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Islamic Finance: Authenticity and Innovation — A Regulator's Perspective

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INTRODUCTION

The impetus for Islamic finance (IF) comes not only from its strong appeal and demand both from Muslims and now from the Western world, but from the recognition and reality that IF is indeed an alternate and viable financing mechanism. If appropriately nurtured, it has the potential to broaden and deepen financial markets. This is critical for financial markets that suffer from (1) a low level of financial penetration—the level of financial exclusion in developing markets is as high as the level of financial inclusion in developed markets; (2) high dependence on banks and debt-based systems; and (3) speculative capital markets. IF's appeal lies in its inherent ability to enrich and supplement conventional finance—by offering options and solutions that address gaps in the existing financial system—while effectively and efficiently allocating capital and allowing opportunities to optimize economic value and activity.

Triggered by growing knowledge and research undertaken by *shari'a* scholars and academics, IF is now being nurtured more by industry experts and practitioners[2] as they recognize the benefits of exploiting synergies between IF and conventional finance.

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[1] The author is the former Governor of the State Bank of Pakistan, Karachi, Pakistan. This paper was adopted from the keynote address she delivered while Governor at Harvard Law School during the 8th Forum of the Harvard Islamic Finance Project.

[2] See, e.g., Muhammad Ayub, *Islamic Banking and Finance: Theory and Practice,* Karachi: State Bank of Pakistan Press, 2002; Hossein Askari, Zamir Iqbal, and Mirakhor Abbas, "New Issues in Islamic Finance and Economic: Progress and Challenge," *Wiley Finance,* July 2008; *Encylopedia of Islamic Finance,* ed. Aly Khorsid, Euromoney, 2008.

Conventional finance has steered the global financial markets for ages backed by well-tested policy, legal and regulatory prescriptions, tools, and structures; now IF is offering its own ideology, approaches, modalities, legal and contractual structures, and risk management perspectives in recent times. It is inevitable that the two disciplines have come into juxtaposition and transposition with each other to foster innovation and mutually benefit the financial markets while prompting cross-border flows and offering new perspectives on financial stability and sustainability.[3]

The debate on authenticity of IF is simplified, provided that developing synergies and an interface between IF and conventional finance is considered acceptable to scholars. In carrying forward this strand of thought, I propose to:

(i) Make the case that IF is by design authentic. Authenticity here refers to originality of IF discipline given its unique ideological, economic, and social settings and its ability to offer new ethical and equitable perspectives to the world of finance. IF is distinct and distinguishable from the conventional finance in a number of ways ranging from the stance it takes on prohibition of *riba* and other conventional instruments to the flexibility it allows to recognize the benefits and principles of risk sharing in the financial transactions that implicitly serve well investors/depositors.

(ii) Show that it allows flexibility to nurture businesses based on partnership and profit and loss sharing (PLS) mechanisms based on a fair and just contractual framework. The application of these IF guidelines and principles to well-tested tools of conventional finance itself ought to be treated as an innovation.

(iii) Highlight that the engineering of IF has facilitated the proliferation of Islamic products that include a range of (a) stand-alone products that have been tweaked to ensure conformity and convergence of returns with conventional finance, (b) hybrid Islamic products structured by blending two to three Islamic products that suit the financing requirements of businesses, and (c) equity-based funds, products, indices and insurance.

[3] Shamshad Akhtar, Governor of State Bank of Pakistan, "Islamic Finance: Its Sustainability and Challenges," Keynote Address, Georgetown University, Washington, DC, October 18, 2007.

(iv) Highlight that while financial innovation is occurring in IF, there is scope for unleashing its potential further to facilitate financial stability. To start off, there is a need to recognize that IF has strong potential for serving as a framework for delivery of financial services because it offers flexibility of economic and trade business transactions. To unleash this power and flexibility of Islamic finance, one needs to be creative and constructive in order to apply the basic principles and structures of Islamic finance to the different types of financial transactions and also to seek opportunities to blend IF with conventional structures.

In this context, I propose to offer a few selective perspectives on IF's distinguishing features, its interface with conventional finance, and the range of financial engineering that has already occurred in IF through applying IF principles to conventional finance tools. Going forward, it is critical that the IF industry starts to exploit more deeply and substantively the PLS modalities that promote equity-based financing options and offer better risk sharing arrangements between financial institutions and customers. However, it has to be recognized that this would require further enhancing the IF legal, regulatory, and supervisory frameworks. It would also require instituting proper governance standards for PLS modalities that provide adequate safeguards for investment account holders. A greater appreciation and understanding of risk frameworks and the development of intellectual capacities would facilitate the adoption of complex Islamic products and would help in enhancing the depth and breadth of IF.

