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INNOVATION VERSUS REPLICATION
Some Notes on the Approaches in Defining Shariah Compliance in Islamic Finance

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Abstract

Shariah contains the principles and foundations upon which financial system from an Islamic perspective is established and acts as guidance and framework on which the direction of the industry is set. This would include the whole processes from product conceptual inception of developing shariah product compliance manual, developing product structure, reviewing the legal documentation, and producing report or opinion on the product application in the market. Islamic finance is expected to offer something new to the market instead of a mere replication and modification of conventional practices in Islamic forms. The paper attempts to survey the approach in developing Islamic finance, including the debate on replication and innovation in a product to the structure as well as the gaps between ideals and practices.

[Keuangan Islam dikembangkan berdasarkan atas semangat, filosofi dan prinsip-prinsip hukum Islam sebagaimana terangkum dalam ekonomi shariah. Makalah ini berusaha mengamati berbagai pendekatan dalam mengembangkan keuangan Islam, perdebatan mengenai replikasi ekonomi konvensional, dan inovasi dalam produk hingga struktur maupun kesenjangan antara yang ideal dengan kenyataannya.]

Keywords: Islamic finance, product structuring, economic innovation, economic replications, economic expectations

A. Introduction

The evolution of the Islamic finance industry is viewed by many as fantastic. From its small beginning in the 1970s, Islamic finance has now considered as a global industry. The audience of Islamic finance industry is expanding to non-Muslims and Western countries. It is now in the stage of global integration to be adopted as part of the global financial system.

Many view this stage as a seamless continuation of the earlier decades (especially 1970s–1990s) of Islamic finance's development, in which scholars and practitioners laid its philosophical and conceptual foundations. The dramatic expansion might be seen as a success story which shows the world that Islam and the shariah can contribute positively to solving modern finance needs. It is one the main be practical manifestations of the Islamic worldview in the field of economics and finance as well as one of the most visible features of Islamic revivalism in the latter part of the twentieth century. [1] Some, however, do not view the dramatic development in a relatively short period as a natural progression from the pioneering stage. Many questions have been raised about the Islamicity and genuineness of Islamic finance and the nature of its progress.[2]

While evaluating progress is always a subjective enterprise, the criticisms cannot be underestimated, especially if we want to have real Islamic finance that can be sustainably developed in the future and have a solid implication to the actual economic sector. Islamic finance has been expected to offer innovative solutions to the modern financial problem while having its roots on shariah principles. In other words, what is expected from Islamic finance is not only a legal solution of avoiding *ribā* or other prohibited transactions in financial services but more than

[1] Hafas Furqani, *Islamic Economics, Banking and Finance: Contemplating Raisons D'etre and Future Directions*, Research Paper, no. 27 (Malaysia: ISRA, 2011), p. 2.

[2] Abdulazeem Abozaid, "Contemporary Islamic Financing Modes between Contract Technicalities and Shari'ah Objectives", *Islamic Economic Studies*, vol. 17, no. 2 (2010), pp. 5–75; Asad Zaman, "Objectives of Financial Institutions - Western and Islamic", *Journal of Islamic Business and Management*, vol. 5, no. 2 (2015), pp. 41–68.

that, how a good financial system can be established as a response to the conventional financial system.

This paper attempts to observe the approach in developing Islamic finance by looking at the product structuring in Islamic finance. This is done by (1) understanding the meaning of innovations in Islamic finance, its scope and dimensions, (2) analyzing the progress that has been achieved that would include the approaches in innovations in Islamic finance and some problems in the approach of innovation, and (3) observing the future direction of innovations in Islamic finance that would also include the challenges and expectations.

B. Financial Innovations and Product Structuring

Finance is one of the important aspects of human life in fulfilling various needs as well as in increasing the quality of life. Finance assists economic development by allocating funds within society from those who have extra funds to those who needs funds to fulfil their needs.

In line with human progress, financial practices have been evolved from a simple transaction into a complicated and sophisticated arrangement. Throughout the history of mankind, financial innovations have been attempted that would assist the human being in their financial arrangement in an efficient and effective way. Financial innovations involve all aspects from the design, development, implementation of innovative financial instruments and processes, and the formulation of creative solutions, to problems in finance.[3]

Product innovation by structuring financial products that is new or significantly improved in its characteristics or intended uses is one of the aspects of innovation in finance. Innovations in the history of financial market varied hugely in terms of the size and nature of their effect, which may be profound or relatively trivial. Some innovations are quite radical and bring significant impact in the way finance is practiced. Radical innovation is defined as an innovation that significantly disrupts the market into which it is born. This disruption has costs attached to it, but these are outweighed by the long-term benefits. Importantly, the

