

Innovation & Financial Engineering in Islamic Finance

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Introduction: Islamic financial innovation

- The objective of Islamic financial innovation
“Developing new financial products for the Islamic financial services industry, which replicate economic effects of the conventional products in a Shari’a compliant way”
- Objection
“What’s the point of re-inventing the wheel?”
- The process is as important as the end result
“However, it is important that
Haram + Haram ≠ Halal
Haram + Halal ≠ Halal”




Introduction: new trends in Islamic financial innovation

- Revised objective of Islamic financial innovation
“Developing new products and institutional models for Islamic finance so that this must lead to a new financial (and economic) model to replace conventional (interest-based) banking & finance”
- This should mean more involvement of governments and financial authorities
- Malaysia provides an example of leadership role played by the government
- No where else in the Islamic world, we find that kind of governmental support for Islamic finance
- The market will drive this innovation – and I believe it will be the Western financial institutions doing it!




Introduction: new trends in Islamic financial innovation

- Shari’a compliancy is only a necessary condition for the sustainable success of Islamic banking & finance
- A sufficient condition is commitment to social responsibility
“Therefore, objective of Islamic financial innovation should be developing financial structures (products and institutions) that offer distinct social value in addition to being Shari’a compliant.”
- However, it is important not to belittle the recent financial innovation that happened in the Islamic financial services industry



The Biggest Innovation in Islamic Finance in the 21st Century

- The use of promises as a tool for financial product development
- Before this, Wa'ad was a marginal concept in Islamic jurisprudence
- In future, I believe Wa'ad will become mainstream
- Wa'ad, as opposed to contract, should be the base level arrangement



What is Wa'ad?


“Wa'ad is an undertaking by a Party A to do something (W) for another Party B for a price (P) at an agreed time or during a certain time period (T).”

[(A,B), (W), (P,T)]

- All the elements of Wa'ad must fulfill Shari'a requirements
- A unilateral promise is the one, which is given by one party (promisor) to another party (promisee), without receiving another equal and opposite promise from the promisee

If X = [(A,B), (W), (P,T)], then Y will be an equal and opposite promise if:

Y = [(B,A), (W), (P,T)]



What is Wa'ad?

- Equal and opposite promises are known as diagonal promises
 $(X\Delta Y) = \text{Contract}$
- W could be anything Shari'a permissible
- An act of purchase and sell, renting, an act of charity etc.

If


$W_s(O) = \text{act of selling } O$

$W_p(O) = \text{act of purchasing } O$

then


$X = [(A,B), (W_s(O)), (P,T)]$, and

$Y = [(B,A), (W_p(O)), (P,T)]$ would be considered as diagonal $(X\Delta Y)$




Promises are the spring of innovation

- Promises are quasi-contracts – binding on just one party: the promisor
- Sharia issues around promises
 - Distinction between a 'promise' and a 'contract'
 - A 'promise,' in general is not binding and, hence, unenforceable in a court of law; a contract is binding and enforceable
 - A 'promise,' being unenforceable, does not have an economic value
 - It has an economic value only if it is binding
 - Can we write binding 'promises' ?
 - Yes... conditional upon the OIC Fiqh Academy's resolution




Promises

- The OIC Fiqh Academy allows writing binding promises
 - The promise must be unilateral
 - It must have caused the promisee to incur some costs/liabilities
 - If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the concluded sale
 - If the promisor reneges on their promise, the court may force them either to purchase the commodity or pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by the promisee, and must not include the opportunity cost




Promises (1)

- The issue of “unilateralism” in promises
- Case 1:
 - A unilaterally promises to buy a stock x from B at a future date t for a price p
 - Simultaneously, B unilaterally promises to sell a stock x to A at a future date t for a price p
 - The two promises together are in fact a bilateral promise, which in the eyes of Sharia is binding on both parties, and hence is a full contract




Promises (2)

- Case 2:
 - A unilaterally promises to buy a stock x from B at a future date t_1 for a price p
 - Simultaneously, B unilaterally promises to sell a stock x to A at a future date t_2 for a price p
 - The two promises together do not amount to a bilateral promise because they refer to different execution dates




Promises (3)

