

Islamic Financial Innovation: Tools and Trends

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1. Introduction

In a business context, innovation is of two types: model innovation and process innovation. Model innovation involves developing new instruments and methods (inputs) to achieve new objectives (outputs), which must bring new business and hence improve profitability. Process innovation is, in general, an incremental process that utilises existing instruments and methods in new formats and permutations to achieve desired objectives, goals and outcomes in a more efficient and cost effective way. In a business context, it will still be considered as an innovation if a desired outcome is achieved by utilising the same existing instruments and methods with no increased efficiency or cost effectiveness, as long as the new format and permutation result in increased profits.

Islamic banking and finance provides an example of process innovation, as it attempts to achieve the economic effects of conventional financial products by employing Islamic legal contracts and methods in product development. Most Islamic financial products employ classical Islamic nominate contracts to develop financial products that

attract either shari'a sensitive users of financial services or those who are willing to pay a higher price probably because the mainstream financial institutions exclude them due to the higher credit risk they pose to such institutions.

The higher price that a shari'a sensitive user of financial services is willing to pay contains what is known as shari'a premium. The higher price that an Islamic financial institution may charge someone excluded by the conventional financial services industry accounts for the risk premium that an Islamic financial institution must charge to remain profitable. Over the last twenty-five years, the incidence of shari'a premium has gradually gone down, reflecting the decrease in the willingness of shari'a sensitive users of financial services to pay more for having access to shari'a compliant products. Also, with the increase in the size and sophistication of Islamic banks and financial institutions and a greater awareness of risk, Islamic banks have gradually moved away from the riskier clients. This has resulted in Islamic banks and financial institutions becoming more mainstream in their product offering, marketing strategies and customer orientated approach. This has also increased competitive pressure on Islamic banks and financial institutions, which in turn calls for more product innovation.

This article looks into the trends and tools of innovation in Islamic finance.

2. Islamic Financial Innovation Defined

Islamic financial innovation, the way it has been practiced, can be defined as the process of utilising Islamic legal contracts in new ways to develop financial products that are in compliance with shari'a and have the ability to replicate the economic effects of conventional financial products.

Utilisation of shari'a rules and regulation for achieving secular outcomes has generated a debate on authenticity and innovation in Islamic finance. According to this critical

view, the process is as important as the end result. Hence, it is important that the process of Islamic financial innovation must not add any prohibited components i. e.,

Haram +Haram \neq Halal

Haram + Halal \neq Halal

It is also important to note that it is not necessarily the case that the adding of two halal components will always lead to a halal outcome.

A revised definition of Islamic financial innovation in light of the above may involve developing new products and institutional models for Islamic finance which would lead to a new financial (and economic) model, that is able to efficiently compete with conventional (interest-based) banking and finance. Shari'a compliancy, in such a framework, is only a *necessary* condition for the sustainable success of Islamic banking and finance. A *sufficient* condition is the commitment of the industry to social responsibility. Therefore, an objective of Islamic financial innovation must be developing financial structures (products and institutions) that offer distinct social value in addition to being shari'a compliant.

2.1 Some recent examples of Islamic financial innovation

Islamic alternative investment products such as hedge funds, private equity funds and structured products are some examples of Islamic financial innovation.

Islamic alternative investment products have grown gradually. Among these alternatives, hedge funds have proven to be the weakest link. Devout Islamic investors have by and large kept themselves away from this asset class. Consequently, most managers of full-fledged Islamic banks shy away from investing their proprietary money in hedge funds and become nervous by the prospect of having to sell an Islamic

hedge fund. The performance of Islamic hedge funds has not helped to change the negative attitude towards this asset class. The most widely publicised success story of an Islamic hedge fund is related with the Al Fanar Islamic hedge funds, managed by the US fund management company Permal (and seeded by Saudi Economic and Development Company – SEDCO). Their performance, however, remains at best mediocre. Although the four Islamic hedge funds launched by Dubai Shariah Asset Management (DSAM) – a joint venture between the US-based Shariah Capital and Dubai Multi Commodities Centre (DMCC) – did fairly well after its launch in 2008, they have not been able to attract wider investments beyond the seed capital (of USD50 million each) provided by the Government of Dubai. The more recent performance of the DSAM funds has not been impressive.

The failure of Islamic hedge funds is primarily due to some widely publicised failures and frauds in the hedge fund industry in the West. Negative publicity of short-selling, following its suspension from a number of Western financial exchanges, and other similar factors (that are deemed as responsible for accentuating the current financial crisis), have also not helped the cause of Islamic hedge funds.