[3] Oliver Wyman and World Economic Forum, *Rethinking Financial Innovation, Reducing Negative Outcomes while Retaining the Benefits* (Geneva: World Economic Forum, 2012).

benefits largely accrue to the innovator and the consumer of the product, and the costs accrue to established market suppliers.[4]

Financial innovations also can be seen in Islamic finance enterprise. Islamic finance came into existence in the late of the 20th century as a response to the conventional finance which is considered as illegitimate in Islamic law perspective since it involves some prohibited practices, such as interest (*ribā*), gambling (*maysir*), uncertainty (*gharār*) and other prohibited (*ḥarām*) elements.[5] Innovations are directed to provide a 'legal' (*ḥalāl*) form of financial products and services. The concern, in this regard, is more on finding 'legal structure' of a financial product that would justify financial practices in accordance with Islamic commercial law (*fiqh al-mu'āmala*).

Nevertheless, as it evolves, Islamic finance eventually emerges as an alternative financial system. Islamic finance is initially practiced by Muslim in individual countries has persuasively integrated into the global market and being viewed as an alternative system to the Capitalist financial system. Moving forward, innovations are expected to go beyond legal-matters, by looking at the dimension of ethics, social, and economic values that would assist in the development of Islamic finance to be a solid financial system and empower community at large.[6]

1. *Approaches in Islamic Finance Product Structuring*

Islamic finance emerged in the modern time with no clear precedence on the operational framework of financial intermediaries in Islamic framework. In the absence of a 'working model' of banking and financial institutions in the past, contemporary Muslim scholars and financial practitioners have no option rather than to rely on conventional financial structure/model and put their effort in producing such

[4] *Ibid.*, p. 13.

[5] Muhammad Ayub, *Understanding Islamic Finance* (Hoboken, NJ: John Wiley & Sons, 2007), p. 43.

[6] Volker Nienhaus, however, observes that the driving force behind most of the new Islamic banks of today is not development but commerce. Their aim is not to change the behavior of the rural population but to offer the well-established business community most if not all the banking and financial services of conventional banks, but on an interest-free basis. See Volker Nienhaus, "Islamic Banking: Microeconomic Instruments and Macroeconomic Implications", *Thoughts on Economics*, vol. 9, no. 1 & 2 (1988), p. 71.

prototype that is not only capture all the Islamic principles in financial practices but also viable and can be operationalized in modern context.

Therefore, in developing Islamic finance, the scholars and practitioners adopted 'replication approach' of conventional financial model/structure into an Islamic form. The approach is recognized as a pragmatic approach in in developing finance in Islamic finance in the modern context. It is widely recognized that Islamic finance should not be started from the crux or reinventing the wheels. Instead, Islamic finance can utilize the advance development of conventional finance to achieve the desired result as outline by the shariah (*maqāṣid al-sharī'a)*. Replication, in this regard, is not only natural, especially in the early stage of Islamic finance development, but it is also needed as it would help promote the development of Islamic finance.[7]

The replication of conventional financial product and structure is done by adjusting the interpretation of financial principles in Islamic law to accommodate and provide the same type of services and investment mechanisms as the dominant conventional financial system that is felt still needed by the society. However, to ensure the acceptability and originality of Islamic finance, the process should be achieved without compromising Islamic finance's ideological and spiritual distinction and uniqueness, which is critical for public confidence in the system.[8]

The approach is taken because it is perceived that Islam shares similar perspective on the functions and objectives of financial intermediaries as in conventional perspective namely to channel funds from ultimate savers to ultimate borrowers. This financial intermediary role is highly needed and socially desirable in a society whether the economy concerned is secular or Islamic. Likewise, the practical problems encountered in performing these functions are also common to all financial systems. The differences, emerge from the different paradigm in how the universal function of banks are performed (such as in the modes of finance) and the mechanisms by which the problems are solved in practice which largely relates to the type of contracts used. Furthermore,

[7] Abdullah Saeed, "Islamic Banking and Finance: in Search of a Pragmatic Model", in *Islamic Perspectives on the New Millennium*, ed. by Virginia Hooker and Amin Saikal (Singapore: ISEAS, 2004), pp. 113–29.

[8] Shamshad Akhtar, "Islamic Finance: Authenticity and Innovation – A Regulator's Perspective" (Harvard Law School, 20 Apr 2008), p. 2.

Islamic finance is operating in the same financial market with conventional finance. It has to compete to get customers as well as in venturing the investment projects. In this regard, to ensure the applicability of Islamic finance and competitiveness of the Islamic financial industry, scholars and practitioners have turned to replicating conventional products and aligning returns on Islamic products with them.

Therefore, the financial innovations in this objective would be defined as how to find alternative ways of performing the universal functions of financial system through various contracts approved by shariah that would perform financial intermediaries in a shariah compliant way.[9] In this perspective, innovations in Islamic finance can be interpreted as the ability and creativity to imitate the existing conventional financial structure and modify it with Islamic contracts to make it shariah compliant.

