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Islamic financial product innovation

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Abstract

Purpose – The purpose of this paper is to study the financial product innovativeness of Islamic financial institutions.

Design/methodology/approach – A qualitative research methodology is used to collect and analyze the views of practitioners and researchers of Islamic finance. Different assessments are noted which raise the issue of lack of clarity on that subject.

Findings – Innovation levels of Islamic financial institutions are low owing to the development of Islamic finance as a new activity.

Research limitations/implications – The data available for the study are limited to the views of a small sample of practitioners and researchers in the field of Islamic finance.

Practical implications – The major practical implication is the necessity of developing financial product innovativeness programs as a means for survival and growth.

Originality/value – The paper demonstrates the value of Islamic financial product innovation within the wider context of product innovation.

Keywords Islam, Finance, Product innovation, Securities, Governance

Paper type Research paper

1. Introduction and literature review

The Islamic finance industry is a relatively new entrant to the world of finance because its operating principles differ from the conventional finance xmodes of operation traditionally practiced in the West. It operates in compliance with Islamic Sharia. This raises the need for developing appropriate financial instruments and services for that industry. The major challenge facing the industry is the preservation of its excellence in providing services, expanding the scope of its financial activities, and exploiting in a beneficial way the developments in the financial markets.

Islamic financial institutions can attain competitive advantage through a process of strategic innovation, which amongst other factors, requires the development of at least some new knowledge and capabilities (Katila and Ahuja, 2002), and have high potential for revenue growth (Govindarajan and Trimble, 2005). New ideas must be implemented and delivered to customers to create commercial value (Lyons *et al.*, 2007).

Several developments resulting from globalization, transparency, and capital movements were noted to have a major impact on the Islamic financial services industry, and present it with major challenges. The major challenge is developing products in compliance with Sharia. Since Islamic finance is a new activity, it is imperative that products and services are developed on a continuous basis. This focuses on the quality and diversity of products and services provided by Islamic financial institutions, and the major challenges that they face in that regard.

However, the question arises as to the product innovativeness of Islamic financial institutions.

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1.1 Islamic and conventional financial products

Given the growth in demand for Islamic banking services and products amongst bank customers, there is a growing debate and differing viewpoints about their nature, and the extent to which they are different from products provided by conventional financial institutions. Some Islamic products are similar to those provided by conventional institutions, but others are different (Table I).

Islamic banks must therefore develop products to achieve the goals of Sharia, and at the same time meet the economic needs of society. Critics of the concept of Islamic finance do not see any difference between Islamic and conventional economics, and if any exists, it is artificial in nature and not substantive in any way (Hafeth, 2006; Al Yasseen, 2007). As a consequence, the majority of customers of Islamic products are convinced that Islamic products are similar to any other bank products, and hence, separating Islamic from non-Islamic operations would be unrealistic. It is noted that there is a widespread use of securitization (*tawreeq*), "fictitious" Morabaha deals, and certain "fabricated" Sukuk, provided by some financial institutions as Islamic banking products and services. The reason for the prevalence of these practices is the engagement of conventional or *rabawiyya* banks in providing Islamic products in a way that does not distinguish between Islamic and conventional financial operations, and the control systems applied to it (Hafeth, 2006).

The problem of specifying clearly what an Islamic product stands for is compounded by the interpretation by religious scholars (*Olamas*) of Sharia, and hence unclear rulings (*Fatwas*), and the resultant divergence from the consensus of Islamic scholars (Appendix – Glossary of terms). This can lead to a questioning of Sharia certification and authentication of Islamic banking products. One cannot rule out the presence of a partial or an incomplete similarity between Islamic and conventional products, because it is not a pre-condition that Sharia operations be completely or 100 percent different from conventional products. However, there is a clear difference between these products in form and substance, and in the resultant outcomes.

