

THE CHALLENGE OF INNOVATION IN ISLAMIC BANKING

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Introduction

- The need for Innovation in Islamic Banking is a statement recently referred to in most conferences, interviews and publications.
- It has become a “buzz” word like “transparency”, “globalization” and “Corporate Governance” that emerged in the last decade and became fashionable words to use in every conversation.
- Although Innovation is a process needed for the continued survival of any industry, I believe we are over-using the statement **“Need for Innovation”** and sometimes to cover for deficiencies that still exist in the Industry.
- Actually if it is badly needed, do we all know:
 - ❖ What we need,
 - ❖ Where we need it,
 - ❖ When we need it, and
 - ❖ Who needs it.



Definitions



- **Innovation** is a complete process that starts with the identification of opportunities or problems, followed by the discovery and development of solutions, taking the shape of products or services (or capabilities) which are then implemented or applied to the market.
- Distinction has to be made clear that **Innovation** does not necessarily rime with **invention**.

**How does this apply to our
INDUSTRY?**



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Islamic Finance Background

In Brief:

- Still in its infancy stage, around 35 years old,
 - Growing at a fast rate, yet
 - The bulk of existing business is:
 - Centered around very few products, and
 - Not all products are fully utilized or exploited.
 - There is still some dissatisfaction in several areas such as:
 - Consumer finance,
 - Treasury operations, and
 - Equity financing.
- However, the developments noticed by the industry in recent years in addition to the crash that happened recently and still going on in the global financial markets, leads us to believe that Islamic Finance will provide very soon substantial and promising opportunities both for specialization and diversification.

Thus we need to face the challenge!!!



The Challenge Ahead

- To provide satisfactory products, services and results to our existing clientele and eventually make sure they are “repeat customers”.
- To attract Muslims who have been in business with conventional banks so they shift their business to Islamic financial institutions.
- To provide competitive products & services in order to tempt and persuade the non-Muslim clientele to buy into our products.

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HOW TO ADDRESS THE CHALLENGES AHEAD?

As already said;

Innovation is crucial to business survival, and in our industry more so to:

- help revitalizing Islamic roots,
- improve meeting customer needs,
- offer businesses a competitive edge, thus
- All resulting in new and sustained income sources.



Areas of Application

I. Products

II. People

III. Market Place

IV. Regulatory environment



ISLAMIC FINANCE

EQUITY FINANCE

Musharaka

- Permanent
- Diminishing
- Temporary (JV)

Mudaraba

HYBRID

Preferred Stock

Leasing

Sukuk

Warrants

Convertibles

DEBT FINANCE

Murabaha

- Consumer
- Corporate

Ijarah

Istisna'a

Bai-Salam



I. Products

- More of the conventional financing are in the form of equity financing,
→ Yet we do not see it growing enough in Islamic finance.
- True that equity funds exceeded the 120 funds in GCC and same number in Asian markets with billions of US\$ invested in them,
→ But we do not see real *medium* to *long* term direct equity investments. Reasons among others include:
 - ❖ Lack of appetite,
 - ❖ None existence of a clear exit strategy, and
 - ❖ Mismatching worries.

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I. Products

- Liquidity management products:

- ✓ Maybe addressing this issue by the technical teams that work on development and innovation will eventually solve issues related to liquidity, exit strategy, and funds mismatching.
- ✓ Growth in the liquidity instruments will pave the road for the long term investments.
- ✓ A title such as **ASSET BACKED LIQUIDTY MANAGEMENT INSTRUMENTS** should be a great domain for innovation when we started seeing some new unique funds put forward in real estate and equipments as well as airlines.
- ✓ Similarly we hear about leases and even synthetic leases where a well chosen basket of investment grade assets were placed as up to an average life of 5 years.
- ✓ Furthermore, the sukuk were an excellent solution in the beginning of the century to attract investments and enhance yields. Moreover, these instruments provided a secondary market opportunities for banks as well as institutions, although still of a very minimal and limited scale.

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- ✓ Nevertheless we need to see more products of handling and transferring risks particularly cross border risk and particularly currency risks
- ✓ We like to see more work done to confirm, adapt or evolve products such as the (IPRS), Islamic Profit Rate Swap or (ICCS) Islamic Cross Currency Swaps.
- ✓ We like to see more work done on (DEP) Diminishing Equity Participation as a bridging tool to encourage more people to look at Musharaka as an ultimate and most deep rooted instrument in Islamic Finance.



II. People

In this industry of services, the most three important factors for success will be people, people and people:

The innovation here has to be not only in how to attract good, qualified and experienced people into the industry but also in how to retain them.

- Adequate and competitive packages.
- Incentives through bonus schemes of profit sharing and maybe buying into the equity for further commitment.
- Intensified levels of training both at the entry ranks and senior ones.

