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Sharia Compliant, Innovation and Product Development within Islamic Financial Institutions.

Conformité Charia, Innovation et Développement des Produits au sein des Institutions de Finance Islamique.

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Abstract:

The growth of the Islamic financial industry depends on its ability to innovate new financial instruments. Indeed, under the constraint of responding to growing market demand, Islamic financial institutions must maintain their competitiveness by innovating new financial products. However, this innovation process must be subjected to rigorous monitoring to ensure that any new financial innovation or new product idea is in compliance with the Sharia. The purpose of this article is to present in its first section the main stages of the Islamic finance development, the fundamental principles related to Islamic finance, and Islamic financial instruments. Then in its second section, it points out the importance of innovation in Islamic financial institutions as a driver of progress and evolution of their activity. It then discusses innovation and new product development within Islamic financial institutions, while highlighting the role of Sharia compliance in the development process of Islamic financial products.

Keywords: Islamic finance; Charia Compliant; Financial Innovation; Product Developement; Financial Products.

Résumé:

L'essor de l'industrie financière islamique dépend de sa capacité à innover de nouveaux instruments financiers. En effet, sous la contrainte de répondre à une demande croissante du marché, les institutions financières islamiques doivent maintenir leur compétitivité en innovant de nouveaux produits financiers. Cependant, ce processus d'innovation doit être soumis à des suivis rigoureux pour s'assurer que toute nouvelle innovation financière ou idée de nouveau produit s'inscrit dans le cadre de la Charia. Le but de cet article est de présenter dans sa première section les fondements de la finance islamique. Ensuite, dans sa deuxième partie, il souligne l'importance de l'innovation dans les institutions financières islamiques en tant que moteur de progrès et de l'évolution de leur activité. Il traite ensuite de l'innovation et du développement de nouveaux produits au sein des institutions financières islamiques, tout en soulignant le rôle de la conformité à la Sharia dans le processus de développement des produits financiers islamiques.

Mots-clés : Finance islamique; Conformité Charia; Innovation financière; développement produit; Produit financier.

Introduction:

Today, Islamic finance is taking an increasingly important place in the economies of all countries. The ethical principles of this financial industry have attracted a wide range of ethical clients who wish to adhere to a fair and socially responsible financial system.

However, in an environment marked by globalization, interdependence of economies and intense competition, Islamic financial institutions regularly find themselves in search of financial innovations to increase their profits and ensure their survival.

Indeed, the Islamic financial industry is a financial system open to innovation as long as it is in line with its fundamental principles. Thus, in order to meet the diversified needs of the population, which are constantly increasing, Islamic financial institutions are under pressure to diversify their offerings, by innovating and developing new financial products.

However, this innovation process must be rigorous to ensure that any new financial innovation or new product idea is in accordance with the precept of the Sharia. In this context, the main issue of our article is raised under the following question: What is the role of Sharia compliance in each step of the Islamic financial products' development process?

To address this issue, we will first present the emergence of Islamic finance, its fundamental principles and Islamic financial instruments. Next, we will discuss in a second part innovation and new product development in Islamic financial institutions, highlighting the role of Islamic ethics and Sharia compliance in the development process of Islamic financial products.

1. The foundations of Islamic finance:

1.1. The Emergence of Islamic Finance

According to (Hassoun, 2008), Islamic finance is "a compartment of so-called "ethical" finance, a finance that intends to make itself available to the real economy and serve it, in the light of a limited number of structuring principles". The latter is considered as a segment of ethical finance because it is characterized, above all, by a moral and socially responsible dimension. It can then meet a need that goes beyond financing (Guéranger, 2009).

The history of Islamic finance and banking can be structured into three main phases: the genesis phase, the structuring phase and the development phase. Each of its phases presents critical incidents that mark the evolution of the history of Islamic finance and banking:

- Establishment of Mit Ghamr Saving bank (1963).

- First Malaysian experience of Tabunj Hadji (1969).

- Establishment of the Islamic Development Bank (1975).

- Creation of the (AAOIFI) Accounting and Auditing Organization for Islamic Financial Institutions (1991).