IF FEATURES AND ITS INTERFACE WITH CONVENTIONAL FINANCE

Distinguishing Features of IF

At one level, it is now well established that IF is quite different from conventional finance simply because IF is based on Quranic and *shari'a* injunctions and principles. Islam prohibits exploitative interest rate-based transactions (*riba*), transactions involving uncertainty (*gharar)*, speculative behavior (*maisir*), and trading of debts. In conjunction, IF advocates "material finality" that underscores backing financial transactions with real economic activity and transactions.[4] The two key ideological differences between IF and conventional finance are these prohibitions and IF's emphasis on economic activity on the principles of equity and mutual sharing of benefit to all the involved parties.

Also, IF encourages relationships between financiers and entrepreneurs (borrowers) in which the lender and borrowers share investment risks in businesses and assets. Under these arrangements, returns are not fixed but commensurate with the identifiable rights and obligations of stakeholders. These transactions are well anchored in an elaborate contractual framework that derives its structure and application from IF. The ideological underpinnings of Islamic economics, its supportive contractual framework, and the wide range of financial and business transaction options permissible under IF allows for a rich array of approaches, options, and modalities in IF.

IF and Conventional Finance Interface

At another level, to properly nurture IF, it is inevitable that IF relies on the conceptual framework of conventional finance and its tools. The interface and linkages between Islamic and conventional finance will help promote the development of IF, though this process needs to be delicately managed. To ensure the acceptability and originality of IF while it converges and conforms to conventional finance's basic principles, the process should be achieved without compromising IF's ideological and spiritual distinction and uniqueness, which is critical for public confidence in the system. Concurrently, there is a need to recognize that the comparative advantage of IF is rooted in *risk sharing* through PLS features of IF modalities, as opposed to interest-based modalities in conventional finance.

[4] Alsadek H. Gait and Andrew C. Worthington, "A Primer on Islamic Finance: Definitions, Sources, Principles and Methods," *Working Paper*, University of Wollongong, School of Accounting and Finance Working Paper Series No. 07/05, 2007.

FINANCIAL ENGINEERING AND INNOVATION

Generally, the IF industry has witnessed an explosion of Islamic products that approach close to a full menu of conventional finance industry options and instruments. Today, the industry offers stand-alone or hybrid Islamic products, capital markets options for fund management, and insurance products via *takaful* to meet the requirements for the sovereign, corporate, and retail sectors. To ensure competitiveness, the IF industry has turned to replicating conventional products and aligning returns on Islamic products with them. This has generated concerns regarding the excessive concentration of banks on one or two products. Practically, the Islamic industry is currently bank-based. Product diversification, albeit slow, is emerging with engineered returns to ensure conformity and convergence with the conventional industry. IF product innovation can be grouped as follows:

(i) ***Islamic Core Products.*** Broadly, a number of Islamic products have been structured to achieve the same goals as their conventional product equivalents.[5] Three core structures are most popular: (a) *murabaha*[6] synthetic (debt-based) products that are backed by sale-repurchase agreements or back-to-back agreements of a borrower-held asset or lender's purchase; (b) *ijara* leasing (asset backed) provide financing; and (c) equity-based profit sharing contracts, such as *musharaka,*[7] *mudaraba*, and crop sharing (*muazarah*).

(ii) ***Engineering of Islamic Synthetic Products.*** Drawing from the core products identified above, new products can, in some cases, be created to suit new needs by careful structuring and engineering. Examples include the reverse

[5] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance—Theory and Practice*, Hoboken: Wiley Finance Editions, John Wiley & Sons, 2006.
[6] In its original form, *murabaha* refers to a buy and sell contract at an agreed cost plus profit margin selling price for a specified kind of asset. See Islamic Financial Services Board, "On Strengthening Liquidity Management," Technical Note*,* 2008; hereinafter cited as IFSB (2008).
[7] *Musharaka* refers to an investment partnership where all partners are entitled to a share in profits from a project on the basis of mutually agreed terms and losses shared in proportion to investments. See IFSB (2008).

murabaha,[8] diminishing *musharaka*[9] (to provide house financing), *sukuk* and its variants along with *Musharaka* Term Finance Certificates (MTFCs). MTFCs have greater appeal since these are issued against the strength of the issuer's balance sheet, rather than specific assets of the corporation, and are close to a PLS framework.