Zamir Iqbal in this regard argues that the process of financial engineering in Islamic finance would aim at designing and innovating more complex instruments without violating any of the conditions defined by the Islamic system. This is legitimate since a close examination of the instruments underlying the Islamic financial system reveals that they share many of the features of today's basic building block of conventional finance.[10]

In this regard, Islamic finance product structuring is mostly concerned with technical/operational concern of transforming the conventional finance products by satisfying all Islamic legal requirements (usually termed as shariah compliance). This is done by exerting intellectual effort on achieving legal compliance of financial products by modifying the existing (non-*ḥalāl*) conventional products to meet Islamic legal requirements while maintaining the same objectives as the financial capitalist system.[11]

It should be noted that to replicate the conventional structure and transform it into a shariah compliant structure is not easy. This requires strong effort and creativity to understand the conventional product

[9] Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance, and Prospects* (New York: Palgrave Macmillan, 2005), p. 4.

[10] Zamir Iqbal, "Financial Engineering in Islamic Finance", *Thunderbird International Business Review*, vol. 41, no. 4–5 (1999), pp. 541–59.

[11] Abdullah Saeed, "Islamic Banking and Finance:", p. 114.

structure and function as well as the shariah concept and principles on economics and finance. The expectation is very high. Islamic finance products is expected not only viable and marketable, but also comply with Islamic law as well as truly reflect the spirit and objective of shariah in financial sphere.

In practice, the approach is done in three general steps, namely the negative screening of prohibited elements in the conventional structure, applying Islamic principles/contracts in different types of conventional finance, and adding new features based on shariah contracts as in the following:[12]

- Negative screening by removing the prohibited elements in the conventional structure. The exclusion of negative elements in conventional finance structure is done based on the shariah concepts of *ḥalāl* and *ḥarām* and their ethical postulates. The common negative elements such as *ribā* (interest), *gharār* (uncertainty), *qimar* (gambling), and other prohibited transactions are eliminated from the contract.
- Applying Islamic principles and appropriate shariah contracts to the different types of financial transactions and also to seek opportunities to blend Islamic contract with conventional structures. The approach is usually called as *takyīf fiqhi* which means characterizing of what *fiqhi* contracts can be adapted to conventional financial structure. This stage is a critical part in the Islamisation of conventional product and the most difficult one. The outcome of this effort is to come up with a shariah compliant products in standalone products that have been tweaked to ensure conformity and convergence or returns with conventional finance or hybrid products structured by blending two to three Islamic contracts that suit the financing requirements of business.
- Adding new features and enhancement based on shariah in the structure. This phase of Islamic financial innovations attempts to enhance the structure by adding new features or offering 'new' aspect in financial practices which might not be found in conventional structure.

[12] Mohamad Akram Laldin and Hafas Furqani, *Positive Screening in Islamic Finance and the Role of Shariah Scholars*, Thomson Reuters-Responsible Finance Institute Report 2015 (UK: Thomson Reuters, 2015), pp. 60–4.

2. *Replication Approach in Islamic Financial Product Structuring*

The pragmatic approach through replication and modification of conventional financial product dominated the approach in the global Islamic finance development. This approach was able to provide practical solution to an urgent need to release Muslim from keep practicing *ribā* when they deal with conventional banking and financial institutions and has facilitated the development of a viable Islamic finance sector in the modern economic landscape.

With flexibility in interpreting shariah texts to keep pace with the global economic and financial environment, Islamic finance industry has witnessed an explosion of Islamic products that approach close to a full menu of conventional finance industry instruments. Quite many Islamic products have been successfully structured to perform the same functions and achieve the same goals as their conventional product equivalents such as hedging and financial derivatives products. This shariah compliant product would replace the conventional product in the costumers' menu of financial products and put Islamic financial institution in a competitive advantage.

Nevertheless, while it is undeniably that the replication approach to conventional financial structure is needed at the nascent stage of Islamic finance development, this approach, however, has led criticism of scholars and society on its genuineness and authenticity. In addition, some problems also have occurred in practice and brought to the court due to confusion in Islamic financial products' substance that resemble conventional financial products. The following are some notes that need to be considered in the replication approach in developing Islamic finance:

- Replicating the structure of conventional finance is done to ensure that Islamic finance remains close in practice to conventional finance products that are considered as still relevant and needed for society. Nevertheless, looking at the nature of financial intermediaries in Islamic finance that is different to the conventional as it requires a real underlying asset in the transaction as well it has to deal with various parties in the transaction, the structure would be not that simple. It is very rare to be found that one nominate contract (*al-'aqd al-musammā*) could be adopted as it is in a single conventional product. Some products need to have two or more Islamic contracts as a supportive contract to have the same function and effect as the conventional products offer. This combination of contracts (*al-'uqūd al-murakkaba*) is inevitable in certain shariah compliant product, especially if we want to Islamize conventional finance product that has sophisticated structure and forms. However, replication approach through contracts combinations, in practice has brought a more complicated and sophisticated structure of Islamic financial product. Islamic finance product is having multiple legal documentations as compared to conventional products which eventually make the products costly and less competitive.