- Creation of the (IFSB) Islamic financial services board (2002).

1.2. Islamic finance principles

Islamic finance is based on justice, equity and transparency values. This ethical finance promotes the conception of work and capital, considers money as a way and not an ultimate goal. According to (Karich,2002) "Any fructification of any capital, any acquisition of additional richness must come from the deployment of an effort, whether it is individual or collective, from an exchange, a donation or even from an inheritance". The Islamic financial industry must therefore respect the five fundamental principles of Sharia law, namely: The prohibition of interest (Riba), prohibition of gambling (Gharar) and speculation (Maysir), prohibition of illegal activities, profits and losses sharing and the asset-backing. We will try to explain each principle in itself:

•**The prohibition of interest (Riba):** The prohibition of interest is the major difference with conventional finance. According to (Al-Jaziri, 1986) Riba is defined as "any advantage or excess received by one of the contractors without any acceptable and legitimate consideration from the point of view of Muslim law".

•**The prohibition of gambling (Gharar):** El-Gamal (2002) considers Gharar to be: "the sale of a good whose existence and characteristics are uncertain because of the risky nature that makes the transaction as gambling". It is therefore a hazard, an uncertainty whose occurrence is not certain and which can lead to an imbalance between the losses and profits of the various stakeholders.

•**The prohibition of speculation (Mayssir):** Speculation consists on "taking advantage of the short, medium or long term evolution of the general price level or of a particular price in order to obtain a surplus value or a benefit"(Ahmed,1995).This is a practice that is amply linked to uncertainty and is strictly prohibited by Islam.

•**The prohibition of illegal activities:** Islamic finance values are based on an ethical and socially responsible approach. Thus, Islamic financing prohibits investing in an activity that contradicts the Sharia, such as financing weapons, alcohol, tobacco, pornography....

•**Profit and Loss Sharing:** In the Islamic financial industry, the financial institution is not only a lender or borrower but a partner in the business project. Islam encourages the sharing of profits and losses between the project partners. The objective is to achieve judicious and fair contracts.

•Asset-Backing: In the Islamic financial industry, financial transactions are backed by real, tangible and held assets. This is a principle that aims to strengthen stability, control risks and maintain the link between the financial and real spheres. Asset Backing ensures the development of a stable economy based on real economic activity (El-Melky, 2011).

1.3. Islamic finance instruments

The instruments of Islamic finance are divided into two main categories. We will first present the participatory instruments and then we will present the financing instruments.

The participatory instruments concerns two Islamic contracts, namely the Moudharaba and the Moucharaka.

The Mudaraba called "Trust financing" is a partnership contract between an investor, called "Rab el Mal", who provides the capital, and an entrepreneur, called the "Mudharib", who provides his activity and expertise.

The Mudharaba is a "profit and loss sharing" contract. Both of stakeholders share the profits generated at a predetermined rate in advance, after the investor has recovered his capital and the entrepreneur has recovered all his management costs (Pastré & Jouini, 2009). In terms of losses, the investor assumes all losses, the entrepreneur loses the remuneration of his labour force.

The Musharaka is an association between two or more people who invest together in the same project and share the benefits according to the proportion of each person's contributions, defined when the contract is signed. As for losses, they are supported depending on the percentage of the capital invested (Pastré & Jouini, 2009). Musharak is also a product based on profit and loss sharing. The difference between the Mudaraba and the Musharaka is that in the latter all partners can participate in both labour and capital, and management can be assigned to all the partners.

The funding instruments are divided into four Islamic contracts, namely Murabahah, Ijara, Salam and Istina'a.

• **Murabaha:** According to (Smith, 2009), Murabahah is "a financing technique whereby a financier buys an asset and then sells it to his client on an instalment basis at a premium price". It is a saling contract where the funder buys an asset on behalf of a client with a profit margin.

• **Ijara:** The Ijara contract is assimilated to the leasing contract, or to the conventional finance leasing contract. The creditor buys goods and then rents them out to a customer in return for periodic rent. The latter will have the possibility, if he wants, to redeem the property when the contract expires (purchase option). The contract must mention, as is the case in conventional finance, the price of the property, the rental period, the amount of rent and the guarantees required.

