A. Introduction

It’s a privilege to be addressing the floor of Harvard Law School that is now well recognized for its contribution to Islamic Law. Along with others, I have benefitted from the rich debate among Shariah scholars, academics, researchers and industry specialists on the topic of “Islamic Finance: its authenticity and innovation.” I would like to offer a regulator’s perspective regarding debate on “authenticity and innovation” of Islamic Finance (IF).

Impetus to Islamic Finance (IF) comes from not only its strong appeal and demand both from Muslims and now from Western world but from recognition and reality that IF is indeed an alternate and viable financing mechanism. If appropriately nurtured, it has potential to broaden and deepen financial markets. This is critical for financial markets that suffer from (a) low level of financial penetration – level of financial exclusion in developing markets is as high as level of financial inclusion in developed markets; (b) high dependence on bank and debt based systems; and (c) small and illiquid capital markets. IF’s authenticity lies in its inherent characteristics to enrich and supplement conventional finance by offering options and solutions to address these gaps in financial system, while effectively and efficiently allocating capital and allowing opportunities to optimize firm’s capital structure.

Triggered by growing knowledge and research undertaken by Shariah scholars and academics, IF is now being nurtured more by the industry experts and the practitioners as they recognize the benefit of exploiting synergies between IF and conventional finance. While IF offers its own ideology, approaches and modalities, legal and contractual structures and risk management perspectives, conventional finance has steered the global financial markets for ages backed by the well tested policy, legal and regulatory prescriptions, tools and structures etc. It is inevitable that this has resulted in juxtaposition and transposition of the two disciplines to foster innovation and benefit the two fields of finance mutually, while prompting cross border flows and offering new perspectives on financial stability.

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

(i) Make the case that IF is by design authentic as it offers new ethical and equitable perspectives to world of finance, while allowing flexibility to nurture businesses based on partnership and profit and loss sharing (PLS) mechanism based on a fair and just contractual frameworks. Application of these IF-guidelines and principles to well tested tools of conventional finance itself ought to be treated as innovation.

(ii) Highlight that IF engineering and re-engineering has facilitated proliferation of Islamic products which include a range of (a) standalone 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 and indices, and insurance.

(iii) Finally, it has to be recognized that though pace of financial innovation is occurring in IF, there is scope for unleashing its potential further which in turn would also facilitate financial stability. In this context, I propose to offer few selective perspectives which underscore need for enhancing the legal, regulatory and
supervisory frameworks for IF to allow for greater diversification both on asset and liabilities side supported by proper governance standards for PLS modalities including adequate safeguards for investment account holders. Greater appreciation and understanding of risk frameworks and development of capacities would facilitate adaption of complex Islamic products and would help in enhancing depth and breadth of IF.

B. 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 former is based on Quranic and Shariah injunctions and principles. Islam prohibits exploitative transactions such as (riba), or transactions involving uncertainty (gharar) or speculative behavior (maisir) or trading of debts. In conjunction, IF advocates “material finality” that underscores backing of financial transaction with real economic activity/transactions. The combination of these prohibitions and IF’s emphasis on backing transaction with real economic activity are the two key ideological differences IF has with the conventional finance.

Also, IF encourages financial relationship between financiers and entrepreneurs (borrowers) where 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 on an elaborate contractual framework which drives its application and content from IF. The ideological underpinnings of Islamic economics and its supportive contractual framework, along with wide range of financial and business transaction options permissible under IF, allows a rich array of approaches, options and modalities for IF.

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

C. Financial re-engineering and innovation

Generally, IF industry has witnessed explosion and proliferation of Islamic products offering close to full-menu of conventional finance industry options and instruments. Today, industry offers standalone or hybrid Islamic products, offers capital markets options for fund management, insurance products via takaful, and meets requirements for sovereign, corporate and retail sector. To ensure competitiveness and customer acceptability, replication and aligning of returns on Islamic products with conventional products has generated concerns regarding dilution and excessive concentration of banks on one or two products. Practically, the Islamic industry currently is bank-based. Product diversification, albeit slow, is emerging but returns are engineered to ensure conformity and convergence with conventional industry. Re-engineering and engineering in IF can be grouped as follows:

(i) Islamic synthetic products. Adopting reverse engineering, a number of Islamic products have been designed as conventional product equivalents. Three core

structures are most popular: (i) Murabahah synthetic (debt based) products that are backed by sale-repurchase agreements or back to back agreement of a borrower held asset or lender’s purchase, (ii) Al-ijarah leasing (asset backed) provide financing; and (iii) equity based profit sharing contracts Musharakah or Mudarabah or crop sharing (Muazarah).

(ii) **Re-engineering of Islamic synthetic products.** Drawing from the core products identified above, re-engineering has been possible in some cases such as the reverse Murabahah, diminishing Musharakah to provide housing finance, Sukuk and its variants along with Musharakah Term Finance Certificates (MTFCs) which is a form of Sukuk. MTFCs have greater appeal since these are issued against the strength of issuer’s balance sheet rather than specific assets of the corporate and are close to PLS framework.