(iii) ***Hybrid Islamic Products.***[10] Hybrid Islamic Products have grown considerably, combining the characteristics of both equity and debt. Supported by advances in Islamic securitization, there has been acceptance of Islamic Investment Certificates, i.e., *sukuk* bonds that are *shari'a* complaint and tradeable asset-backed securities. Although the industry has floated various types of *sukuk*, only 14 or so forms are widely recognized and used. Most *sukuk* are sponsored by sovereigns, both in domestic and international markets, and backed by approved government assets. Although *ijara* (asset-based) s*ukuk*[11] are the most popular, other hybrid *sukuk*, such as *sukuk* backed by synthetic loans, sale-lease-backs or head-lease/sublease *ijara* and profit sharing structure, are now emerging to be quite popular. The underlying pool of assets for some *sukuk* consist of *istisna'* and *murabaha* receivables as well as *ijara*.[12] Another example is the convertible *sukuk*—whether pure *ijara* or

[8] Reverse *murabaha* (or *tawarruq*) is often used for personal financing when a customer buys something on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party without taking an interest-based loan. See http://www.hsbcamanah.com/1/2/hsbc-amanah/about-islamic-banking/glossary.

[9] Diminishing *musharaka* allows participation and sharing of profits on a pro rata basis whereby the financial institution's ownership of the project decreases over a period of time with the settlement of payments. Ultimately, the asset is transferred to the participant. See http://www.alburaq.co.uk/glossary.asp.

[10] Andreas A. Jobst, "The Economics of Islamic Finance and Securitization," IMF *Working Paper* No. 07/117, 2007.

[11] *Ijara sukuk* refers to financial obligations, issued by a lessor, and backed primarily by cash flows from lease receivables from a credit lessee.

[12] A. Arsalan Tariq, "Managing Financial Risks of Sukuk Structures," Masters Dissertation, Loughborough University, 2004, available at: http://www.sbp.org.pk/departments/ibd/sukuk-risks.pdf.

hybrid, it can have an embedded option allowing it to be converted into another asset form depending on the specified conditions.

(iv) ***Islamic Mortgages.*** These are fast gaining ground and are being structured as: (a) the *ijara* (lease) contract along the lines of a conventional mortgage; (b) an equity partnership (diminishing *musharaka*), where the mortgagee (lender) and mortgagor (borrower) jointly share ownership of the house and the the ownership is transferred to the mortgagor over a period of time as the mortgagor buys shares of the lender's ownership interest each month, thereby allowing the lender to generate a return on their investment out of the fair rental value of the property; (c) *murabaha* (sales transaction) is practiced in the United Kingdom, where the property transfer tax (stamp duty) discriminates against the *ijara*- or *musharaka*-based mortgage; and (d) cooperative societies, where members buy equity (*musharaka*) membership and help each other to purchase property from the pool of the society's funds.

In parallel to these developments, IF is making key inroads in the development of Islamic capital markets.[13] Among the significant initiatives on this front are:

(i) ***Islamic benchmarks*** are evolving as Islamic sovereign papers are being issued, that in turn are helping central banks to offer instruments for liquidity management. Among others,[14] some key initiatives in this areas include the launching of (a) Investment Certificates by the Government of Sudan based on a pool of *ijara, salam,* and *murabaha* instruments to raise long term financing and one-year maturity Government *Musharakah* Certificates based on equity partnerships; (b) Government Investment Issues by Malaysia, called b*ay' al-dayn* (debt trading); and (c) *salam sukuk* by Bahrain, whereby the government agrees to sell forward to Islamic banks a commodity

[13] Michael J. T. McMillen, "Islamic Capital Markets: Developments and Issues," *Capital Markets Law Journal*, 1(2), 2006, p. 136.
[14] These initiatives are further elaborated in http://www.ifsb.org/docs/mar2008_liquidity (last visited on July 9, 2009).

(typically aluminum) against spot payment. In turn, Islamic banks designate the government as their agent to sell the commodity to a third party on delivery, and the price of the sale determines the price of the *sukuk*.

(ii) ***Islamic Investment Indices.*** Equity benchmark indices are designed to track the performance of leading publicly trading companies that are involved in activities consistent with Islamic *shari'a* law. Examples of this are Dow Jones and FTSE Islamic indices, which focus on a limited range of companies and exclude companies that are involved in products and businesses not permissible under Islam.

