

A Practical Approach to Product Development

Thomas R. Gainor*

ABSTRACT

This paper covers a variety of matters that are important in the development of Islamic investment products. While it is not intended to be comprehensive, it covers areas from the inception of the idea through the ultimate delivery of the product to the end user. It is written from the Islamic banker's perspective and attempts to address the issues in a practical "hands-on" manner. Personal experiences in the Islamic product development area are shared. Research and development, the emergence of Islamic funds and alternative investments, and the benefits resulting from the creation of certain indices are addressed in some detail. Considerable emphasis is placed on the interaction among *sharī'a* scholars, Islamic financial advisors, and Western institutions specializing in asset management services.

I. INTRODUCTION

This paper covers a host of issues that should be considered in the development of Islamic investment products. While not intended to be comprehensive, it covers issues arising from the inception of the idea through to the ultimate delivery of the product to the end user. The paper covers the "what, why and how" from the perspective of a practitioner of Islamic investment banking. It attempts to address the issues in a practical "hands-on" manner. The author intends to share his personal views and experiences in the *sharī'a*-compliant product development area.

II. A THRESHOLD CONSIDERATION

For Islamic banks and those already dedicated to serving this marketplace, the issue of whether or not to serve (invest in) this market is moot. The Islamic bank may, however, be grappling with strategic matters related to maximizing the quality of its service to the marketplace while expanding its business. In that sense, product development is an important area in which the Islamic bank will focus and deploy its resources.

However there are diverse views in the industry. Some, are doubtful about investing in this market in the first place, a second group has adopted a "wait and see" attitude, while there are those who believe in investing today so as to develop the track record that will help them become leaders (pioneers) in this niche business.

The practical aspects of product development therefore become relevant when a prospective participant decides to commit/invest resources to the Islamic marketplace.

III. PRODUCT DEVELOPMENT IN GENERAL

A. Definition and Overview

The term "product development," for purposes of this paper, is defined as "the internal process that a financial organization adapts in order to create a financial product or service for delivery to its customer." Since there is no single process that fits all organizations or products and services, the definition is necessarily broad. The process differs depending on factors such as the financial organization's target customer, its experience and expertise, internal resources, corporate culture, regulatory environment and any number of other internal and external factors.

An organization with extensive experience may have a refined process while a new one might use trial and error. Either way the process is modified and improved with experience and practice over time.

The product development process includes several stages starting from the idea generation or conceptual stage through to the implementation and follow-up stages. While some reference may be made to specific products or services, the core concepts discussed will generally apply to all Islamic products whether they be Islamic mutual funds, unit trusts, closed ended funds, portfolio management, leasing products/transactions, real estate related

* Managing Partner, The International Investor, London, United Kingdom.

products, securitized paper, Islamic indices, capital protected products and other traditional and not so traditional (the flavor of the month) Islamic products.

B. Soliciting Views of Others

The concept “product development” is perceived differently by finance and non-finance professionals in a number of industries including Islamic and conventional finance. The following responses shed some light on the variety in perceptions with respect to this concept;

1. Most believe that the preferred approach is to develop the product in response to the values, needs and desires of the customer. However, engineers (financial or otherwise) often fail to listen to what the customer wants. Organizations sometimes retain outside specialists who generate product ideas through research on the values, needs and wants of the targeted customers.
2. A second approach starts with brainstorming within the organization with the objective of developing a product that should appeal to the customer. In this regard, the product developer seeks to create demand for the product or responds to a perceived demand.
3. An approach some consider best is to use a combination of (1) and (2) above where there is some input from the end user coupled with internal expertise regarding financial engineering, marketing and other disciplines within the project team.
4. The longer the time span from the inception phase to the rollout phase, the more difficult it is to predict from the onset whether the market will be receptive and actually purchase the product. Timing within the “flavor of the month” is crucial since things may change if one is too slow in responding. Coming to market too soon (i.e., before the customer can truly appreciate the product) may also prove problematic. External events such as the publicity surrounding Long-term capital management’s affairs and the resulting impact this negative publicity had on hedge funds in general also influence the timing of a particular type of product.
5. While there are certain generalizations about customers, the targeted customers of the product distributor are likely to require some segmentation in terms of factors such as age, sophistication, demographics, risk tolerance, etc. The product developer should target the right product for the right type of customer.
6. Some geographic markets (i.e., the United States with respect to Islamic products) are underserved and one may wish to commence tapping this opportunity by offering straightforward and simple solutions. This contrasts with a provider that perceives a new more exotic product is necessary to capture the attention of a more mature marketplace (e.g. the Gulf Cooperation Council States).
7. Product developers can find themselves in a predicament where the customer is demanding a type of product without adequately appreciating the risks involved. This situation persists even though the product provider goes to great efforts to educate his customer. The issue of “suitability” is one that the Islamic finance provider must focus on since it owes a high moral obligation to its customer.