(iii) **Hybrid Islamic products.** Supported by advancements in Islamic securitization, there has been acceptance of Islamic Investment Certificates, i.e. Sukuk bonds that are Shariah compliant and tradable asset backed securities. Industry has floated different types of Sukuk with AAOIFI recognizing about 14 different types of Sukuks. Most Sukuks are sponsored by sovereigns, both in domestic and international markets, backed by approved Government assets. Although Ijara (asset based) Sukuk are the most popular, other hybrid-Sukuk’s backed by synthetic loans, sale-lease backs or head-lease/sublease ijarah and profit sharing structure are now emerging to be quite popular. Underlying pool of assets for some Sukuk comprise of Istdisna and Murabahah receivables as well as Ijarah. Another example is the convertible Sukuk – whether pure Ijara or hybrid it can have an embedded option allowing them to be converted into another asset form depending on specified conditions.

(iv) **Islamic mortgages.** These are fast gaining ground and are being structured as: (a) the Ijarah (lease) contract along the lines of conventional mortgage; (ii) equity partnership (diminishing Musharakah), where the mortgagee (lender) and mortgagor (borrower) jointly share ownership, which over a period of time is transferred to the mortgagor, who buys shares in interest of ownership by contributing each month toward buying out the mortgagee’s share in the property and return to the lender is generated out of the fair rental value of the property; (iii) Murabahah (sales transaction), is practiced in the United Kingdom, where the property transfer tax (stamp duty) discriminates against the Ijarah – or Musharakah-based mortgage; and (iv) cooperative societies, where members buy equity (Musharakah) membership and help each other to purchase property from the pool of the society’s funds.

In parallel to these developments, IF has progressed on capital market development. Few significant development on this front are:

(i) **Islamic benchmark** has evolved to provide an alternate to LIBOR by introducing Islamic sovereign paper. Some initiatives include (a) Sudan Government Investment Certificates based on pool of Ijara, Salam, and Murabahah instruments to raise long term financing, one year maturity Government Musharakah Certificates based on equity partnerships; (b) Bay al-dayn (debt trading) Government Investment Issues (GII) by Malaysia; and (c) Baharian al-salam Sukuks whereby Government agrees to sell forward to Islamic banks a commodity (typically aluminium) against spot payment. Islamic banks in turn designate the Government their agent to sell the

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2 Ijara Sukuk are financial obligations, issued by lessor, and backed primarily by cash flows from lease receivables from a credit lessee.

commodity to a third party on delivery and the price of 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 who are involved in activities consistent with Islamic Shariah law. Examples of this are Dow Jones and FTSE Islamic indices which focus on limited range of companies excluding companies which are involved in products/businesses not permissible under Islam.

(iii) **Islamic equity funds** include Shariah-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 risks. Such funds are designed to ensure that equity stocks included in the fund are not only well diversified but also fully compliant with the Shariah’s guidelines.

(iv) **Development of derivatives and its equivalents.** There is a debate on whether IF allows setting price at a future date with some scholars arguing it is not permissible and others with flexible interpretation that forward trades are permissible in Islam, if structured to provide specific quantity, time, weight and date. Devising solutions which are acceptable to all players are further complicated by difficulties in structuring contractual obligations, methods of eliminating risk inherent in the derivatives contract i.e. counterparty and operational risks, and lack of benchmark data. Despite these impediments, few Islamic OTC financial derivatives on the lines of the conventional ones have been structured. For example: Standard Chartered and Bank Muamalat Malaysia structured Islamic Cross Currency Swap (US$ 10 million) and Citigroup floated a 5-year US$ 230 million Currency Profit Rate Swap, while work is underway to float Forward Rate Agreement (equivalent of conventional FRA), Profit Rate Swap (equivalent of interest rate swap) etc.

D. **Way forward for Islamic financial innovation**

Industry’s effort to engineer and re-engineer financial innovation has been impressive, but authenticity demands that industry continues its efforts to innovate. To facilitate this, there is need for IF industry and regulators to now consider a change in mind set accompanied by enhancement of the legal, regulatory and supervisory infrastructure backed by proper governance framework to allow banks to transact in equity based transactions. Traditionally, banks main business has been debt financing and regulators have been conservative in allowing bank’s to indulge in equity products or nonbanking businesses. However, consolidation and conglomeration has pushed the financial industry to universal banking and other structures to retail better different products. Among others, this has resulted in scale and efficiency of financial institutions and required regulator’s to change their regulatory frameworks and supervisory approaches. Given this, in this section I offer some selective perspectives which should allow IF to move and compete in tandem with conventional finance.

**Consistent with IF provisions, one concrete way forward is to focus efforts to develop right framework and applications for PLS-Shariah compliance products.** Currently, equity investment share in IF ranges from 0% to 24% of the Islamic bank’s books. PLS modalities, such as mudaraba and musharaka, being driven by equity partnership arrangements offer interesting options for innovation but weaknesses in policy, regulatory
and legal have impeded growth of such options. Some of the constraints to its effective application\textsuperscript{4} include (i) equity holders and entrepreneur’s aversion to risk given the uncertainties with return on businesses in PLS arrangements; (ii) absence in most countries of proper property rights which could protect PLS contracts in case of litigation; and (iii) PLS does not lend itself for short term financing and equity transactions underlying it are taxed more than interest income.