(iii) ***Islamic equity funds*** include *shari'a*-compliant equity and hedge funds, commodity, leasing, and trade related funds. Barring equity funds, other funds are low risk. In the case of leasing, the fund is a securitized pool of lease contracts dealing with collateralized assets generating a steady stream of cash flow. Similarly, commodity funds have a short-term exposure in markets that are efficient and have developed forward markets, thus reducing the level of risk. In contrast, equity funds are similar to conventional mutual funds and are exposed to a higher degree of risk. Such funds are designed to ensure that equity stocks included in the fund are not only well diversified but also fully compliant with the *shari'a*'s guidelines.

(iv) ***Development of Derivatives and Their Equivalents.*** There is a debate on whether IF allows future price-setting. Some scholars argue it is not permissible. Others have a more flexible interpretation that forward trades are permissible in Islam if they are structured to provide the specific quantity, time, weight, and date. Devising solutions that are acceptable to all players is further complicated by the difficulties in structuring contractual obligations and structuring methods of eliminating risk inherent in the derivatives contract, such as counterparty and operational risks, and the lack of benchmark data. Despite these impediments, a few Islamic over-the-counter (OTC) financial derivatives, similar to conventional ones, have been structured. Some examples include the Islamic Cross Currency Swap (US$ 10 million) by Standard Chartered and Bank Muamalat Malaysia and the five-year US$ 230 million Currency Profit Rate Swap floated by Citigroup. Work is also underway to float some other financial derivatives, such as a Forward Rate Agreement (equivalent to the conventional Forward Rate Agreement) and a Profit Rate Swap (equivalent of interest rate swap).

WAY FORWARD FOR ISLAMIC FINANCIAL INNOVATION

The industry's effort to engineer financial innovation has been impressive, but authenticity demands that the industry continue its efforts to innovate. To facilitate this, there is a need for the IF industry and regulators to consider a change in mindset. Moreover, this needs to be accompanied by an enhancement of the legal, regulatory, and supervisory infrastructure backed by proper governance framework to allow banks to transact in equity-based transactions. Traditionally, banks have been primarily focused on debt financing and regulators have been conservative in allowing banks to indulge in equity products or nonbanking businesses. However, the market-led consolidation and conglomeration has pushed the financial industry to universal banking and other structures that allow them to retail diversified and innovative financial products. Structural moves of this nature have promoted the scale and efficiency of the financial sector and institutions, while requiring regulators to make appropriate changes in their regulatory and supervisory framework. These developments, combined with the special features of IF, offer a rich perspective on how IF should position itself to move and compete in tandem with conventional finance.

Consistent with IF provisions, one concrete way forward is to develop the right framework and applications for PLS-*shari'a* compliant products. Currently, equity investment shares in IF range from zero to 24 percent of the Islamic banks' books. PLS modalities such as *mudaraba* and *musharaka*, driven by equity partnership arrangements, offer interesting options for innovation, but weaknesses in the legal, policy, and regulatory infrastructures have impeded the growth of such options. Some of the constraints to their effective application[15] include (1) equity holders' and entrepreneurs' aversion to risk given the uncertainties and variability of return on PLS business

[15] Humayon Dar and John R. Presely, "Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances," *International Journal of Islamic Financial Services*, vol. 2 no. 2, 2002.

arrangements; (2) the absence in most countries of proper property rights that could facilitate the protection of PLS contracts in case of litigation; (3) PLS does not lend itself to short term financing; and (4) equity transactions underlying PLS are taxed more than interest income.

Nevertheless, promoting the PLS modality would help move the financial system from being bank-centric to being market based and thereby facilitate sector-wide risk diversification. The benefits of PLS that involve different stakeholders include greater emphasis on project rigor, soundness and productivity, and appropriate sharing of losses between financial institution and investors. Workable solutions to reducing principal-agent problems and supportive screening and monitoring of projects upfront would go a long way to promote efficiency in capital allocation as it links financial returns with real project returns due to PLS. Promoting equity-based products would help address the issue of the mis-match of assets and liabilities and reduce IF's excessive reliance on short-term, low-profit, and fixed-income assets. However, it has to be recognized that the risk-sharing edge of IF products for customers is neutralized when Islamic banks pay investment account holders benchmark returns regardless of the performance and profitability of the business venture.