Private equity (PE), on the other hand, has flourished in the emerging markets, including the Middle East and North Africa (MENA) region, where Islamic investors have over the last two decades assumed significance and influence. Pioneering PE companies like Emerging Markets Partnership (EMP) and , most notably Abraaj Capital in Dubai, have emerged in the Middle East, offering Islamic as well as non-Islamic PE.

Islamic PE is a recent phenomenon in the Islamic markets, especially in the Middle East in general and the Gulf Cooperation Council (GCC) area in particular. In Malaysia, another important Islamic financial market, the size and number of Islamic PE transactions remain small. However, there are now some serious players in the Islamic financial market in the Far East (Malaysia, Brunei and Singapore) who are

contemplating setting up Islamic PE platforms for the ASEAN region. In the GCC region, it is fast emerging as an important asset class, in line with a growing trend in favour of alternative investments in the region. According to some estimates, alternative investments by ultra high-net-worth individuals in the GCC region grew by over 22 percent in the last ten years. Islamic PE is rapidly assuming importance in this growing sector. Out of about 60 Middle Eastern institutions involved in private equity, at least 20 percent have practised Islamic PE.

Although Islamic investment banks (the likes of Arcapita, Bank Alkhair and Bank Al Salam in Bahrain) were involved in PE deals before the current financial crisis, establishment of Islamic PE funds is very recent. Since 2006, there has been significant growth in Islamic PE funds in the GCC region both in terms of number and size. However, the history of Islamic PE funds does not go beyond the previous decade. Most of the funds were set up during the previous decade and were of a modest size, with the exception of Abraaj Infrastructure and Growth Fund and Siraj Hospitality & Tourism Fund, which had USD2 billion and USD500 million in committed capital, respectively. The reason for this late entry of Islamic finance into PE is primarily explained by the relatively minimal exposure of the region to local PE deals. This is not to say that the region did not have exposure to PE deals at all. In fact, until the mid 1990s the Middle East was the second largest source of capital for international PE funds. Most governments in the GCC area had significant investments in PE funds and deals in the West. It is, however, recently that the region has witnessed the growth of PE funds (conventional and Islamic) managed by local management companies.

The third important alternative asset class – real estate – has always been an Arab's friend, mostly a loyal one but unfortunately deserting him in times of difficulty. Although some Islamic real estate trusts (REITs) exist, Islamic investors prefer to feel the bricks and mortar for themselves. The current downturn in the real estate market in

the GCC countries (particularly in Dubai and Kuwait) has, however, confirmed Islamic finance's over-exposure to this asset class.

Among the three above-mentioned alternative asset classes, the latter two fit well in the Islamic culture. Hedge funds are at best misunderstood and mostly considered as an untamed horse. Many Islamic investors would like to be in love with it but would refrain from riding it, fearing injury and collapse.

It is interesting to note that shari'a concerns surrounding hedge funds have by now been resolved with the help of an increasing number of scholars. There are now more than one shari'a compliant method of short-selling, a technique crucial for the success of long/short Islamic hedge funds. The days are gone when shari'a scholars could not understand the mechanics of short-selling and, hence, would take the conservative stance of disallowing it. There is now a growing recognition that short-selling is not a shari'a concern, if done properly. It is deemed a regulatory issue. If the regulator is happy with shari'a compliant short-selling, then it should also be acceptable by market players.

3. A Focus on Islamic Structured Products

Nevertheless, many Islamic institutional investors and high-net-worth (HNW) families have been shown to accept structured products offering the economic results of hedge funds, sometimes with principal protection and at times without it. Most of the successful offerings of Islamic structured products have been those offering exposure to commodities. Since 2005, when Deutsche Bank sold a commodity-linked Islamic structured product referenced to platinum, aluminium and crude oil, to Abu Dhabi Commercial Bank, a number of such products have emerged on the scene. Given the

excellent performance of some commodity futures programmes during the current economic downturn, Islamic structured products built around commodities must attract investment from the savvy Islamic investors who are used to earning high returns.