Issuer	Country	Issue size (million $)
Lagoon City Sukuk (corporate)	Kuwait	200
Government of Bahrain-BMA Issue No. 7	Bahrain	250
Commercial Real Estate Sukuk (corporate)	Kuwait	100
DIB Sukuk Company	United Arab Emirates	750
Sukuk Brunei Inc.	Brunei	77
Sharjah Electricity and Water Authority Sukuk	United Arab Emirates	350
ADIB Sukuk	United Arab Emirates	800
SABIC Sukuk (corporate)	Saudi Arabia	800
Sanctuary Building Sukuk	United Kingdom	261
Islamic Development Bank	International	500
Dubai Global Sukuk FZCO (government)	United Arab Emirates	1,000
Stichting Sachsen Anhalt Trust (government)	Germany	120
Saxony-Anhalt State Properties	Germany	120
Malaysia Global Sukuk (government)	Malaysia	600
Total of Sukuk 84		16,981.91

Source: Liquidity Management Center, available at: www.lbcbahrain.com (accessed April 5, 2007)

Table I.
Sukuk issues

The unclarity or confusion over what is Islamic and what is not, is due to the practice by some banks of engaging in what they consider to be Islamic operations, when in actual fact, they are not Islamic. They are a form of circumventing dealing in interest or *riba*, called by Islamic scholars *rabawiyya* tricks. Such products are closer to conventional products and are different from Islamic dealings that have been considered in compliance with Sharia by Islamic scholars. Hence, some current operations that are provided as Islamic in nature can be considered non-Islamic and are closer to conventional products. Changing the names or titles or designations for such products does not alter the distinguishing nature and element of what is Islamic and what is not (Hafeth, 2006; Middle East Economic Digest, 2007; International Financial Law Review, 2004).

This can result in the provision of banking services and products that are not Islamic in substance, where there is a true and genuine need to Islamize these operations. Such operations result in confusion for the customer of Islamic financial products, which will ultimately lead to the avoidance of Islamic products in a final form, if such operations continue to be practiced in the future.

What are considered to be the most successful Islamic banking operations are short-term products, which differ from long-term ones. Most of these products are considered partly Islamic because they do not meet the requirements for being Islamic in full form. The reason for such a situation is that Islamic banks operate in a dual banking system which is practiced in existing economic systems. Thus, they experience what can be considered conditions that are not natural, or are alien to their mode of operation and functioning, which results in structural imperfections. This situation will limit their professional achievements and does not result in products that are well developed. This unusual or negative situation is not accommodated fully by the legal system because it does not give adequate recognition to Islamic financial operations. This situation directs some Islamic scholars to approve what they consider to be Islamic operations, while they are in fact very similar in form and substance to conventional or *rabawiyya* operations.

The outcome is a blurring of the distinction or difference between Islamic and conventional financial products as far as bank customers are concerned. In addition, conventional banks are taking the lead in providing Islamic banking operations, and promoting them in a manner that does not distinguish between them and conventional ones, this being done to serve their interests. Given the acceptance of the coexistence of the Islamic and conventional or *rabawiyya* systems in the finance field, some Islamic economists suggest that conventional banks must not be allowed to provide Islamic products in order to prevent the elimination of the distinct nature of Islamic financial products (Al Alaywi, 2006; Tomlinson, 2007).

1.2 Need for funds

The Islamic finance industry initially started its operations in the form of Islamic banks in the 1970s and 1980s, when it had access to large pools of capital. At that time, it did not see the need for developing financial instruments to attract funds, and it managed instruments that were considered adequate and profitable. But in the 1990s, a large number of non-bank financial institutions were established in Kuwait, and resulted in strong competition for funds.The outcome facing Islamic financial institutions was the necessity to borrow funds from a limited capital supply base.

1.3 Investment projects

Islamic finance institutions have unique characteristics, especially from the intellectual aspects and in the method of dealing with society's problems and hopes. Investment projects are considered a way of life, and a means to develop society's capabilities, maximize production, and achieve development plans. This is shown in the variety and diversity of the forms of transactions employed in the various products and services provided by Islamic institutions (Ameen, 2005; Hamwi and Aylward, 1999; Zaher and Hassan, 2001). Islamic finance provides the basic building blocks that can be used to construct more complex instruments, thereby enhancing liquidity and offering risk management tools. Some examples include asset securitization and swap transactions that conform to Islamic principles. Innovation is considered significant in the Islamic financial industry. The Islamic finance industry can develop financial instruments for low-cost funding, which shows the capabilities of these institutions to develop and innovate (Iqbal, 1999; El-Gamal, 2006; Chiu and Newberger, 2005, 2006; Martin, 2006).