Nevertheless, promoting PLS modality would help move financial system from being bank centric to market based and thereby facilitate system-wide financial and risk diversification. Workable solutions to reducing principal-agent problems and built in supportive screening and monitoring of projects upfront would go a long way to promote efficiency in capital allocation as it links returns with actual project. Promoting more equity based products would also tackle the mis-match of assets and liabilities which has aggravated since IF has relied excessively on short-term, low-profit and fixed-income assets. Moreover, risk-sharing edge of IF products can be neutralized when Islamic banks pay investment account holders benchmark return regardless of the performance and profitability of business venture.

To fully comprehend complexities and dimensions of proper risk and reward sharing mechanism there is need to enhance understanding of management and mitigation of the specific and multiple risks associated with certain types of Islamic products. This requires a mindset change of both Islamic banking industry and regulators whose primary focus has been debt-based financial intermediation. At the same time, it requires development of financial legal and regulatory infrastructure which will help manage principal agent-entrepreneur relationships, while catering for investment account holders concerns.

While augmenting regulatory framework to facilitate IF-innovation, there is need for development of the IF supervisory framework. Currently, the process of thinking of IF supervision varies. By and large, Islamic banks are supervised using the same methodology and approaches adopted for conventional bank. Suitable modifications are needed to delve into oversight of Shariah compliance, a task daunted by the lack of Shariah expertise in regulators and differences in fiqh. A review of Shariah compliance will help facilitate innovation and enhance transparency and disclosure in Islamic banks.

\textit{Another important area where work is underway but needs to be accelerated is to develop proper understanding of prudential regulations and Shariah inspection and supervision of Islamic banks.} Guidance on prudential regulatory framework should incorporate appropriate amendment and refinements to the Basle or other best practices with the objective of providing effective treatment of risks associated with the Islamic products and balance sheets. An important contribution is the introduction of profit equalization reserve fund which is created for the PLS modalities to provide a cushion for the associated risks of businesses, while safeguarding the investment account holders interests. Islamic banks have to incorporate interests of depositors who are considered creditors and first claimants on the banks’ assets and the interest of investment account holders has to be aligned with the Islamic banks’ owners. Accompanying this is the Shariah corporate governance framework which protects the interest of the investor and customer by underscoring need for compliance and ethics as well as maintaining high degree of transparency and disclosures.

Before delving into the mechanics of Shariah supervisory framework, it is pertinent to highlight the key challenges faced by Islamic banks with respect to Shariah governance. These challenges are inter-linked and mutually reinforcing and range from:

- Reputational risk arising from lack of or uncertainty on Shariah compliance;

Demarcation and responsibility and accountability between Board, Management and Shariah Advisor;

Investment policies – compliance with Shariah prohibitions;

Investors' protection;

Disclosure and transparency of Shariah rulings;

Harmonization of Shariah rulings and offerings; and

Vigilance and Oversight of the supervisor to cater for above factors.

Currently, in absence of well conceptualized framework, Shariah compliance standards and their oversight varies across jurisdictions:

- In Iran, Council of Ministers and Regulations under the Usury Free Banking Act, 1983 serve as the Shariah Board and set guidelines for the IF industry;
- In Malaysia, under Central Bank Act, 1958, Shariah Advisory Council has sole responsibility for IF and court of arbitrator refers disputed cases to this council for their position/advice;
- In Indonesia, the National Shariah Board is responsible for Shariah rulings on Islamic products, with IFIs required to establish a Shariah Division in the institutions and NSB approves the Shariah Supervisory Board to oversee the division;
- In Pakistan, three tier model of Shariah framework is put in place. This includes Shariah Advisory Board that provides advise and guidance on prudential regulations, guidelines, modes of financing, and model agreements for Islamic industry, but the central bank issues instructions though in case of differences in perspectives on Shariah matters the advisory boards notified by central bank is final; Shariah Advisor, meeting central bank fit and proper criteria, approve products and give guidance on legal and tax matters etc.; and a mechanism for Shariah Audit System which inspects the Shariah compliance of all bank operations. Shariah Advisory Board has Shariah scholars but also industry representatives.
- Bahrain, Sudan and Syria have adopted Shariah standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and some others use them as guidelines.

Both the prudential regulation and Shariah inspection and supervision are integral elements of the check and balances to ensure products and transactions meet the test of authenticity and compliance with Shariah. While these systems may not be in place right away but development and implementation of this regulatory and supervisory infrastructure requires build up of capacities both at institution and regulators level and will pave way for building confidence in Islamic system.

E. Conclusion

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

Product proliferation and approaches to security markets, development of Islamic exchange and fund management will help nurture financial diversification from bank based to market
centric system. Proper application of PLS system will help provide greater opportunities for innovation provided it is backed by the right corporate governance architecture.

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