Another important area where work is under way but needs to be accelerated is in the development of prudential regulations and proper *shari'a* guidelines for Islamic banks. Guidance on prudential regulatory frameworks should incorporate appropriate amendments and refinements to the Basel or other best international practices with the objective of providing effective treatment of risks associated with the Islamic financial products and institutions. An important contribution in IF is the introduction of profit equalization reserves on the balance sheets of financial institutions, which is created for the PLS modalities to provide a cushion for displaced commercial risk[16] (risk of flight of customer deposits due to inadequate returns). To safeguard the interest of investment accountholders, Islamic banks have to incorporate the interests of depositors who are considered creditors and first claimants on the banks' assets and provide goal congruence with the management goals. Accompanying this is the *shari'a* corporate governance framework that protects the interest of the investor and customer by

[16] Islamic Financial Services Board, *Guiding Principles of Risk Management for Institutions Offering Islamic Financial Services*. Kuala Lumpur, December 2005.

underscoring the need for compliance and ethics, as well as maintaining a high degree of transparency and disclosure.

Before delving into the mechanics of the *shari'a* supervisory framework, it is pertinent to highlight the key challenges faced by Islamic banks with respect to *shari'a* governance. These challenges are interlinked and mutually reinforcing:

- The reputational risks arising from product and institutions' lack of understanding or uncertainty on *shari'a* compliance;
- Demarcation, responsibility and accountability between the board, management and *shari'a* advisor;
- Investment policies—compliance with *shari'a* prohibitions;
- Investors' protection;
- Disclosure and transparency of *shari'a* rulings;
- Harmonization of *shari'a* rulings and offerings; and,
- Vigilance and oversight of the supervisor to deal with these factors.

Currently, in the absence of a well-conceptualized framework, *shari'a* compliance standards and their oversight varies across jurisdictions:[17]

- In Iran, the Council of Ministers and Regulators under the Usury Free Banking Act of 1983 serves as the *shari'a* board and sets guidelines for the IF industry;
- In Malaysia, under Central Bank Act of 1958, the *Shari'a* Advisory Council has sole responsibility for IF and the court of arbitration refers disputed cases to this council for their position/advice;
- In Indonesia, the National *Shari'a* Board (NSB) is responsible for *shari'a* rulings on Islamic products, with IF institutions required to establish a *Shari'a* Division in the institutions and the NSB approving the *Shari'a* Supervisory Board to oversee the division;
- In Pakistan, a three-tier model of *shari'a* framework is put in place. This includes a *Shari'a* Advisory Board at the Central

[17]Ausaf Ahmad, *Instruments of Regulation and Control of Islamic Banks,* Jeddah: Islamic Development Bank, Islamic Research and Training Institute, 2000.

Bank that provides advice and guidance on prudential regulations, guidelines, modes of financing, and model agreements for the Islamic industry. Second, a *Shari'a* Advisor, meeting the Central Bank's fit-and-proper criteria, appointed by the banks to oversee their Islamic banking operations. Last, a mechanism for a *Shari'a* Audit System that inspects the *shari'a* compliance of all bank operations. The *Shari'a* Advisory Board includes both *shari'a* scholars and industry representatives.

- Bahrain, Sudan, and Syria have adopted *shari'a* standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and some other countries use them as guidelines.

Both prudential regulations and *shari'a* inspections and supervision are integral elements of the checks and balances needed to ensure that products and transactions meet the test of authenticity and compliance with *shari'a*. While these systems may not be in place right away, the development and implementation of this regulatory and supervisory infrastructure requires the build-up of capacities both at the institutional and regulatory level and will pave the way for building confidence in the Islamic system.

CONCLUSION

In conclusion, from a regulator's perspective, the development of IF in tandem with conventional finance will help broaden and deepen financial markets. This will help not only meet diverse requirements, but will also infuse financial stability. The evolution and path pursued by the IF industry has triggered debates regarding the authenticity of innovations. What is critical to recognize is that IF, by design, is authentic and brings in superior corporate governance frameworks as good ethical practices are embedded in IF. The authenticity and superior corporate governance frameworks, along with risk-sharing structures and product diversity that the system offers, lend itself to innovation.

Product diversification, expansion of security markets, and the development of Islamic exchanges and fund management will help nurture the financial diversification from a bank-based to a market-centric system. The proper application of a PLS system will help provide greater opportunities for innovation provided it is backed by the right corporate governance structure.

On their part, regulators have provided the industry a free rein. Cooperation among regulators has helped to develop core and supportive IF infrastructures, which better weaves in the unique features and nuances of IF. The development of Islamic prudential regulatory and supervisory frameworks, which subscribes to Basel standards for conventional banking, will pave the way for the development of IF while tweaking the regulations to accommodate the special risk characteristics of IF. The institutional framework and evolving approaches for supervision systems will help build confidence among investors and customers. It is my belief that the proper and practical application of IF has the potential of taking global finance to new frontiers and heights.