1.4 Islamic investment funds and securities

In recent years, Islamic investment funds have prospered in the Gulf countries and Malaysia. Among the different categories are equity funds, real estate and property funds, Morabaha funds, commodity funds, and leasing funds. A range of Islamic instruments is also in use in several countries for financing specific government projects and for the procurement of goods and services. Launching Islamic funds may well be an effective way to compete with foreign and domestic conventional banks (Hassoune, 2004).

The Islamic debt market – both foreign and domestic – has been the most rapidly growing segment of Islamic finance. In Malaysia, for example, Islamic securities accounted for 42 percent of total outstanding private debt securities by the end of 2004, and Islamic securities accounted for 25 percent of total outstanding bonds (El Qorchi, 2005).

2. Islamic finance products

2.1 Successful products

Islamic banks were mostly successful in promoting the importance of applying Sharia principles in the economic and financial spheres. Islamic banks provided fully Islamic financial products such as *Modaraba*, *Istisna*, and *Morabaha* which are in full compliance with Sharia principles and guidelines. However, they failed in other products, such as in certain forms of *Mosharaka* that are based on trust (*Amana*), because it is difficult to accomplish it in practice. Also, the absence of the method or tool to ascertain its presence, a fact which makes it difficult for Islamic banks to expand in providing it (Al Alaywi, 2006).

2.2 Innovations in financial instruments

Several financial instruments have been developed and are considered innovations in Islamic finance. Commerce International Merchant Bankers Berhad Islamic's Islamic profit rate swap, a Sharia-compliant version of an interest rate swap, is considered an innovation in Islamic finance. It is not derived from the trading of exchange of interest rates but rather, from the trading of real assets (Euromoney, 2006).

2.3 Sukuk: a development tool

Another development in the area of Islamic financial instruments is a new form of debt; Islamic Sukuk, in their diversity and capability to provide funds. These are Islamic bonds that act like regular bonds but comply with the rules of Sharia. Their risks are similar to those of bonds; they rely on the financial soundness of the issuer. Sukuk are Islamic investment certificates, where each holder owns an undivided beneficial ownership interest in the underlying assets. Consequently, Sukuk holders are entitled to share in the revenues generated by these assets, as well as being entitled to share in the proceeds of their realization. They can be considered a development tool and not a financial instrument (Box, 2005; IMF, 2006).

Sukuk can be considered an ideal solution to the limited availability of Islamic finance instruments in local markets, where there is a concentration on *Ijara*, *Morabaha*, and *Wakala* investment, in addition to securitization, which is considered controversial by religious figures. Islamic Sukuk can be an ideal solution in developing an integrated market of financial instruments of various risk levels to meet the needs of the investors. Islamic Sukuk will enhance the ability of the markets to grow, because its growth will not depend on the size of the institution and its ability to borrow, but on its ability to issue Sukuk resulting from securitizing assets. Permitting institutions to issue Sukuk will improve their financial returns, growth prospects, and spread the risks resulting from the institutions borrowing from a larger number of investors: those that issue Sukuk, and not to let it be borne by banks. In other words, it will improve the credit rating of the institutions that issue the Sukuk and the banks that finance it.

Islamic banks issue Sukuk as a mechanism to mobilize savings, and their issuance can be diversified and expanded to benefit from the opportunities existing for these financial market instruments. However, the growth in the Sukuk instruments will only be accomplished when liquidity is provided to its bearers. The Sukuks will bolster the activities of Islamic banks, as it is considered an acceptable instrument from the Sharia standpoint for investing liquid funds, achieving returns, and lowering risk.