Islamic structured products in themselves are a growth area. A number of Islamic as well as conventional banks now offer a variety of Islamic structured products, covering traditional as well as alternative asset classes. These Islamic products are being offered in three forms: (1) structured deposits; (2) structured notes and certificates; and (3) hedging solutions. The structured deposits are primarily offered to premier clients (both HNWI and corporate) of Islamic banks. The structured notes are sold as over the counter securities or through exchanges such as Dubai International Financial Exchange (DIFX) and the Luxembourg Stock Exchange. With the start of a fully-recognised Islamic derivatives market in Kuala Lumpur, exchange tradability of Islamic structured products is bound to improve. Islamic hedging solutions are being offered by a number of Western investment banks in the form of profit rate swaps, currency swaps and other Islamic derivatives.

An attractive feature of these structured products is that they offer principal protection – something highly desired when the general market trend is downward. They became immediately popular amongst the HNW clients of banks like Dubai Islamic Bank (DIB) when it started distributing Islamic structured notes manufactured by Western banks such as Deutsche, Goldman Sachs and RBS.

Another more important reason for their popularity is that selling these products represents a natural progression to what Islamic banks have been doing for last three or four decades. Profit sharing investment accounts (PSIAs), especially unrestricted, offered by Islamic banks are very much in line with the underlying structures of Islamic

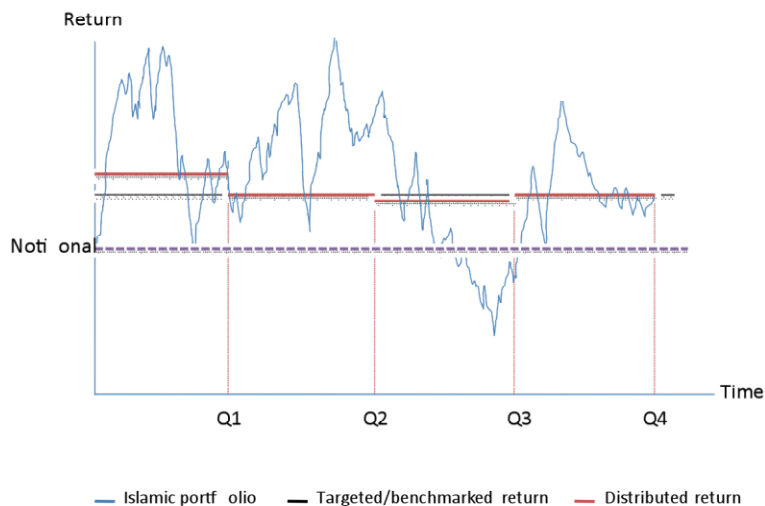
structured products. Based on the principle of mudaraba (an investment management agreement that allows Islamic banks to offer variable return deposits), PSIA's behave very much like principal-protected structured products (see Box 1 for explanation on how PSIA's work).

Box 1: Profit Sharing Investment Accounts

PSIA's are of two types: unrestricted (depositors' money may be mixed with shareholders' capital to be used for general banking and investment purposes) and restricted (the depositors' money is used for specific projects and investments). In both cases, although theoretically depositors must be fully exposed to profit and loss made by the bank on their investments, Islamic banks in practice have devised a mechanism around Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR) to ensure that depositors receive a return similar to a targeted market rate of return and are not exposed to any short-term loss.

Thus, if in an accounting period the PSIA portfolio outperforms the targeted return, the Islamic bank can distribute only the targeted profit (or slightly more than this) – retaining the rest in PER and IRR. Conversely, if the PSIA-portfolio underperforms, the Islamic bank will make the shortfall by having access to PER and IRR. The following Figure depicts this behaviour.

PSIA's are principal-protected by their very nature (as required by many regulators in many cases for unrestricted ones) or by device in the case of the restricted PSIA's. The way principal-protection is achieved in PSIA's, however, is not as transparent as is the case for most of the Islamic structured products offered by the institutions around the globe. While there has been a lot of ambiguity over the ownership of funds in the PER and IRR until recently when Islamic Financial Services Board formally clarified the situation, the regulators require that the mechanisms for attaining capital-protection in Islamic structured products should remain transparent and understood by investors.



For example, Islamic banks in Malaysia for long have been offering two types of unrestricted PSIAs (called General Investment Accounts and Special Investment Accounts). Following the success of restricted PSIAs, offered by CIMB Islamic, many banks now contemplate offering restricted PSIAs, which are structured similarly to “Islamic structured deposits.” Consequently, there are now two types of Islamic structured deposits being offered by Islamic banks in Malaysia – restricted PSIAs and structured products offered to retail customers in the form of structured deposits. Examples of the latter are CIMB All-Star Structured Products range and Maybank’s Al Sayf Structured Islamic Deposits (see Table 1 below).