- Replication approach, to some extent, also implicates to the compromise and conformation of conventional structure in Islamic form. This is true especially in the midst of competition with the conventional counterpart while developing its own niche. For example, to be able to compete with its conventional counterpart, Islamic banking and finance innovate profit equalisation reserves (PER) and investment risk reserves (IRR) that resemble the principle of profit guarantee for depositors to maintain the costumers and protect the Islamic bank from displaced commercial risk.[13]
- The approach of replicating the structure, form or model of conventional finance in Islamic finance, while might be done successfully, does not mean a total release from conventional finance's spirit and substance. Some of the conventional finance's spirit such as risk transfer from bank to the customers and insignificant impact of transactions to the real sector economy are also prevalent in some of the Islamic banking products that are based on *bay' al-'inah* or *bay' al-tawarruq*.
- In consequence of that, the replication approach also has an implication that Islamic banking and finance follows the behavior of conventional finance. For example, regulations in conventional finance are an *ex-post* effort as a response to past abuses or transgressions not foreseen by previous rules. In this, financial institutions and market players are constantly in search of ways and means of circumventing the rules of the regulatory framework. This behavior is referred to

[13] Humayon A. Dar, "Islamic Financial Innovation: Tools and Trends", *Journal of Emerging Economies and Islamic Research*, vol. 1, no. 3 (2013), p. 17.

as the search for 'regulatory arbitrage'.[14] Shariah rules in contract, however, are not an ex-post framework. Instead, they have been established earlier by the shariah. Islamic financial practices are expected to fully comply with those rules and regulations. Flexibility in shariah does not mean freedom to circumvent the law without any specific justification. Nevertheless, replicating conventional structure in Islamic form might also bring the behaviour of circumventing the rules of the game as outlined by shariah. This behavior is termed by Mahmoud el-Gamal as 'shariah arbitrage'.[15]

- Replication of conventional structure in Islamic form also contributes to the spread of legal stratagems (*ḥiyāl*). The ambition to follow the same functions and objective of conventional financial structure has led the Islamic financial engineers to find ways to suit the shariah contracts following the existing conventional structure through some legal stratagems/tricks (*ḥīla*, pl. *ḥiyāl*). *Ḥīla* is a technique used to adjust the law to facilitate the functioning of the legal system in a shariah compliant way. In this paradigm of Islamizing conventional structure, *ḥīla* becomes an important instrument to achieve the same result in a shariah compliant way. It is widely used in Islamic finance product structuring.

Bay' *al-tawarruq* and *bay*' *al-'inah* are the examples of *ḥīla* in Islamic finance product structuring that is widely applied in various products to facilitate the liquidity needs without involving in a loan contract with interest. In both contract arrangements, the interest of contracting parties is invariably the cash and never the purchase or sale of commodities although it is a sale contract. In this regard, no commodities are changing

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[14] Abbas Mirakhor, Hossein Askari, and Zamir Iqbal, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (Singapore: John Wiley & Sons (Asia), 2010), p. 90.

[15] El-Gamal explains further how Islamic finance based on Shariah arbitrage is constructed. First, a prohibition is invoked to create market demand for an Islamic alternative. Then, using the methods of financial engineering various contracts are bundled or unbundled using multiple steps depends on the needs of product structure to synthesize the ostensibly forbidden practice. Finally, the Islamic brand name for the synthetic alternative is established by using Arabic names for the products and contracts that are marketed. See Mahmoud A. El-Gamal, "Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering", *Wisconsin International Law Journal*, vol. 25, no. 4 (2008), p. 605.

hands, and no payments are made to the supplier or the first broker or by the second broker or any ultimate purchaser, as only book entries (and brokerage) are at work, and the outcome is the cash received by the costumer from the bank. The paperwork is irrelevant to the intention of the parties.[16]

Habil, however, reminds that when *ḥīla* dominates the legal scene in Islamic finance product structuring, this will become an alarming sign of a juridical predicament. This is also a symptom of intellectual incoherence, simplistic reasoning, and preoccupation with the form oat the cost of substance. In addition to that, once the *ḥīla* box is opened, there is no guarantee that only lawful *ḥīla* will be employed, as all types evasive devices can gradually creep into the system until the benign of *ḥīla* is hardly distinguishable from the destructive one.[17]