•**Salam:** The Salam contract is a contract by which the buyer pays in advance the price of an item in exchange for a promise of future delivery. It is therefore a forward sale where delivery is made in the future and payment is made in cash. The characteristics and description of the property must be clearly determined when the contract is signed. The Salam contract is a financing method for agricultural or import/export operations (El khamlichi, 2012).

•**Istisna'a:** The Istina'a contract is a contract under which one party (MOUSTASNI'I) asks another party (SANI'I) to manufacture a good for a fee payable in advance, in instalments or in the future. In order to benefit from this financing, the investor must be able to finance, by his own means, either the cost of raw materials or the cost of manufacturing (El khamlichi, 2012). Unlike the Salam contract, the Istina'a contract, unlike the Salam contract, the delivery does not concern goods purchased in the same condition as they are but rather finished products that have undergone processing.

2. Innovation within islamic financial institutions:

Innovation is a necessary lever for the development and growth of all countries. According to the OECD, "An innovation is the implementation of a new or significantly improved product (good or service) or process, a new marketing method or a new organizational method in business practices, workplace organization or external relations". It is therefore a fundamental condition for the survival and development of any organization.

According to (Freeman, 1982), the survival of the financial system depends on maintaining innovative financial products that are compatible with new global economic and financial changes.

Thus, all the financial institutions that have been able to develop and gain a place in the world have adopted innovative strategies in their fields of activity. Islamic financial institutions (IFIs) are no exception. Indeed, these institutions are under pressure to meet growing market demand and must maintain their competitiveness by innovating and developing new financial products. However, this innovation process must be subject to rigorous monitoring to ensure that any new financial innovation or new product idea is in line with Sharia law.

2.1. Product development within Islamic financial institutions:

Smith & Reinertsen, (1998), define product development as "a process of gradually building up a set of information until it provides a complete formula for the manufacture of a new product".

The competitiveness of Islamic financial institutions depends largely on their ability to innovate and develop new products in order to offer alternatives to conventional financial institutions. The new industry of Islamic financial products and services needs to be developed on a continuous basis. They must be designed with quality and diversity of choice (Al-Salem, 2009).

2.2. Sharia compliance and product development processes.

The product development process represents a formal flow of information and activities necessary to create new products (Ulrich & Eppinger, 2008). In Islamic financial institutions, (Ahmed, 2011), describes the product development cycle as being designed for the development of conventional financial products that are under Sharia control at all stages of the cycle. The respect of Shariah is considered as a priority essential to the survival of the establishment (Bari & Tani, 2019). According to (Ahmed, 2011), this product development process involves three stages: the generation and acceptance of ideas, the conversion of the concept into a product and commercialization.

Each stage through which a product passes is submitted to a rigorous control carried out by the Sharia Supervisory Board (SSB), also known as the Sharia Supervisory Committee (SSC) or the Sharia Control Committee (SCC), which is composed of Sharia lawyers and experts, who meet regularly to ensure compliance with the Sharia and approve new products. In the following, we will attempt to describe the role of Sharia Supervisory Boards in each stage of the product development process.

•Stage n°1: Idea generation and acceptance.

The generation and acceptance of ideas represents the first necessary step to identify a new product. According to (Kelly & Storey,2000), several ideas selection criteria are used to identify products that can potentially be developed. The most important aspect for a financial institution is the financial impact of the new product and the assessment of the market demand.

Furthermore, an important aspect in the idea generation phase in Islamic financial institutions is to determine the shariah-compliant contract which can be used for the product, and this is the role of the Sharia Supervisory Board (SSB).

Indeed, the SSB will examine the concept and structure of the new innovation and contribute to the development of new products by providing advice on the different Sharia-compliant structures for the product. This would include approving the financial innovation and product development cycle with associated processes (Qattan,M.A & Muljawan, 2006).