As Table 1 suggests, Islamic structured products in their present form are a very recent phenomenon. In the last five or six years, they have gradually appeared as a regular product offering by Islamic banks – starting with the Western banks like HSBC, they are now being offered by Islamic banks owned by conventional banking groups such as CIMB and Maybank. In the Middle East, the products manufactured by Western banks are being distributed by the likes of DIB in the UAE and National Commercial Bank (NCB) in Saudi Arabia. Homemade Islamic structured products in the Middle East are rare.

Table 1: Some of the Islamic Structured Products on Offer

	Institution	Year	Product nature	Underlying	Islamic contracts
1	HSBC	2003	Guaranteed-equity bonds linked share basket	Equity	Rolling Murabaha
2	HSBC	2004	Islamic CPPI	Equity	Arboun & Murabaha
3	HSBC	2005	Dynamic asset allocation strategy product	Equity	Rolling commodity Murabaha
4	HSBC	2005	Dynamic asset allocation strategy CPPI product	Equity	Arboun & rolling commodity Murabaha
5	BNP Paribas	2005	Equity linked structured product	4 Islamic mutual funds, namely, Oasis Crescent Global Equity Fund, Al Fanar Europe & US Large Cap Fund, Amana Growth Fund, and Wellington Hegira Global Equity Fund	
6	Noriba / UBS	2005	Currency-linked structured product	Two currencies (\$ and Euro)	Commodity Murabaha
7	Deutsche Bank	2005	Commodity-linked Islamic structured note	Platinum, aluminium, and crude oil	Murabaha, Wakala and Salam
	Deutsche Bank	2006	Islamic structured products range	Various – almost all asset classes	Wa'ad & Murabaha
8	Deutsche Bank	2009	Islamic structured products platform (called Al Mi'ayar)	Various – almost all asset classes	Wa'ad & Murabaha
9	CIMB Islamic	2007	All-Star Islamic structured products range	Equities	BBA & rolling Murabaha
10	Maybank	2008	Al-Sayf structured Islamic deposit	Commodities	BBA & rolling Murabaha

3.1 Shari'a issues in Islamic structured products

There are two broad categories of Islamic structured products on offer in the market: (1) the so-called A-Z shari'a compliant structured products, with both the structure and the underlying asset fully shari'a compliant; and (2) the so-called Islamic bridge products, with a shari'a compliant structure exposing investors to the economics of non-shari'a underlying assets.

There has been a steady rise in the popularity of both these types.. Western banks tend to specialise in the Islamic bridge products while the likes of CIMB Islamic (and some other Islamic banks) prefer to favour the purer form. It is interesting to observe that the use of Islamic bridge products is on rise, despite their criticism by some shari'a scholars. Major criticism of such products has come from Sheikh Yusuf Talal De Lorenzo (a shari'a scholar based in the USA) while other prominent scholars like Sheikh Hussein Hamid Hassan, Sheikh Nizam Yaqubi, Dr Mohamed Elgari, Dr Mohd. Daud Bakar, Dr Abdul Sattar Abu Ghuddah and almost all other globally recognised scholars (from the Middle East and Far East) have signed off on the products offered by Deutsche, Citi, RBS, UBS, Goldman Sachs, PNB Paribas, HSBC and Societe Generale etc.

Although the controversy around Islamic bridge products was created by one prominent scholar while all other globally recognised scholars approved such products, it is still important to explain the structure of such products. A simple sketch of Islamic structured products is given in Figure 1 below.

The whole structure is based on a master murabaha agreement, which is governed by an investment agency agreement between the bank and investors. This structure can be

used for developing Islamic structured deposits or notes and certificates. While structured deposits are a retail product, notes and certificates are new forms of Islamic securities, which are being sold over the counter as well as through exchanges.

This is a robust structure that can be used to affect principal protection (through a first murabaha that uses the price equal to “Notional”), range accrual, multiple returns (e.g., x percent in year 1, y percent in year 2, and z percent afterwards) and a variety of risk-return profiles. All this is possible because of the master murabaha agreement between the issuer and the third (related / unrelated) party that serves as the buyer in the murabaha sale. The flexibility of the master murabaha agreement is crucial to structuring such products. It allows the buyer (issuer in this case) and seller (the related / unrelated party) to enter into a series of murabaha transactions to generate a variable return benchmarked to another asset / index. Many advocates of such products favour this use of murabaha because it makes it possible to diversify the use of benchmarks in Islamic finance, which otherwise has relied upon on the London Interbank Offer Rate (LIBOR) and its regional / national variants.