- Case 3:
 - A unilaterally promises to buy a stock x from B at a future date t for a price p_1
 - Simultaneously, B unilaterally promises to sell a stock x to A at a future date t for a price p_2
 - The two promises together do not amount to a bilateral promise because they refer to two different settlement prices



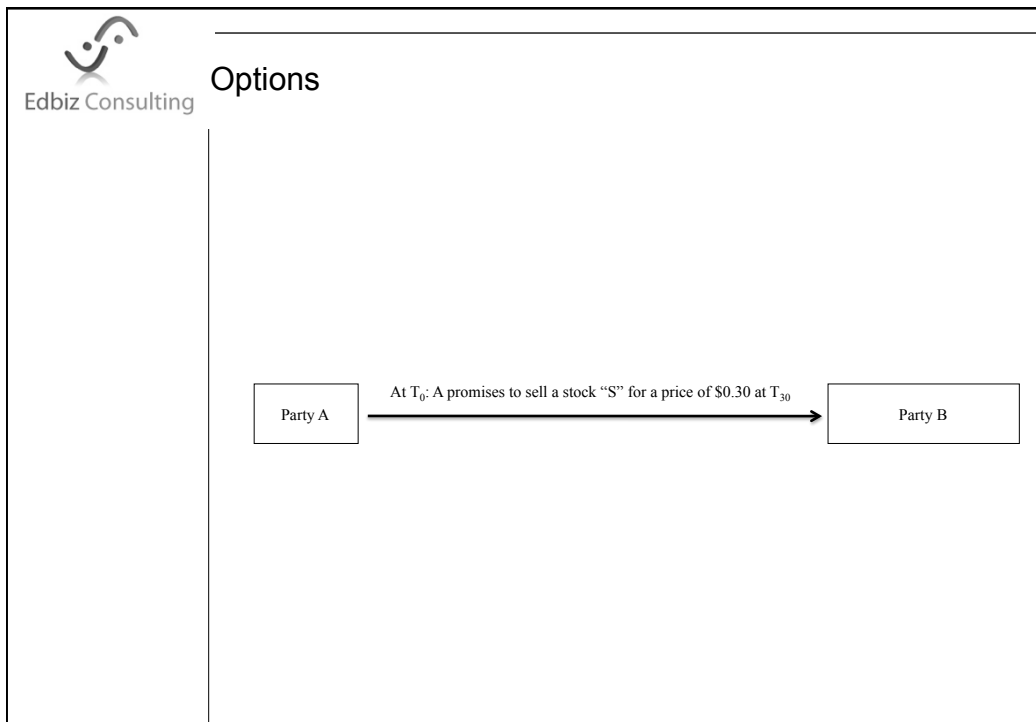
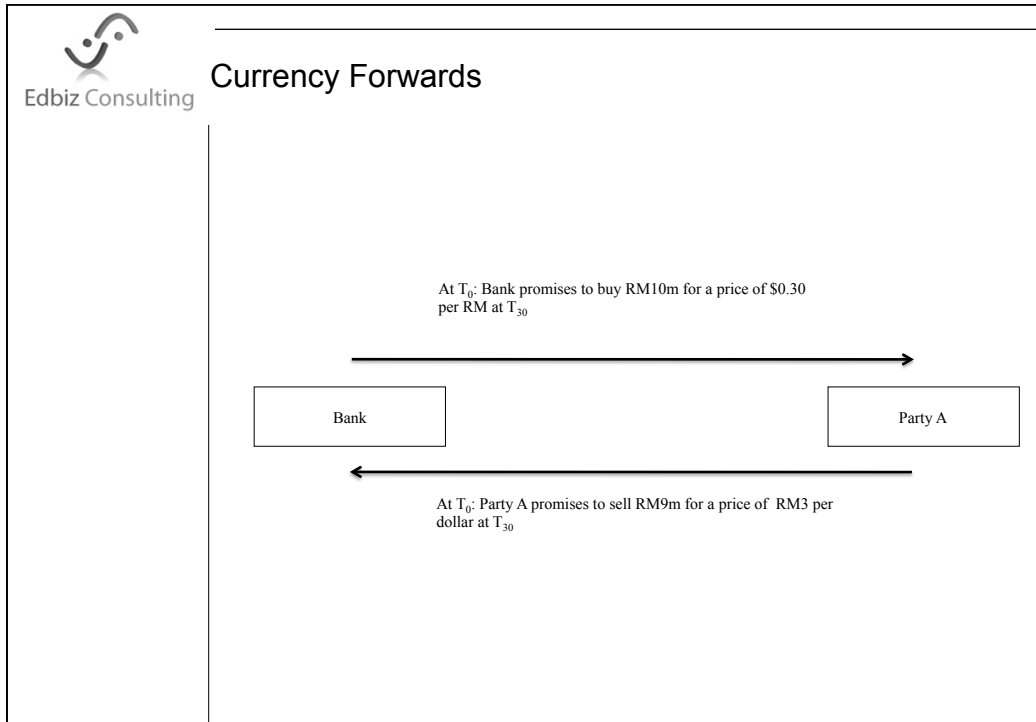
Promises (4)