Sharia governance does not only cover the design stage of the new product, it also includes its documentation. The financial institution's Sharia department will be responsible for preparing the Discussion Paper. The role of the SSB is to carefully review and officially approve the product structure before moving to large-scale development. The objective of having the concept approved by the SSB is to minimize the risks of Sharia compliance before developing the product algorithm (Habib, 2014).

•Stage n°2: Conversion of the concept into a product:

After approving the development of a new product, the senior management of the financial institution proceeds to the conversion of the concept into a product. The first step to be undertaken is to develop a product master plan that presents all the product specific steps and processes. All departments of the financial institution that are engaged in the product development process must provide all documents related to the product.

Product development within Islamic financial institutions must meet the requirements of Sharia law. The Sharia compliance service must take into consideration the implications of the country's laws and regulations for the Islamic economy, and in order to ensure that the product does not contravene any national laws and regulatory rules and standards, there must be a part of liaising with the relevant regulatory authorities to place the product in the market (Habib, 2014).

Before proceeding to the commercialization of the product, it is necessary to complete the product by preparing all the necessary documents for its delivery such as forms, contracts, leaflets... (Habib, 2014).The legal department of the Islamic financial institution reviews all new product documents, which are then submitted to the (SSB) for final approval. The latter is responsible for carefully reviewing and approving all relevant documents. This would also include the product manual, marketing advertisements, sales illustrations and brochures for describing the product (Nik, 2001).

•Stage n°3: Commercialization

The product launch and commercialization stage is the last phase of the product development process. According to (Robert, et all., 1994), several factors related to the preparation of the product launch can make the product widely accepted by the customers increase the probability. Here we can mention: Understanding and support of the product by all concerned employees, commercializing the new product within the organization before its launch and providing advanced training to the customer support team staff. Reference (Edgett, 1996) confirms that marketing assistance during the launch of the new product has a strong and significant influence on the success of the product. According to (Edgett &Parkinson, 1994), products with strong post-launch support have a better position than other competitors.

Success in commercializing new Islamic products also depends on the ability of staff to promote the characteristics of the contract in order to convince customers of the compatibility with Sharia law. Thus, staff members must be well trained on the characteristics of the products so that they can answer customers' questions about Sharia compliance structures.

When the financial institution comes to the post-launch stage of the Islamic product developed the procedures' and processes' compliance with Sharia must be respected. The internal Sharia compliance department or unit is required to establish an internal audit of the processes used by the Islamic financial institution to deliver its products (Habib, 2014). The internal Sharia compliance department or unit is required to establish an internal audit of the processes used by the Islamic financial institution to distribute its products. While effective management of the monitoring of Sharia requirements related to operational issues is managed by the internal Sharia department or unit, the SSB must be able to control and correct deficiencies whenever it is necessary to do so.

The SSB is responsible for conducting a regular Sharia compliance audit covering all operational and commercial activities of Islamic financial institutions. They could do this themselves or by appointing someone else who is qualified to do the job (Rammal, 2006). This task is usually performed by an internal Sharia compliance department, the audit findings will be communicated to the SSB, which will then report to the shareholders and board of directors of the Islamic financial institution. This report is then made public.

Conclusion

Islamic finance has gained in recent years a significant place in the economies of all countries. This ethical finance, which is presented as an alternative to conventional finance, is now enjoying increased interest, particularly in terms of its promising prospects. However, to meet the modern needs of the population, the Islamic financial industry must offer innovative products that respect the precepts of Sharia law, thus enabling it to keep its competitiveness on the market.

In this article we have presented in the first part, the emergence of Islamic finance over time. Then we outlined its fundamental principles related to Sharia law, which are: The prohibition of interest (Riba), prohibition of activities considered illegal, prohibition of gambling (Ghararar) and speculation (Maysir), asset-backing and profit and loss sharing. We also presented the main instruments of Islamic finance, which are organized into two main categories: Participatory instruments and financing instruments. In the second part of this article we have highlighted the importance of innovation and product development within Islamic financial institutions as a driver of progress and evolution of their activity. Then we exposed the role of Sharia compliance in the process of developing new products

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