C. The Market Environment

The Islamic product provider has a special moral obligation to educate its customer since the latter may or may not be a “sophisticated investor.” Education is equally important for the provider. The Islamic marketplace though dynamic and fast growing is still a relatively new industry and reasonably immature.

Education on financial matters is critical since it enables the product developer to respond specifically to the needs of a customer who knows what he or she requires. In this regard the product developer must ask potential customers the right questions in order to effectively draw out the values, needs and wants of the customer. This is a key issue in product development for Islamic banking today because of the immaturity of the market and the global nature of the industry. As the industry continues to innovate and as the barriers to growth are removed or lessened (e.g. through regulation), the confidence of the investors and their participation will gradually rise.

Due to the diversity of the Islamic banking marketplace it is difficult to collect accurate and meaningful data on many attributes such as its current size or predict its short- and long-term future. Estimates indicate a market size of \$100–\$150 billion growing at 10%–15%. There is however, need to clarify these figures. An analysis by *Failaka International Inc.* indicates for example, that Islamic equity funds have grown at over 50% per year since 1996 with total assets under management estimated at between \$5–7 billion, from only \$800 million in 1996.

The Islamic marketplace is clearly a niche offering enormous potential. Great strides have been made over the last five years with the introduction of a variety of quality equity funds, capital protected products and other specialized products managed by world-class organizations and indices such as the Dow Jones Islamic Market Index

and the FTSE Global Islamic Index Series. It is also anticipated that there will be Web-based delivery channels sparking further interest and growth.

D. Why Product Development is Important

Product development is not just important, it is a critical in the retention of customers in the face of competition in today's financial services environment. It also obviously acts as a catalyst for generating interest and energy in the development of the Islamic financial services industry as it seeks to realize its full potential. Effective product development creates a synergy between the service providers and the customers. Both gain valuable insights from the interaction. The provider gains a better understanding of the customer's needs while the later becomes a satisfied (and often) repeat customer.

The financial services industry is highly competitive and an inferior product will be rejected. The product must be sound in all regards in order to protect and enhance the reputations of those institutions with whose names it is associated. In some regions where Islamic banking is prevalent, regulatory barriers are being loosened and competition is increasing. Increased competition is generally favorable for consumers as it creates and exerts pressure for change on those institutions that are not customer focused.

Majority of providers who prosper in the industry are those who focus their resources and talents on serving the customer. Product development is an integral component in the quest to serve the customer.

E. What Constitutes a "Successful" Product?

Bottom-line profit, though not the only measurement tool, business is important if the organization is to prosper, grow, retain qualified employees and serve the community. The success of an Islamic finance product must be measured in the context of the strategy and goals of the provider as a whole. There will be short-term targets and longer-term goals that need to be well thought out and understood.

A certain level of assets under management and fees generated may be set as targets. Other goals such as market penetration, expertise gained and the acquisition of long-term intangibles ought to be considered. Management assessment tools such as a balanced score card analysis may be undertaken. Ultimately, the question of whether a particular product is "successful" or not can be answered by understanding why it is in the Islamic marketplace in the first place.

IV. RESEARCH AND DEVELOPMENT

A. In General

The term "research and development" is somewhat analogous to product development. Both include a "development" aspect but a brief discussion of the research component is necessary for proper analysis.