Using Sukuk as a financial instrument of various capabilities is suitable for a wide variety of economic performance aspects on an international scale. Some of Sukuks' main advantages are to increase the capital available to develop major economic projects, to control liquidity, to use funds in an optimum manner, and to increase the size of capital markets for investors (Box, 2005; Al Manea, 2006; Al Miraj, 2006; Al Musallam, 2006). Several indices were developed to measure their performance in the financial marketplace. The Dow Jones Islamic Market Index and the Dow Jones Citigroup Sukuk Index measure the performance of Sukuk. In Kuwait, the Al Madar Finance Company developed a Sharia-Compatible Index-Series; a series of 12 Sharia-compliant indexes for the Kuwait equity market.

2.4 Islamic capital markets

The emergence of the Islamic capital markets has its roots in the Malaysian government's inaugural Sukuk issue in 2002. Since 2002, the market has grown exponentially and the size of this market is estimated at about $8 billion. Another estimates it at $15 billion globally (Al Manea, 2006; Box, 2005; Al Bahar, 2005; Hassanein, 2005; El Qorchi, 2005). The Sukuk market was originally the domain of sovereign issues. The governments of Malaysia, Qatar, Pakistan, Bahrain and the

German State of Saxony-Anhalt (the first non-Islamic Sukuk issuer) have tapped this market. More recently, a number of corporates in the Gulf Cooperation Council have begun to tap the Sukuk market (see Table I – Sukuk issues). As the financial infrastructure and education in the region increases and the pool of assets that are suitable for securitization develops, such as consumer finance assets, market participants are looking to structure non-collateralized, non-recourse, Shariah-compliant securitization transactions (Box, 2005). Sukuk have added value through establishing a new and vibrant secondary market, providing long-term sources of funds, lessening the burden of managing liquid assets, and generating more attractive returns than bank deposits, and making it possible to use it as a mortgage when needed. Sukuk can meet the financial requirements and needs of projects planned in the Gulf region in the next five years, at a size of $1 trillion, with current financing at $800 billion. Kuwait Finance House participated as a lead manager and participant in several Sukuk issues amounting to $2.8 billion in large projects in Kuwait, the region and the whole world.

Several Sukuk issues were made in many parts of the world (Ameen, 2005; Zawya, 2005; Liquidity Management Center, 2008; Al Bahar, 2006; Lane, 2006; Box, 2005).

2.5 An Islamic pension fund

Another financial service innovation was introduced by HSBC, which became the first UK bank to offer a pension fund that is in compliance with the requirements of Sharia. The HSBC Life Amanah Pension Fund is the latest addition to a portfolio of products offered by HSBC Amanah Finance, the Group's global Islamic financial services division, which was established in 1998 to provide Islamic alternatives to conventional banking (HSBC, 2004).

2.6 Securitization

Financial innovation has changed the business of banking. The most noticeable trend is the trend in the loan-making process is the movement toward securitization and fee-based activities (Kwan, 2001). Securitization (*Tawreeq*) is a financing method adapted to comply with Islamic law. Bankers, lawyers, and regulators are now investing considerable resources in the development of the Islamic capital markets.

Particular focus is on the area where most market participants believe the next stage of development to be the development of the Islamic securitization market. The securitization market has strong growth potential and is expected to grow at a considerable pace. The purpose of securitization services is to provide companies with a financial service that is off balance sheet at a lower cost than that provided by any other source in the market. This will ultimately lower the burdens on a company's balance sheet. Such a service will result in higher returns, and lower risks resulting from additional guarantees to the investor (Al Tawari, 2006; Box, 2005). An example of securitization opportunities in the Muslim world is in the Saudi Arabian capital market which developed the Caravan I transaction, a Shariah-compliant vehicle finance securitization. Another example is in the UAE where Barclays Bank arranged a securitization issue that was backed by payments under real estate finance arrangements and long-term leases in respect of properties located on one of the Dubai Palm Developments. Other examples in securitization were in Qatar, Indonesia, and Malaysia (International Financial Law Review, 2005; Al Mobarak, 2007).

