economics” of financial transactions but Shari'ah requires that the contractual relationships are such that the requirements of Shari'ah are met.

Take for example risk management in investment.

We know that to manage risk we need tools for risk management prime among which is options. But conventional options as they stand are not permissible. However, the basic concept of managing risks, the economics of risk management may not be contrary to Shari'ah.

People were able to find that one form of sale contract in Islamic jurisprudence that is sale of Arboon is capable of delivering the same economics of a call option. Yet it is Shari'ah permissible, as stated in the ruling of the Figh Academy. And the rest is history.

Almost in every bank we know today there is an investment fund based on the same concept of sale of Arboon and create the economics of capital protection.

Where are we heading in terms of innovation?

I believe Islamic banking has covered almost all the needs of a viable consumer banking business, we have personal Murabaha and Tawarruq, we have mortgages and credit cards. What we need now is treasury, corporate and government products. There are a number of bold and imaginative ideas going around, in these fields providing that innovation in Islamic finance is still alive and ticking. Take for example hedging, in a few months we will see a number of major initiatives in Shari'ah acceptable hedging opportunities. We will see innovation of new products such as Murabaha rate swap (not interest rate swap), we will even see variable rate Murabahas.

A lot of activities are going on in the field of capital market as well. The sukuk business turned out to be extremely successful. There is huge appetite by investors which must be met by more and more issues of sukuk. But the word on sukuk is not final yet. More is needed to perfect the model.

However, this is how the school of Islamic finance works today have something and keep improving upon its basic structure until it reach the most stringent Shari'ah requirements. I think we are just starting. Our aim is no longer to create a substitute for conventional banking; it is to create a superior system.

With this note I conclude, and be very happy to answer your questions.