The term "research" conjures up a picture of men in white jackets with test tubes in the laboratory testing a new concept or a new application of an existing concept. In a sense, these technicians are performing a form of "brainstorming." Earlier in this paper there was mention of brainstorming in order to determine what the customer "might" or "should" want. How then does Islamic banking today generate its product development ideas? How is brainstorming done? How can the research process be stimulated or improved with respect to Islamic products and services? Product development is critical and these questions are of paramount importance.

B. Adaptation or Islamization

Much of the research and development that has worked its way into existing products in the marketplace was generated from adapting conventional product to Islamic needs. It may follow that if a product is successful in the conventional marketplace and is then successfully engineered to be acceptable and consistent with the *sharī'a*, it will be successful in the Islamic marketplace. This logic would hold if one presumed that Islamic and conventional investors had only one critical difference, in the form of *sharī'a* compliance. However, the paper queries if it is appropriate to characterize investors as "Islamic" or "conventional" in the first place.

This paper is not intended to be critical or supportive of a heavy reliance on the adaptation of conventional financial products. One may properly contend that there is considerable innovation and value addition in reengineering or adapting a conventional product in order to create a new product that incorporates a *sharī'a*-compliant structure. Others may voice some skepticism regarding a mere transformation that, in their view, is in substance substantially similar to the conventional product.

C. Innovation

Considerable ingenuity and innovation is often exerted in adapting conventional products. The substance of the underlying transaction must be scrutinized as well as its form. Certain structures such as equity ownership or a partnership interest cannot be labeled as Islamic or conventional structures. The point here is not semantics but rather how to think “out of the box,” as well as move beyond the adaptation of conventional products to stimulate new ideas, which will help the industry flourish. The following comments provide some of the possible answers.

1. *Sharīʿa* scholars are among the most qualified group of persons to stimulate ideas and creative thinking and this is clearly happening. The scholars are studying the practical application of concepts in many areas (e.g. equities, options, and other risk management tools, capital protection, *takāful*, arbitration, and the use of trusts).
2. Specialist practitioners, including Islamic Financial Advisors, are integral drivers in this process. They exert considerable efforts in seeking new solutions. They work closely with the Scholars and both gain from each other’s views and perspectives in pioneering new concepts that work.
3. Universities and other institutions of higher learning are a rich source of research and innovative original thinking. They are incubators of knowledge and a vital link. I hesitate at listing some of these esteemed universities and institutions for the fear of omitting some out of ignorance. I have had the pleasure of having first hand experience with Harvard University, Loughborough University, and the Islamic Research and Training Institute at the Islamic Development Bank. Many others are making outstanding contributions to the industry.
4. Governmental bodies have done much to support the industry, create opportunities, and provide leadership. Some that come to mind include Bahrain, Abu Dhabi, and Malaysia.
5. Customers and investors are a great source of ideas, especially at the institutional level. As the industry flourishes and customers become more enlightened and aware, the customer will increasingly be an initiator of new ideas. Product developers will need to listen to the customer.

D. Relying on Basics May be Best

Innovation in product development does not necessarily mean the creation of a new exotic offering. Innovation may take the form of a new application of an existing structure or perfecting techniques as technological advances and other developments arise. An example of the former is creating a capital protected product through a *bayʿ ʿurbūn* structure. An example of the latter is refining the process of purifying dividend income with respect to company in an Islamic index.

A novel product may not be desirable to the target customer who wants an understandable straightforward investment product. What good is a product that does not sell because investors do not understand it? One must also consider the range of products and services that will be offered and perhaps conclude it appropriate to offer a balanced portfolio solution, such as an Asset Manager type solution. There are challenges in the effective management of any product during its life cycle so the best approach is to keep the matters straightforward and to focus on service.

There are always new opportunities that call for analysis. For instance, the product development group may look at Exchange traded funds, Wrap accounts, Folios and Interpretive Letter #867 issued November 1999 by the U.S. Comptroller of the Currency (discussing *murābaʿa* financing) and concludes the need to develop a strategy that brings these concepts to the Islamic marketplace.

V. THE PROCESS

A. In General

Product development is very much a process. It should be comprehensive, well documented and fully understood within the organization. It must have internal cooperation and support from all parties whose contribution is crucial. The “buy-in” of people selling the product and upper management are especially important. The adage, “the chain is only as strong as its weakest link” holds true and hence the importance of strong linkages.