3. Challenges to Islamic finance product development

3.1 Islamic Sharia: problems and challenges

Despite these innovations and developments in financial instruments, and the growth in demand for such instruments, there are still several major problems, different viewpoints, and challenges facing Islamic financial institutions. The question arises as to the nature of Islamic financial products and the extent to which they are different from products and services provided by conventional banks. A central issue is developing the operations of Islamic banks and financial institutions in compliance with Sharia. Operating according to Sharia is a promising and lucrative area; however, it is not served adequately. In addition, globalization has a great impact on its spread. However, the challenge is to develop products in compliance with Sharia (Al Aloush, 2005). Sharia supervision played a major role in the development of Islamic banks and institutions. Its role is pivotal in establishing banks and institutions and controlling their operations by applying Islamic Sharia, supporting the transformation of traditional banks to Islamic institutions, and giving trust and credibility in the operation of these institutions with their customers. Providing innovative Islamic solutions for the financial problems has as its basis an Islamic foundation, starting from the financial need and developing an appropriate solution to the funding (Boodai, 2006; George, 2005).

3.2 Mature management

There is also the issue of the absence of sound or wise governance (*Al Hokm Al Rasheed*) at any Islamic financial institution. That absence will impact the performance of the industry in a negative manner, and will ultimately make its survival impossible. Good governance occupies the most important place in the Islamic finance industry (Rifaat, 2006). In addition, developing products according to Sharia is burdensome and more difficult than the traditional ones. Development is not an easy task because Sharia committees need time to do their work. The larger financial institutions are advancing in developing Sharia committees. They also have the proper infrastructure, capabilities, experience and resources. All of these factors will permit the growth in developing their products (Al Aloush, 2005; Al Muzaini, 2005).

3.3 Various tendencies

Despite the fact that several countries passed laws pertaining to the Islamic finance industry, there are still organizational challenges facing these institutions owing to the lack of standardized measures. The presence of "various tendencies" of the societies in which these banks operate, makes it imperative to develop unified Sharia criteria and professional competence to maintain the unique position of Islamic banks. Islam is not governed by a monolithic theology; there are four competing centers of Islamic jurisprudence, ruling on what is proper and what is not for Islamic finance. Their opinions can vary widely over such matters as to what constitutes interest (which is forbidden), and what constitutes profit (which is allowed). This can create uncertainty. The lack of uniformity among Islamic institutions as to the interpretation of Sharia on certain issues can hamper the structure of a project finance transaction (De Belder and Ruder, 1999; Martin, 1997; Yasseen, 2005).

3.4 Appropriate financial instruments

One of the most prominent obstacles and problems facing the Islamic financial industry is the inappropriateness of many traditional financial instruments when applying Sharia. For one thing, Islamic banks cannot manage liquidity at hand in ways similar to traditional banks investing in notes or government treasury securities. Also, it has no Sharia alternative in the market and at the right size. The above factors deprive Islamic banks of the financial instruments which the banks can use to manage the maturity gap at the lowest risk possible. Also, Islamic financial services are of a different nature and differ from those provided by traditional institutions, either in transactions or activities that require approval of the Sharia committee. This is the main difference between the operations of traditional and Islamic institutions (Rifaat, 2006).

3.5 Monetary operations

Designing Islamic instruments for monetary operations has proven conceptually difficult. In countries with a dual banking system, the lack of non-interest-bearing securities has limited the scope of monetary management. The liquid nature of a bank's liabilities, related to the predominance of deposits of short-term maturities, predisposes the system to hold substantial liquid assets and excess reserves. This in turn inhibits financial intermediation and market deepening. Islamic financial institutions are not innovative, and the development of financial products is low. There is also the problem of the non-existence of indexes to measure performance. Difficulties in defining rates of return on these instruments have also constrained the development of money and interbank markets (Mishaal, 2006). The markets for Islamic instruments and government securities remain shallow and an organized international Islamic financial market is still nascent. The sector must improve the range and sophistication of asset and liability classes and develop new instruments and financial techniques that would enable Islamic banks to diversify their balance sheets. For any country to be a sophisticated financial services and risk management center, the regulator will need to satisfy an ever-growing appetite for new products (El Qorchi, 2005; Wheatley, 2005; Obaidullah, 2005).