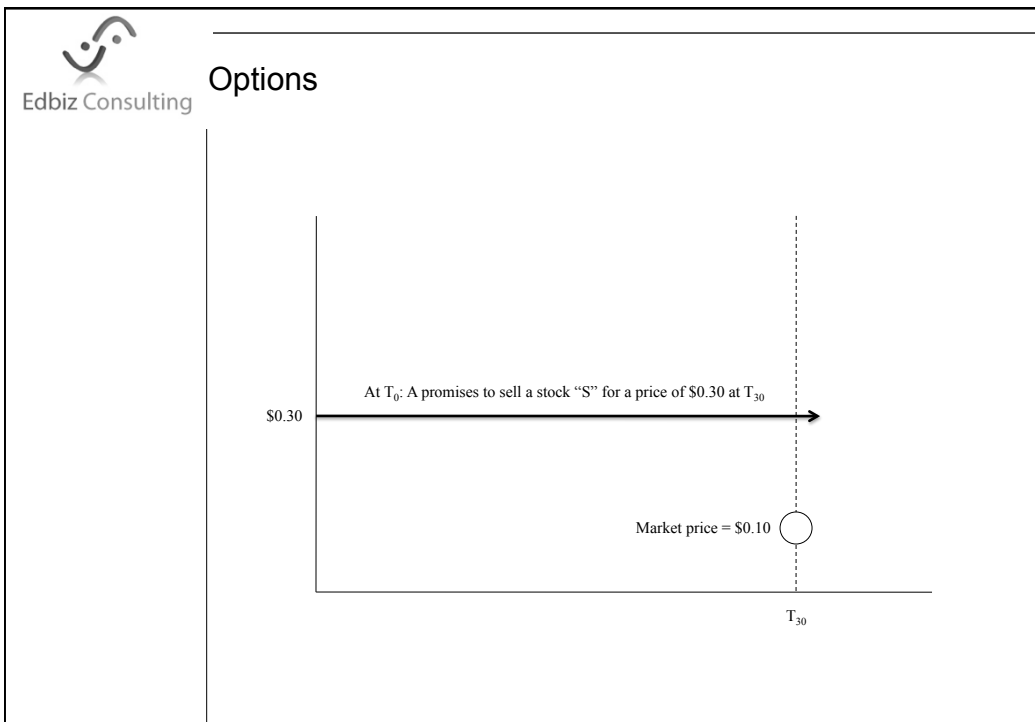
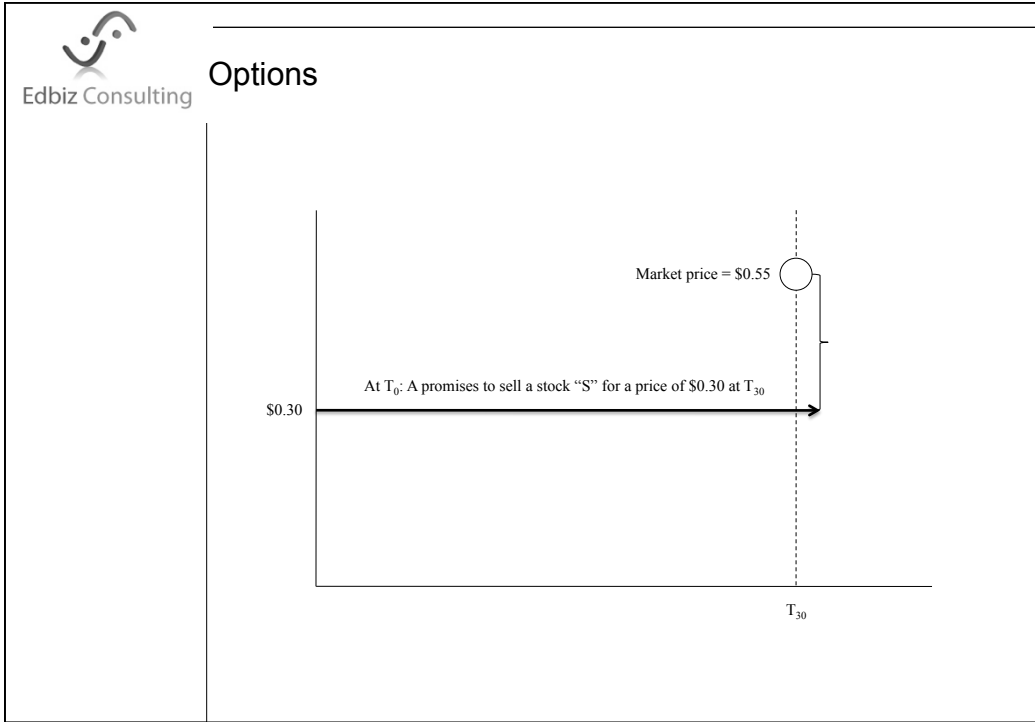
- Case 4:
 - A unilaterally promises to buy a stock x from B at a future date t for a price p
 - Simultaneously, B unilaterally promises to sell a stock y to A at a future date t for a price p
 - The two promises together do not amount to a bilateral promise because they refer to two different objects of sale