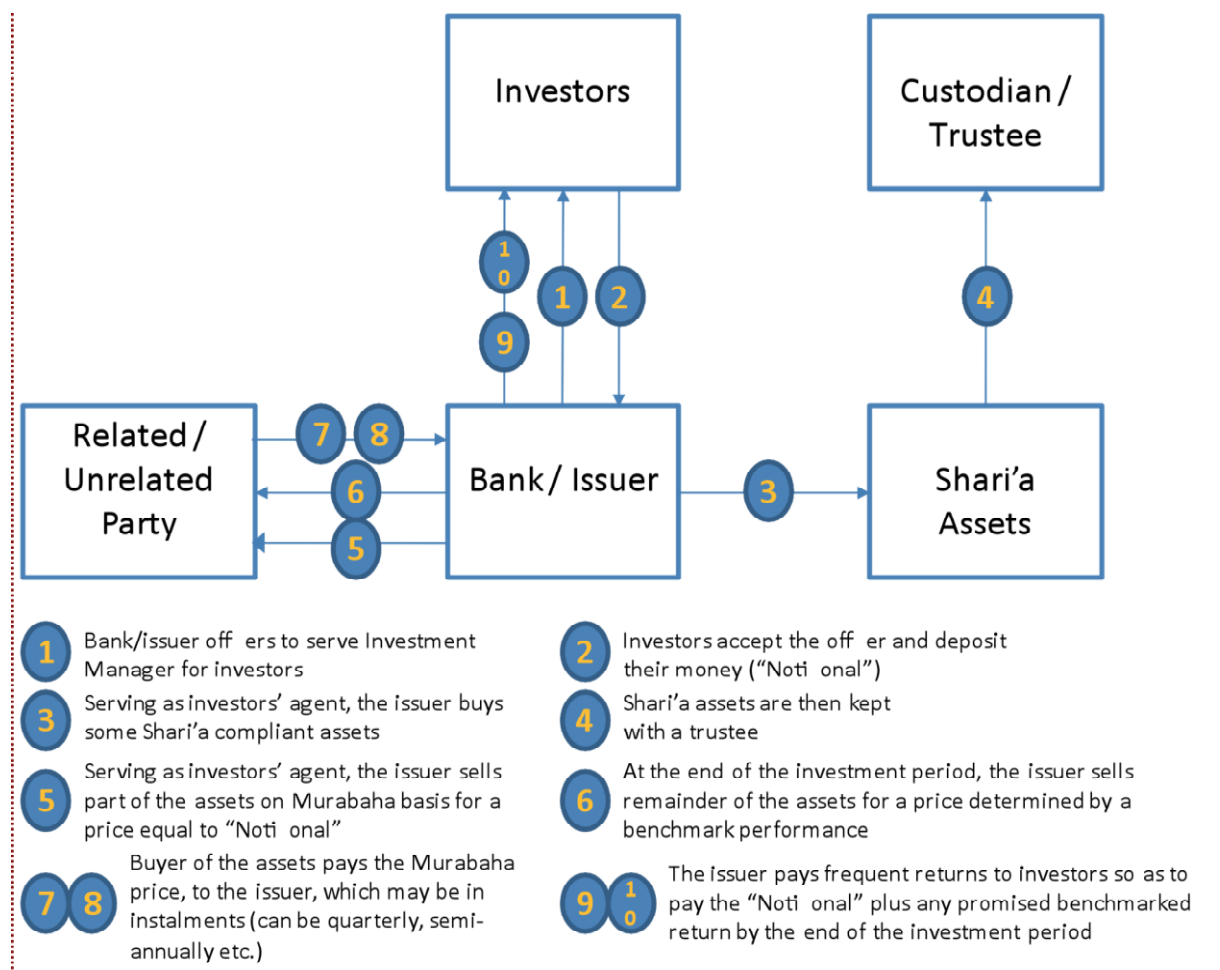
3.2 The controversy over the use of wa’ad (undertakings) in Islamic structured products

Some analysts have rather naively criticised the use of wa’ad (undertakings) in Islamic structured products. Although Deutsche Bank was the first bank to explicitly base its Islamic structured products on wa’ad, the use of this extremely useful concept has helped strengthen the Islamic financial services industry and increase the product range. In fact, almost all Islamic financial products have to rely on wa’ad to make the underlying structures legally binding. From the retail banking operations based on murabaha and ijara wa iqtina (hire purchase) to sophisticated products such as Islamic

put options, short-selling, swaps and other derivatives, wa'ad is extensively used to affect the economic outcomes these products aim to emulate.