3.6 Risk of rate of return

The risk of rate of return is a problem area facing Islamic financial institutions. The exposure of the balance sheets to the risk of rate of return, calls for Islamic solutions suitable for these instruments. The refusal to sell debt and investment guarantees is one of the major principles of Islamic banking activities. However, selling debt can be considered acceptable on condition that the sale does not result in dealing in interest. The risk of the rate of return can be managed by a variety of instruments in conformance with Sharia, despite the fact that some of these instruments are under study to raise them up to a standard acceptable internationally in the management of the risk of return (Arbuna, 2006).

3.7 Impact of globalization

The impact of the entry of international banks providing Islamic services on Islamic banks in the region, given their limited capital base, is clear and evident. Certain aspects of the entry of international banks into local markets, will be of a limited Islamic nature. This can be a positive situation given that it is ascertained that Sharia is implemented by Fatwa committees. The result will be the provision of highly developed products that are in compliance with Sharia, which in the end will be in the interest of the customer. An outcome will be to direct local Islamic banks to develop further, and to be more disciplined in complying with Sharia (Sowaylem, 2006).

3.8 International banks

International banks treat Islamic financial products from a purely marketing perspective, and provide specifications approved by some Islamic scholars, and markets them in a framework that is in compliance with the legal requirements and conditions to which they are subject. Some international banks were able to compete with Islamic banks for several reasons, one being the latter's small size. The differentiating point for Islamic banks, if they comply fully with Sharia, is in combining both the religious intentions and compliance with Sharia, a condition which cannot be met by conventional banks (Al Yasseen, 2007).

Although the size of Islamic banks is not small to the extent that their survival is threatened, they are able to compete in many ways. However, the entry of international banks in the Islamic finance industry will lead to upgrading the service level and quality of local banks. The entry of foreign banks in the Islamic finance industry has two contrasting aspects. The positive aspect is the diffusion of knowledge on Islamic financing. However, the negative aspect is that these banks, because of their educational background, might not improve the functioning of Islamic finance in an appreciable manner. This will have a negative impact on the development of Islamic products in terms of compliance with Sharia.

The WTO agreements are flexible enough to accommodate both conventional and Islamic systems. Islamic banks will only benefit from these agreements if Islamic banks are determined to maintain their gains by complying with Sharia, otherwise, bank customers will seek the services of international banks. The future competition in banking will be intense, and institutions capable of complying with Sharia, and developing further in banking (Hafeth, 2006).

3.9 Bank interest

The issue of accepting dealing in bank interest (*riba*) is a controversial one. The Sheikh Al Azhar in Egypt made a ruling (*fatwa*) that charging bank interest is not a violation of Sharia. However, such an issue must be decided by a consensus of Islamic scholars, and the consensus is that bank interest is a violation of Sharia. Some scholars at Al Azhar oppose the *Fatwa* from Iran that say that charging bank interest is not a violation of Sharia (Al Alaywi, 2006). The differences between the Islamic scholars on that issue have not been resolved.

4. Towards improving Islamic finance products

4.1 The innovation imperative

Because customer needs and desires, as well as competitive offerings, are constantly changing, institutions face an innovation imperative: the need to innovate continually just to stay even with competition, or even to remain viable (Govindarajan and Trimble, 2005). There is a need to develop a method for developing products and services in the industry since the basis of the Islamic finance industry is characterized by an investment nature, and not on providing credit facilities, or loans, and the existence of a strong connection between rates of return with the production cycle in the economy. A major characteristic of that industry is the connection and matching between sources and uses of funds, and the expanding scope of new services (Hassanein, 2005; Al Saleh, 2006). This means that the firm needs to search perpetually for new improved products, services, and messages with which to target the customer. The company that fails to innovate quickly falls behind (Moore and Pessemier, 1993; Frame and Lawrence, 2004; Shiller, 2006; Baker and Sikula, 2005).