C. Innovations in Islamic Finance: Some Expectations

Replication of conventional finance's structure in Islamic legal form while receiving wide attention among the Islamic finance practitioners and currently dominating the scene of Islamic finance development, also received wide attention on its novelty, genuineness and Islamicity.[18] There is also a growing concern and consciousness in the society as well as among the scholars and practitioners whether the replication approach would ensure sustainability of Islamic finance that would truly reflect Islamic spirit, values and objectives in financial activities.[19]

The costumers are expecting more than just formalistic differentiation of Islamic finance to the conventional finance. A more fundamental and substantial differentiation in value orientation and real economic contribution to the public is expected. Above all, there is an expectation that Islamic finance could be an alternative financial system

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[16] Abdurrahman Habil, "Authenticity of Islamic Finance in Light of the Principle of Daman", in *Islamic Finance: Innovation and Authenticity*, ed. by Syed Nazim Ali (Cambridge, Massachusetts: Harvard Law School, ILSP, Islamic Finance Project, 2010), pp. 94–6.

[17] *Ibid.*, p. 94.

[18] See for example *Ibid.*, pp. 94–6; Abozaid, "Contemporary Islamic Financing Modes".

[19] Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge [UK]: Cambridge University Press, 2006).

that would replace the Capitalist financial system for an everlasting crisis that has been created in the system.[20]

Innovations in Islamic finance, therefore, should be directed to realize those aspirations. Innovations should be understood as ability of offering a new perspective, framework and product, instead of a mere creativity in replicating the existing conventional products in Islamic form. In other word, innovations are expected in producing Islamic financial products that would not only distinct from the conventional financial products in legal status, but also would reflect Islamic values in financial practices, bring benefits to society in achieving the goals of having an economic justice, minimizing inequality and lead to real prosperity.

1. *The Integration of Economic Substance and Legal Form in Islamic Finance Products*

One of the critics in replication approach in developing Islamic finance is the incoherence of the substance and form in Islamic financial products. The changes in forms of conventional products in Islamic forms using certain Shariah contracts bring the problem of incoherence (if not conflict) between the substance of Islamic law and the structural form of the product. Anwar, for example, argues that although the Islamic banks have successfully replaced the practice of interest with other modes like *bay*' *al-murabaḥ*, *bay*' *bi thaman ajil*, *bay*' *al-'inah* and *bay*' *al-tawarruq*, doubts regarding their Islamicity in a wider meaning persist.[21] This is because there are no substantial changes in financial practices and its objectives. In the real economic sector perspective, Islamic banks in those contracts are not actually interested in real sale as the contract would require, but the intention is to find ways and means to charge for the time value of money, like interest, they pose as traders by engaging in fictitious purchases, adding a profit component to the purchase price to arrive at a selling price of the purchased item, and then sell the item to the customer for deferred payment, treating the selling price as credit (loan) due.

There is incoherence in those products between the form (sale

[20] Furqani, *Islamic Economics*, p. 2.

[21] Muhammad Anwar, *Islamicity of Banking and Modes of Islamic Banking* (Kuala Lumpur: International Islamic University Malaysia Press, 2002), pp. 1–9.

transaction) and substance (i.e., to acquire ownership). This incoherence leads to confusion, conflict and dispute among the customers and Islamic banking. Some cases have raised and being brought to the court to be settled.

Moving forward, the incoherence of substance and form of Islamic law in financial products should be reduced. It should be noted that Islamic critics to conventional finance are not only in terms of structure or forms using *ribāwi* transactions mechanism, in fact, but it is also more than that. Islamic finance also criticises the functions as well as objective of the system. Therefore, the changes that are expected to be done are not only structural changes, but also a more fundamental of substantial and systemic changes.

2. *Genuine Debt-Based Transaction Framework*

Islamic law does not allow the creation of debt through direct lending and borrowing with interest. It rather facilitates the creation of debt through the sale or lease of real assets through sale and lease-based modes of financing (*bay' al-murābaḥa, bay' al-salam, bay' al-istisna', ijāra* and *sukuk*). Such transactions are needed in society to enable individual or firm to buy the real goods and services needed in line with the ability to make payment later.[22]

However, the replication approach has triggered to the emergence and domination of *bay' al-murābaḥa* with *bay' al-'inah* and *bay' al-tawarruq* arrangement to replace the interest based debt transaction. Such debt-based sale transactions, although might not be using interest in its arrangement, the trading of real assets is also never intended by both financiers and costumers. Instead what is intended is to get cash by being indebtedness. The legitimacy of such transaction is being questioned in term of its substance and purpose. It brings similar economic effect to conventional interest debt based in the sense that no connection to real economic activities has been contributing. It facilitates money to be grown out of money using the trick of debt based sale and hence the disconnection of the real market, and financial market problem is