The process should be logical and orderly with clear responsibilities and strong adherence to commitment. All aspects are important from the concept generation through to manufacturing and packaging and to the final launch of the product.

After launching, the ongoing responsibility might no longer fall within the product development area. Ongoing maintenance may be shifted to another unit, such as fund administration or an operations group. Relationship management with the customer clearly plays an important role. The ability as well as the process of

monitoring should be inbuilt and accountable during the product development process. An Islamic product must be closely monitored throughout its existence for compliance with the *sharī'a*, especially if there is any uncertainty in an existing strategy.

B. A Checklist: Simple and Effective

A checklist is a useful tool. It helps in the planning and coordination of the project plus the identification of potential bottlenecks. It can help those involved to focus, learn from experience and periodically refine the process and the checklist. The checklist also plays a role in confirming compliance with relevant regulations and reassures the product development team.

No detail is too small for this planning checklist, including something as simple as establishing a bank account and designating the authorized signatories on that account. The following items may be found on the checklist along with due dates and the individual(s) responsible for completing each task: the Name of the fund, a budget, a terms sheet, *sharī'a* review and *fatwā*, entity jurisdiction, classes of shares, status of core legal documents (Memorandum and Articles of Association, Investment Advisory Agreement, Management Agreement, Islamic Advisory Agreements, Placing Agreement, Custodial Agreement, Prospectus, etc.), marketing brochure including translation, launch schedule, stock exchange listing requirements, and the selection of directors.

C. Planning

Up-front planning pays considerable dividends later and it may even demonstrate the need to delay a product or scrap it all together. It is critical not to lose sight of the customer and his values, likes, dislikes and to tailor the product to meet those needs. It is possible to create a product that will appeal to a wide audience such as institutional, retail and high-net-worth individual.

A basic blueprint should be developed. A one or two page Terms Sheet which contains the basic structure, highlights any potential *sharī'a* issues, sets forth the investment objectives, names the service providers, gets the fees structure, indicate the tenure of the product, and the benchmark by which performance will be measured. Differentiation through the salient features can be highlighted.

It is important to prepare a budget and make sure all necessary internal and external resources are secured. The requirement for some form of outsourcing will be necessary and likely but this depends on the organization and its competencies. A launch date ought to be targeted while setting milestones along the way.

D. The Internal Team

Harnessing internal resources from within the organization is important but this is best done under a team approach since it helps pool resources and expertise. The internal team may include upper management, *sharī'a* counsel, the product development department, marketing, legal, compliance, internal audit, back office, fund administration, relationship management, treasury, accounting, and asset management.

A qualified workforce is crucial. Teamwork with a real spirit of cooperation and cohesion is essential and this can be established with clearly defined and well-understood responsibilities.

E. When Do You Get the *Sharī'a* Scholars Involved?

The essence of a *sharī'a*-compliant product is the *sharī'a* compliance. Certainly before the product goes out of the door, *sharī'a* signoff must be complete. Investors often ask for the *fatwā* and perhaps other underlying documents supporting the representation that the product is not inconsistent with the *sharī'a*.

It is critical to involve the scholars from the beginning, in the middle and through to the end of the whole process as a general rule. This will open timely and meaningful communication between the *sharī'a* scholars and the product developer and scholars will produce the best result. However, for some products the input ought not be too time consuming as the structure presented is well known and therefore perhaps not even an issue. Since it is clearly a two-way street, the *sharī'a* scholars may express their views on the most efficient means of communicating matters.

In summary, the scholar must be well informed in advance and in case of any doubts it must be cleared before the launch of the product. This can be facilitated by a close and open relationship with the *sharī'a* scholar.

F. Putting Together the Project Team

The project team and the internal team are essentially the same when the organization does not outsource and builds the product internally from start to finish (including the *sharī'a* clearance). This is an unlikely scenario but is not impossible. The more common route is outsourcing through which, the service provider is able to focus

on its own core competencies while acquiring the core competencies of others. This concept is generally well understood and accepted in the industry today.

The goal is to bring together a smooth, efficient, and harmonious team, much like a renowned orchestra. All members should be committed and competent to manage the integration of internal and external skill sets, resources, and expertise. The following team members may participate.