The development of new products and processes is increasingly a focal point of competition. New insurance and financial products provide additional diversification opportunities to individual investors (Calvert *et al.*, 2004). Firms that get to market faster and more efficiently with products that are well matched to the needs and expectations of target customers create significant competitive advantage. However, firms that are slow to market, with products that match neither customer expectations nor the products of their rivals, are destined to see their market position erode and financial performance falter. Speed, efficiency, and quality are three imperatives in the development of new products. Also, the products and processes that a firm introduces must also meet the demand in the market for value, reliability, and distinctive performance (Moore and Pessemier, 2004; Wheelwright and Clark, 1992).

4.2 Growth platforms

Financial innovation is an important phenomenon in any sector of a modern economy (Frame and White, 2004), raises the efficiency of financial intermediation (Chuo, 2007) and will lead to higher levels of competitive ability. There is a need to improve the efficiency and effectiveness of operations, through the better utilization of resources and increasing the size of investments (Munsung and Mehra, 2006; Carlucci and Schiuma, 2006; Subramanian and Youndt, 2005; Bettzuge and Hens, 2001). Changing regulatory requirements or social pressures, create the opportunity to satisfy some unmet or latent customer need. New product development is a necessity because companies grow by creating new growth platforms on which they could build families of products, services, and businesses. Possibilities for forming new growth platforms arise with forces of change (Lauri *et al.*, 2006).

Islamic institutions, particularly in Bahrain, Malaysia, and Sudan, have been gearing up for further expansion by continuing to develop, refine and market innovative financial instruments, on both the asset and liabilities sides. In recent years, many new Islamic financial products have been developed and are increasingly used in financial market activities, including equity and bond trading and investment Islamic insurance and reinsurance (*Takaful*), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products (El Qorchi, 2005).

5. Conclusion

The effective management of a developing financial industry is critical to ensure its future survival and profitability. Increasing competition in the product markets, is becoming the norm for the Islamic banking and finance industry. There is a need to innovate and practice new ideas based on Islamic foundations, and at the same time, that are in harmony with the demands of modern markets. The need to further develop financial products and services in compliance with Islamic Sharia is essential to the survival and growth of the Islamic finance industry. To compete, Islamic banks and financial institutions must continually improve their performance by innovating products and processes, and improve quality.

There are certain issues that require further study. Are conventional banks more or less innovative than Islamic financial institutions? What are the factors that can explain the difference? Why are some Islamic financial institutions more innovative than others in the same field of activity? How can the financial innovativeness of Islamic financial institutions be enhanced?

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Appendix

Glossary of terms

Amanah: Trust, with associated meanings of trustworthiness, faithfulness, and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another's funds or property in trust.

Islamic Banking: Financial services that meet the requirements of Sharia, or Islamic Law.

Olama: Sharia scholar or adviser: An independent professional, usually an Islamic legal scholar, that advises an Islamic bank on the compliance of its products and services with Sharia, or Islamic Law.

Riba: Interest. The legal notion extends beyond just interest, but in simple terms, riba covers any return of money on money. Riba is strictly prohibited in Islam.

Financing techniques

Ijara: Leasing. Similar to the conventional lease, it is a contract under which the financial institution buys and leases out an asset or equipment required by its client for a rental fee.

Istisna'a: In this contract, one party buys the goods and the other party undertakes to manufacture the goods, according to agreed specifications.

Morabaha: (Cost-plus financing). The financial institution agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then resells the assets or goods to its client with a mark-up profit.

Mosharaka (Partnership Financing): Although it is substantially similar to the Mudaraba contract, it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment.

Mudaraba: (Trust Financing). Mudaraba is a form of partnership in which one party provides the capital required for funding a project, while the other party, manages the investment using his expertise. Profits arising from the investment are distributed according to a fixed, pre-determined ratio.

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