[22] Mohammad Hashim Kamali, "Ethics and Finance: Perspective of the Shariah and Its Higher Objectives (Maqasid)", *Islam and Civilisational Renewal (ICR)*, vol. 3, no. 4 (2012), p. 629.

unable to be solved.[23]

Kamali in this regard notes that in Islamic law, debt based sale has been allowed with certain provisions to prevent unlimited expansion of debt in society and to ensure debt is tied to a certain real underlying asset. Some of those provisions are:

- The asset that is being sold or leased must be real, and not fictitious or notional;
- The seller must own and possess the goods being sold or leased;
- The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
- The debt cannot be sold, and thus the risk associated with it cannot be transferred to someone else. It must be borne by the creditor himself.[24]

However, through fictitious debt-based sale as in *bay al-'inah* and *bay' al-tawarruq*, millions of debt has been created using similar assets that have been transferred various times among the financiers and costumers without taking ownership and just in book arrangement. While the real underlying assets are there, but the impact of goods circulations in real economy is questionable. Therefore, such practice has been criticised for its novelty and authenticity that would make present Islamic banking and finance is considered as still unable to release itself from the dominant paradigm of debt-based finance *ala* capitalism. Therefore, innovations in this area is very much awaited in order to clearly demonstrate how is debt based sale arrangement can be do done in a genuine Islamic spirit and form.

3. Socio-Economic Agenda

Unlike conventional financial system, profit maximisation is not the sole objective of an Islamic financial institution. Enlightened by the objectives of shariah (*maqāṣid al-sharī'a*), Islamic finance brings a vision of realizing benefits (*maṣlaḥa*) and preventing harms (*mafsada*) in individuals

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[23] Mohammad Nejatullah Siddiqi, "Current Financial Crisis and Islamic Economics", in *Issues in the International Financial Crisis from an Islamic Perspective*, ed. by Rafic Yunus Al-Masri et al. (Jeddah: Scientific Publishing Center King Abdulaziz University, 2009), pp. 2–9.

[24] Kamali, "Ethics and Finance", p. 629.

and society's life.[25]

Private gain is not done at the expense of social cost. In fact, many industry observers and proponents of Islamic banking and finance argue that it must have gone beyond private objective of profit making as in Capitalist financial system by having distinct socio-economic objectives. The society also expects Islamic finance's contribution to social responsibility and commitment to the communities it attempts to serve.[26]

Islamic finance is expected to broaden and deepen the financial market by reaching out the marginalised segment of society. Financial exclusion can be solved if the financial institutions consider the poor and the weak in society as potential partners to grow and develop together. In a debt-based system, this segment of society will always be marginalized due to the reason of high risk of default as they have no collateral and weak ability to settle the debt. Innovations in Islamic finance are expected to bring new hope to this segment of society to nurture, empower and grow together.

Furthermore, risk-sharing financing instruments for small and medium enterprises and micro-insurance can be offered to solve the problem of the availability of credit, mobilisation of savings, insurance and risk management of the marginal segments of society.[27] Islamic finance should be concerned with this sector, not only because the private sector or conventional finance may not be willing to provide financing to some areas because of the high cost associated with credit assessment, credit monitoring and because of the lack of acceptable collateral, but because it is an approach to eradicating poverty, to build a healthy and vibrant economy and as a mean to circulate wealth smoothly among a number of different groups in the society as emphasized in the Qur'an "…*so that wealth is not circulated among the rich in the society only*" (Qur'an, 59: 7).

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[25] Mohamad Akram Laldin and Hafas Furqani, *The Objective of the Shari'ah in Islamic Finance: Identifying the Ends (Maqasid) and the Means (Wasa'il)*, ISRA Research Paper, no. 32 (Malaysia: ISRA, 2012), p. 12.

[26] Dar, "Islamic Financial Innovation", p. 17.

[27] Mahmoud Mohieldin et al., "The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries", *Islamic Economic Studies*, vol. 20, no. 2 (2012), pp. 55–120.

4. *Paradigm Shift in Financial System*

Islamic finance is also expected to develop and work within its own paradigm of how a financial system should be working. A shift of paradigm from the dominant paradigm of capitalism is expected. Replication approach has been claimed as not favorable in the shifting paradigm as Islamic finance is still working the paradigm of Capitalism.

Islamic finance, for example, while prohibiting interest in debt transaction and changing the transactional framework through contract modification, is still working within debt-based paradigm of risk transfer *ala* conventional financial system.

This strategy for Islamic finance development has led many to view it as part of the mainstream conventional system that is reluctant to go deeper to provide a breakthrough on how a just and fair financial system could operate and offering a new paradigm in financial dealings, especially in debt arrangement.