1. *Sharī'a* scholar: *Sharī'a* clearance and adherence is critical throughout the whole product lifetime as discussed earlier. The scholar is an indispensable member of the team furnishing it with leadership and authoritative guidance as well as providing *fatwā*.
2. Islamic Financial Advisor: The Islamic Financial Advisor may be the sponsor, coordinator, or its role may be limited in scope to specific areas. The role of this team member may include interfacing with the *sharī'a* scholar(s), assisting in the application of the *fatwā*. The advisor should provide guidance on Islamic financial techniques and solutions on general and specific business matters with respect to assuring the compliance and promotion of the product.
3. Asset Manager: The selection and monitoring processes are important. The people involved must understand their experience level, record of accomplishment, methodology, and approach. If it is an external party, analyze the organization; its internal compliance, reputation, competitors, disruptions caused by internal restructuring, references and any other information on it. Whether an asset manager has experience in managing Islamic-compliant investments may also be a consideration. There may be benefits in selecting an asset manager with experience in managing Islamic-compliant investments and some familiarity is helpful.
4. Custodian/Registrar/Administrator: These specialists play a significant role in the organization. Some cost highly while others are less expensive but either case, their performance depends on their remuneration. It is necessary to get as much information as possible on their record of accomplishment before they get recruited. Using the same provider for multiple products or funds does create efficiencies.
5. Lawyer: The lawyer's role will involve assistance regarding compliance with the law of the land as opposed to the *sharī'a*. It is required that the lawyer be commercially oriented, has some familiarity with Islamic concepts or at least recognizes the need to invest time in order to get up to speed, and is responsive. The selection and retention of the lawyer who is best suited for the engagement is based on all the facts and circumstances.
6. Directors: In a separate entity structure, directors, trustees, a general partner or some other position of overall legal authority is required. There has been considerable press given recently to the role and function of independent directors and this should be given some consideration.
7. Distributor/selling agents/marketing group: The personnel charged with the selling are indispensable. If the product cannot sell the venture will certainly fail.
8. Customer: The customer is part of the team since the creation of the product is meant for the end user.
9. Project coordinator: This person helps to pull the whole thing together thus they must have the proper authority. A good manager is one who works well with people in championing a common cause, working under pressure and keeps abreast with all the crucial development in the process. It is also helpful that the occupier of this position is a good problem solver.

VI. OTHER MATTERS

A. Distribution

Distribution in the industry generally needs to be strengthened. The choice of the distribution channels used is a strategic decision that is incorporated within the product development process and is integral to the process. The Internet and Web-based deliveries are changing the landscape. Product labeling, brand management, brand recognition, and advertising need to be properly planned and executed.

Should Muslims be the only target? The products are not really "Islamic products" but rather products that do not in their totality require rejection based on *sharī'a* criteria. Thus one should seek a broader audience with a quality product and superior service.

B. Other Matters

There are perhaps as many different considerations to be aware of as there are products and organizations developing the products. A few matters that often raise questions are:

- What is the best choice of domicile (e.g. Cayman Islands, Luxembourg, etc.)?
- What is the best choice of structure (Limited Liability Company, Master Feeder, *muḥārabā*, or *mushāraka*)?
- In anticipation of growth, what structure offers the most flexibility in terms of distribution (e.g. a UCITs or Undertakings for Collective Investments in Transferable Securities under the European Community 1985 Directive)?
- What are the rules regarding distribution over the Internet?
- Should the Fund be listed?
- What is the best way to create liquidity for investors?
- What is the best way to reach the Muslim population in the United States?

VII. CONCLUSION

Product development in the Islamic financial services industry is a comprehensive process. It requires additional steps compared to a conventional product because of the additional and special requirements of the Islamic investor.

Product development is preferably customer driven. It is best to determine the values, needs and wants of the customer by reaching out and performing the proper analysis. Results of market research are then acted upon in a timely and responsive manner.

A team approach to product development works best. All members of the team (internal and external) play a critical role in ensuring that the investor receives the best possible product. There are no quick answers. Product development in this industry is difficult work. It is also extremely rewarding and can be fun.

T.R. Gainor