Following the controversy created over the use of wa'ad in Islamic structured products, the use of wa'ad in such products' structure has become implicit. The master murabaha agreements used in such products are indeed no more than unilateral and independent undertakings (wa'ad) to buy and sell on the basis of murabaha by the transacting parties, i.e., the issuer and the related/unrelated party in Figure 1.

Figure 1: A Sketch of Islamic Structure Products



3.3 Other shari'a issues

There are some other important shari'a issues that must not be ignored while structuring Islamic products. One of these is the issue of guarantee by the investment agent. While the Shari'a Standard on Agency issued by the Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI) allows for an investment agent to give a guarantee in a role other than being agent, it is important that the counterparty to the issuer in murabaha transactions is an unrelated company. In most cases, it has cost implications for the structure. Hence, the contemporary shari'a view is that the related counterparty must at least be 33 percent owned by unrelated / unconnected shareholders.

4. Future of Islamic financial innovation

Islamic structured products assumed an increased importance in the wake of a slowdown of sukuk issuance and their popularity, in the first phase of the financial crisis that also hit Islamic banking and finance in 2008. In 2008, global sukuk issuance witnessed a sharp decline but has been growing gradually since then. This, along with some shari'a concerns around practices like tawarruq or commodity murabaha (e.g., a resolution by the International Fiqh Academy of the powerful Organisation of Islamic Conference (OIC) in 2009 proscribing organised tawarruq), is bound to pave the way for the further development of Islamic structured products, which may effectively be used as liquidity management tools – something of an achilles' heel for Islamic treasury operations. In fact, Deutsche Bank's Al Mi'yar platform (launched in January 2009) aims to address the core issue of Islamic liquidity management by offering tradable Islamic money market products / securities settling with short settlement cycles (T+0). This should enable the issuance of overnight products or other short dated money market instruments and hence enhance the liquidity of the Islamic money markets.

Moreover, Islamic structured products listed on the DIFX TraX Platform offer a potentially excellent opportunity to develop a comprehensive framework for Islamic liquidity management. This will certainly diversify Islamic money market instruments, if it does not entirely replace the existing commodity murabaha practices.

The principal-protected Islamic structured products on global equities and other assets foreign to Islamic investors in different countries are attractive only when domestic or regional markets are not doing well. Once, for example, the GCC equity market is buoyant and the real estate has come out of current sickness, Islamic structured products with foreign underlying assets will get marginalised by the local structured products, even if they do not offer principal protection.

Islamic investors have a preferential investment process: invest locally; then regionally; and then either go eastward or to Africa, especially North Africa. If nothing interests them in these regions, they go for Western assets and it is here they look for principal protection. Those institutions which are looking to use regional assets / indices as the underlying of Islamic structured products may wish to try offering products that are not principal protected, as Islamic investors feel comfortable in taking local risks rather than venturing into foreign risky assets.

However, as alluded to earlier, it is imperative for the Islamic financial services industry to come up with new products and institutions that have direct relevance to the socio-economic needs of the communities they aim to serve. In this way, Islamic banking and finance will emerge not only as a business phenomenon but could possibly be used as a tool for social transformation in the 21st century. The suggestion of using Islamic banking and finance as a tool for social reform has added relevance to the countries in the Middle East, which are facing political turmoil and confronting the possibility of the

collapse of many well-established regimes. Even in countries such as Pakistan, which faces the tremendous task of a war on terror, Islamic banking and finance can be used to promote moderation in social behaviour and the modernisation of financial relations.

In the last three decades, a number of new Islamic financial products have been developed primarily by applying Islamic nominate contracts in new ways to achieve the economic profiles of conventional products, so as to allow Muslims to have access to financial services in ways that are not contradictory with their belief. This was indeed a mammoth effort in which different stakeholders, including governments, international regulatory bodies, law firms, shari'a scholars, accountants and many more played instrumental roles.