The society is expecting a new paradigm in financial dealings. Conventional finance paradigm is structured to systematically transfer wealth from poor people to rich people and from poor countries to rich countries. It is also unstable, having fragile foundations that lead to bubble growth and a steady stream of attendant crises. In this regard, Robertson articulated these concerns:[28]

> "People are increasingly experiencing the workings of the money, banking and financial system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control."

The concern, in this regard, is not merely to secure the narrow legal compliance of debt based transaction in banking and finance practices, but a more substantive movement toward a good financial system enshrining Islamic values and principles whereby debt based transactions are done in the spirit as we have highlighted in the previous section.

There is also a call to change the paradigm from 'risk-transfer' into 'risk-sharing' model. Risk sharing concept is applied in exchange transaction (*'uqūd al-mu'awadat*) as well as partnership contract (*'uqūd al-ishtirāk*). In exchange contract, risk-sharing principle argues that each party in the contract would bear their own risk. The seller would bear

[28] James Robertson, *Transforming Economic Life: A Millennial Challenge* (Devon: Green Books, 1998), p. 54.

the market risk of his products and buyer would bear the credit risk to settle the price to get ownership of the asset. Both parties cannot transfer the risk to the other parties that would not justify the price (profit) for seller or ownership for buyer. Risk sharing in the partnership contract argues both parties to joint partnership over certain business or certain asset whereby both parties would bear the risk in accordance with the contribution and share the loss and profit accordingly.

Shamsad Akhtar opines that this *risk sharing* features are the comparative advantage of Islamic finance as opposed to interest-based modalities in conventional finance. Islamic finance industry is expected to exploit more deeply and substantively the modalities that promote risk sharing principle and offer better risk-sharing arrangements between financial institutions and costumers.[29]

Nevertheless, this would require change of mindset from the customers as well as financial institutions. In addition to that, it has to be recognized that this would require further enhancing the Islamic finance legal, regulatory and supervisory frameworks. It would also require instituting proper governance standards for risk sharing modalities provide adequate safeguards for investment account holders.[30]

D. Correct Meaning of Shariah Compliance

The ambition to replicate all conventional finance structures in Islamic form has created a paradigm of Shariah compliance. Shariah compliance paradigm is considered as the sole business of Islamic finance enterprise that would ensure the development and direction of the industry are on the right track as desired by shariah.

While we might agree with this goal, what does it means by 'shari'a compliance' itself should be correctly understood at the first place by the participants in Islamic finance industry. A narrow meaning of Shariah compliance by legalistic approach of ensuring product structure in Islamic finance follows the mechanism of Islamic law is not adequate. The meaning of Shariah compliance should be broadened to include spirit brought by Islamic law and its objectives (*maqāṣid al-Shari'a*).

In other word, this concern for legal compliance in form and

[29] Akhtar, "Islamic Finance: Authenticity and Innovation", p. 2.
[30] *Ibid.*

structure of Shariah should not be at the expense of asking more fundamental questions concerning the purpose of banking and finance, the place of finance in real economic activities and the bigger aims it should seek to fulfil in the realm of ethics, morality and social dimensions.

The shariah compliance in Islamic finance does not mean a mere satisfaction of the minimum legal requirement of Islamic jurisprudence. Instead, shariah compliance means to structure and orient Islamic finance in the Islamic spirit and value system and achieve the ideals and purpose of Islam in the financial sphere.[31]

For a meaningful development of Islamic finance, there is a challenge in the next stage of Islamic finance development to have shariah compliant proposition to be more genuine (i.e., truly reflect the shariah principles), solid (truly based on the shariah requirements) and comprehensive (truly reflect the objectives of shariah). In the next stage, innovations in Islamic finance are expected to answer those challenges. With an extended meaning of shariah compliance, a broader interpretation of product development and comprehensive agenda in developing Islamic financial system should be attempted.

E. Developing a Solid Financial System

Innovations in Islamic finance are an effort to develop a solid Islamic financial system. To replicate all conventional products in a Shariah compliant form is not the ultimate objective in this endeavour, instead, the aim is to come up with various instruments and products that would assist in the development of an Islamic financial system that would serve humanity in a better way.