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II. People

- Sponsoring programs at world universities to further enhance the knowledge of Islamic Banking.
- Sponsoring students to enroll into these universities.
- Sponsor Muslim scholars to bridge the gap between pure fiqh studies and pure economic and business studies.
- Also, and most important, having done part or most of the above, we have to address issues related to corporate governance, management style, and business guidelines and procedures of our companies. To ensure finding and retain human talent. Most of the movements and sometimes fast ones we see among the professionals in Islamic institutions are not all for better packages!
- Accountability for results should be bound to giving away authority and delegation of powers.

MANAGEMENT NEEDS A VOTE OF CONFIDENCE!



III. The Market Place

The market place is another area where innovation might be needed. It is actually the catalyst in bringing together the investors and the products and it has to be characterized by collectively all the followings.

- A place physical in the basic sense and virtual as actually is.
- Information availability.
- Research capabilities.
- Certified brokers professionally recognized and talented.
- Rating agencies, analysts' coverage, and market indexing.
- Clearing efficient mechanism.
- Regulatory framework.

This should not be confined to only one country but should be the concern to all countries which like to activate the Islamic Banking industry in their economy and thus they have to work collectively to standardize several measurements applications.

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III. The Market Place

- Shareholders and Owners of Islamic banks should believe in this industry and its orientation towards medium to long term activities which means to forgo immediate, short term profits for a sustainable medium to longer term higher profits.
- Need to see more firms like LMC, Elaf bank and KFH coming to the market with the intention of developing the Islamic Secondary market and be market makers.



IV. The Regulatory Environment

This category in the Islamic Banking Industry encompasses both the Sharia'a regulations and the civil regulations.

On the Civil Side:

- (i) What would be required from some of the interested countries is to speed up the passing of laws/decrees that define the Islamic Banking and set the legal procedural framework.
- (ii) For those countries which already have special laws and codes, to revisit them if need be to be flexible, practical and tailored for the industry. Not to confine the Islamic Banking Industry to regulations of the conventional.
- (iii) Financial authorities to work hand in hand with the industry to develop a comprehensive and universal supervision systems to ensure the continued development and thus success of this Industry.
- (iv) Eventually to move into standardization of the regulations to as much as possible at least on global issues.
- (v) Adopt the AAIOFI standards and impose them to have a unified approach.

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IV. The Regulatory Environment

On the Sharia'a Side:

□ We keep hearing about schools of thoughts, which is a fact and something healthy as a process of evolution, but still there could be a minimum level to agree upon of uniformed guidelines which become the standard rather than to leave it to the institutions to search and rely on the reputation of the scholar to ensure its being well received by the public.

□ This step should not preclude the fact that institutions still need to search and rely upon the opinions and ruling of the respectful and well-versed scholars but let that be towards the development and innovation of new products.

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IV. The Regulatory Environment

- ❑ AAI OFI IFSB, and IIFM (*International Islamic Financial Market*) are examples of what could be done towards standardization in the industry, and a similar format or at least a modified concept, concerning Sharia'a rulings on these tested and applied modes of financing be applied which will speed up the processing of basic deals and allow the business personal to focus on sourcing, structuring and executing deals promptly.
- ❑ One of the most Innovative approaches is needed to develop a mechanism among scholars not to shy from each others and become GOD Forbids “a Silent Satin” and wait years before an announcement is made like the most recent one that “... so & so percent of sukuk are not sharia' compliant” after people had held them for a while and after the size was of such a magnitude that it could have created a disaster in the Industry.



DIMENSIONS



Having defined innovation as an **ACT** or **PROCESS**, then it follows that certain **DIMENSIONS** had to control and guide that process to ensure its success and that it achieves its goals and objectives.

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WHAT IS EXACTLY NEEDED?

- Innovation should not be only for the sake of doing something.
- Areas where innovation is required need to be identified.
- Type of innovation needed has to be determined.
- Action has to be put in place.

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WHERE and magnitude of the dosage of the innovation needed?

- There is a tendency to copy innovation and try to fit it in. That could be very dangerous and back fire.
- Too much innovation can destroy competitive advantage because people can handle so much at one time.

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WHEN *innovation is very important?*

- A premature innovation could be harmful as it sets a negative precedent and could delay other future trials.
- A late one is also as bad as it defeats the purpose and clients might have discovered other alternatives to invest their wealth in.

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WHO *should receive innovation?*

Innovation has to be adaptable, comprehensible and implementable.

Too sophisticated, an innovation might turn off or confuse the clients, and thus has a negative impact rather than positive.

Audience, not only has to need it but be able and ready to make benefit out of it.

Thank You



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