Consequently, there is now a wide range of Islamic financial products available, which offer the economic benefits of conventional products in a shari'a compliant way. This process may be termed as conversion of conventional products into Islamic. Some industry experts such as Professor Volker Neinhaus, however, argue that this is at the same time conventionalisation of Islamic banking and finance as well, because this process of conversion of conventional products brings the economic profiles of conventional products into Islamic banking. This is a valid argument.

The question that arises is whether Islamic banking and finance should continue with this kind of product development or attempt to develop a new system comprising institutions and products, which are distinctly different from conventional financial institutions and the products they offer. In other words: what kind of innovation is required to develop a financial model for Muslims (and possibly for others who may share the underpinning values of that model/system), which offers real benefits to the communities and not mere financial sophistication.

Many industry observers and proponents of Islamic banking and finance argue that it must have distinct social objectives for it to survive and sustain in otherwise fiercely competitive financial markets. So far the real value proposition of Islamic banking and finance is in terms of shari'a compliancy. It is now time to start thinking about topping up its value proposition in terms of its contribution to social responsibility and commitment to the communities it attempts to serve.

Islamic banking and finance must have social objectives, which must attempt to bring social reforms by way of promoting good economic agents. It should come up with a notion of a good economic agent and allow only such agents (individuals and institutions) to be part of the Islamic banking and finance practice and movement. One way of defining good economic agents is in terms of efficiency, ethics, responsibility, and charity. Thus, an economic agent is good if it is efficient (e.g., does things well and quickly), ethical (e.g., honest, transparent and just), socially responsible, and charitable. A certain threshold level of efficiency, ethics, social responsibility and charitable giving must be set for accepting an economic agent in the Islamic financial services industry, as a user or as a provider of such services, including the service providers to the suppliers.

This is something very different from the current practice of Islamic banking and finance. The current reality is that Islamic banking and finance is competing with its conventional counterpart and has yet to develop its own niche. This is reflected by a huge emphasis in Islamic banking and finance on the maintenance of profit equalisation reserves (PER) and investment risk reserves (IRR) (as mentioned earlier) and the relevance of what is known as a commercial displacement risk (CDR). All of these concepts and practices are used to ensure that Islamic banking and finance remains

close in practice to conventional banking. In fact, in the countries where Islamic banking and finance is being provided a level-playing field, treatment of Islamic banking products is exactly the same as their conventional counterparts for the purpose of tax neutrality.

While measures such as tax neutrality are helpful for the practice of Islamic banking and finance, these are documented proofs that Islamic financial products are indeed no different from their conventional counterparts in terms of their economic effects. It must be emphasised here that the author is not arguing that the current Islamic financial product offerings are non- shari'a compliant; he is just referring to the fact that they offer similar economic benefits to conventional products.

This is indeed the time for Islamic banking and finance to pause and think of the future path it would like to take. Many industry observers believe that Islamic banking and finance must find its niche, which according to them is not in the mainstream. Once it has identified its niche, it must also identify the type of Islamic banking and finance its potential users would like to see developing.

Admittedly, the market for Islamic banking & finance is limited. Only about 1/4 of Muslims are interested in Islamic banking & finance. This means that out of an estimated global population of 1.6 billion Muslims, 400 million are interested in Islamic banking and finance. Although per capita income ranges from less than \$500 per annum to over \$50,000 per annum in the countries where Islamic banking and finance exists, the incidence of Islamic banking is biased in favour of higher per capita environments. If we choose \$1,000 per capita as a conservative estimate of the annual income of those who are interested in Islamic banking and finance, then an additional annual \$400

billion is available for Islamic banks and financial institutions to draw their business from.

However to grow further from the present size of \$1.63 trillion (as reported in the Global Islamic Finance Report 2013) will be difficult if Western financial institutions do not inject their money into Islamic banking & finance.

For Islamic banking & finance to become more comprehensive and all encompassing, it must now come up with a new institutional form, *in addition to its existing practice*. It is important to emphasise that any new development in Islamic banking & finance must complement the existing practice and it is by no means the opinion of this writer that a new system must be developed to replace the existing practical models of Islamic banking & finance.

5. Islamic Foundations: A New Islamic Model

Many keen observers of Islamic banking & finance are not entirely happy with the current “banking” based model of Islamic financial intermediation and hence suggest that a new Islamic model must be developed for the savers and users of the surplus funds in a society. One such model could be called Islamic Foundations. An Islamic foundation is a collective saving and investment programme that allows its members to save together in order to do business together for the benefit of all the programme members. This could be a deposit taking institution in itself or may have a deposit taking institution as part of its overall operations.