This ambition is very much awaited by the people of the world. The recent 2008 financial and economic crisis opened the eyes of the people of the world to the foundational fragility of the current financial system and the hollowness of its promises of progress. Economic crises, inflation, depression, and unemployment are inseparable companions of the promises of wealth, growth and profit in the capitalist financial system. It has also been widely realized that the crisis is not the outcome

[31] Mohamad Akram Laldin and Hafas Furqani, "The Future of Islamic Finance: A Reflection Based on Maqāṣid al-Sharīah", *TAFHIM: IKIM Journal of Islam and the Contemporary World*, vol. 6 (2013), p. 52.

of some sudden and unexpected shock; rather, the crisis has been building since the Great Depression of 1929. George Soros in this regard observes that the crisis "was generated by the financial system itself".[32] Paul Krugman also admits that the current crisis has been due to the profession's blindness to the very possibility of catastrophic failures in a market economy.[33] Mainstream economists not only failed to foresee the crisis, but they are also blamed for helping to create it by allowing robust financial engineering techniques to create sophisticated but fragile instruments (derivatives) for leveraging credit and managing risk in the name of increasing potential profit.[34] To solve these systemic errors and, hence, systemic crisis we need a new philosophy to manage the financial system. The calls for a new financial system that is more stable and shock-absorbing, that promotes development and social justice and can overcome the inherent stability of the modern financial system cannot, therefore, be dismissed as idle daydreaming.[35]

People throughout the world became curious about the Islamic financial system because it seemed to offer an operating alternative to the failed system, one that could prevent and solve economic crises. The expectation is high of a new approach providing a moral alternative to conventional financial service as part of a complete system of finance. Willem Buiter in *The Financial Times* expresses it thus:[36]

What we need is the application of Islamic finance principles, in particular, a strong preference for profit-loss and risk-sharing arrangements and a rejection of *ribā* or interest-bearing debt instruments. I am not talking here about the sham shariah-compliant instruments that flooded the market in the decade before the crisis; these were window-dressing, pseudo-Islamic financial instruments that were mathematically equivalent to conventional debt and mortgage contracts, but met the

[32] George Soros, "The Crisis and What to do about It", *Real-World Economics Review*, no. 48 (2008), p. 312.

[33] Paul Krugman, "How Did Economists Get It So Wrong?", *The New York Times* (2 Sep 2009).

[34] Alan Kirman, "Economic Theory and the Crisis", *Real-World Economics Review*, no. 51 (2009), pp. 80–3.

[35] Furqani, *Islamic Economics*, p. 10.

[36] Willem Buiter, "Islamic Finance Principles to Restore Policy Effectiveness", *Financial Times* (22 Jul 2009).

letter if not the spirit of shariah law, in the view of some tame, pliable and quite possibly corrupt shariah scholars. I am talking about financial innovations that replace debt-type instruments with true profit-loss and risk-sharing arrangement.

This hope should not be undermined, especially in the state of the world in crisis and the uncertain proposals for solving it, the presence of Islamic finance is more felt and expected. The value propositions of Islamic finance that seems to offer solutions to financial practices that would put break on exotic structure instruments that have no real benefit to the public; bridge finance and real economy and commercial activities; and put high commitment to the triumph of ethics and morality in financial transactions, have attracted wide audiences to Islamic finance. There are a general hope and belief that Islamic finance can offer a coherent perspective for understanding real financial problems as well as a genuine alternative to the very foundations of how finance should be managed to actualise human prosperity.

Islamic banking and finance's emergence as a practical financial system is viewed as timely in the midst of a world financial crisis and uncertain solutions to solve the crisis. Although the phenomenon might be seen by some as part of the global Islamic resurgence to reconstruct Islam's legacy in modern times, the interest in its practice is triggered by the philosophy and system of value it offers. It is expected that Islamic banking and finance can offer a coherent perspective for understanding real economic problems as well as a genuine alternative to the very foundations of how economics and finance should be managed for human prosperity.[37]

Moving forward, innovations in Islamic finance would adopt a 'systemic approach' with the aim of establishing a new system of finance that would not only address the legal issues of financial practices, but also address the shortcomings of the mainstream financial system and more importantly would attempt to manifest the Islamic worldview or, more specifically, the Islamic economic vision in the financial sphere in order to achieve Islam's economic objectives.

[37] Furqani, *Islamic Economics*, p. 4.

F. Concluding Remarks

Islamic finance, being a new perspective in understanding finance and an alternative to the capitalist financial system is expected to offer something new in financial dealings. The expectation is not merely in offering financial products that are shariah compliant by using conventional structure, but also in the ability to provide financial products that are distinct coming up from Islamic teachings, worldview and principles. We also want innovations in Islamic finance to continue to develop products and services that will benefit society and drive economic development. Islamic finance is, considered by many, as having potential to offer solutions and be a solid financial system if the participants of the industry are willing and put their effort to produce a new approach and framework in developing Islamic finance that could be 'alternative' and not 'replicative' to conventional finance.

Innovations in Islamic finance, in the next stage, would, therefore, be directed to answer those challenges. However, to achieve that ambition, we have to create a safer environment whereby financial innovations are not only welcomed, but also supported in order to continue to flourish. This would include strong human capital, supportive legal and regulatory framework and committed participants in Islamic finance enterprise. Therefore, continuous dialogue among stakeholders – financial sector businesses, regulators, industry bodies, scholars, consumers and non-financial institutions should be done.

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