An example of a conventional foundation is Fauji Foundation in Pakistan, which was set up in 1954 as a charitable organisation, and now is one of the largest industrial conglomerates in the country with total assets over 250 billion Pakistani rupees (US\$3.5

billion), serving over 7% of the beneficiary population in Pakistan. It has investments in industrial production (e.g., cement, fertilizers, and oil & gas etc.), education, healthcare and financial services.

A similar kind of model can be adopted for an Islamic Foundation, which should first identify its objectives. Examples of such objectives could be welfare of the elderly, welfare of women, and investing in children in need, etc. An Islamic Foundation must attempt to promote good economic agents in terms of efficiency, ethics, social responsibility and charitable giving.

The members of the Islamic Foundation must demonstrate that they are efficient, ethical, responsible and charitable people. By way of example, each member must have a logbook, which would include a monthly account of at least one project conducted efficiently, ethically, responsibly and in a charitable way. While members of the Islamic Foundation must be the direct beneficiaries of it, the goods and services it produces must be sold in the market for competitive prices to make profit for the Islamic Foundation. The profits must be reinvested within the foundation structure; however, members of the Islamic Foundation should enjoy benefits in terms of free or highly subsidised goods and services. For example, if the Islamic Foundation runs a school, the members' children must attend it either for free or pay a subsidised rate. Similarly, they must have easy and affordable access to healthcare and other social services. Furthermore, if the Islamic Foundation runs a finance programme, it must give preferential treatment to its members. For example, the Islamic Foundation must provide interest-free loans to its members for home purchases and the financing of other durables like cars and other household items.

The foundation model is completely different from a banking-based Islamic financial model. It may be based on the Waqf (a form of Islamic trust) so that the assets are locked into a structure that creates socially responsible assets.

Unlike an Islamic bank, which collects money and finances goods and services and in some cases businesses as well, an Islamic foundation is an institution that organises and runs real businesses for the benefits of its members. As the examples of such social projects abound in the West as well as in the Muslim world, there is a need to study these different models to develop a new model of Islamic financial intermediation.

The author is aware of some notorious examples of foundations in different parts of the world but they should not hide the fact that these are excellent models of social enterprises, if they are regulated and run properly. For examples bonyads (literally meanings foundations) in Iran are often quoted as bad examples of governance. It must, however, be emphasised that many of the problems with foundations are primarily due to either non-existence or poor regulation of such entities.

There is no harm in using Islamic banks (or even conventional banks) for routine payment transactions like payment of bills and even non-interest paying current accounts. However, for savings, investments and social contributions, Muslims can use Islamic foundations. Such Islamic foundations must be tightly regulated and monitored. It is proposed that special arrangements be made to list such Islamic foundations on a stock exchange to ensure that those who invest in Islamic foundations must be able to redeem their investments if they wish to do so. However, to remain within the spirit of a foundation model, the listed stocks must be non-dividend paying and that the investors should have a choice of donating their capital gains, if any, back to the Islamic foundation.

In a country like Pakistan, an excellent model in the form of mudaraba companies exists, and there is a need to modify this model to come up with a framework for the proposed Islamic foundations. In fact, the mudaraba model as developed and implemented in Pakistan is an innovative example of a new model of Islamic investment banking.

6. Conclusion

In conclusion, we can see that Islamic financial innovation has dramatically increased as the industry has continued to grow. Innovative product development teams have developed sophisticated Islamic alternative assets over the last decade. These innovations have opened up a whole new array of asset classes to Islamic investors enabling them to gain access to the risk/return profiles of previously untapped areas. This trend is expected to continue as the industry develops and there is no doubt that product innovation will be an important factor in the continued growth of the industry.

Innovation in Islamic finance has largely been driven by the need to imitate the economic effects of conventional financial products and this has somewhat been achieved as can be witnessed by the presence of Islamic structured products, hedge funds etc. However it is essential, as was mentioned earlier, that Islamic financial innovation incorporates an element of social responsibility in order to ensure its wider acceptability. Shari'a compliance can no longer be the sole factor considered in innovation as it is important that the industry develops its own unique selling point as shari'a premium continues to decline. One possible way to achieve this is the development of alternative Islamic financial institutions with a focus on societal improvement; these alternative institutions together with traditional Islamic banks, can work in collaboration in order to achieve these objectives.