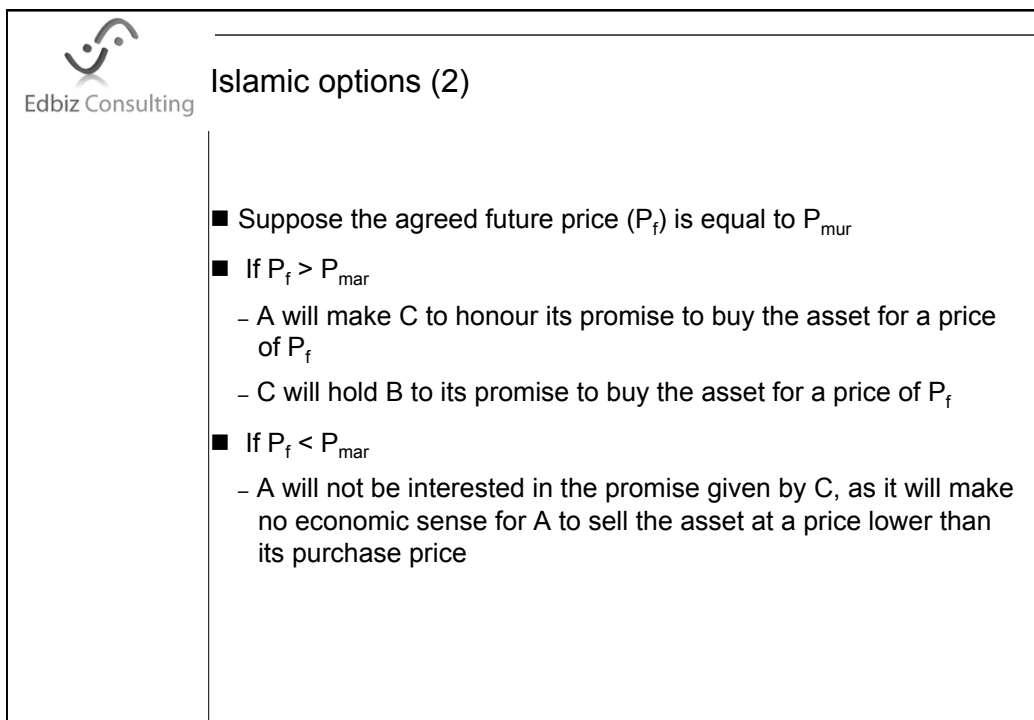
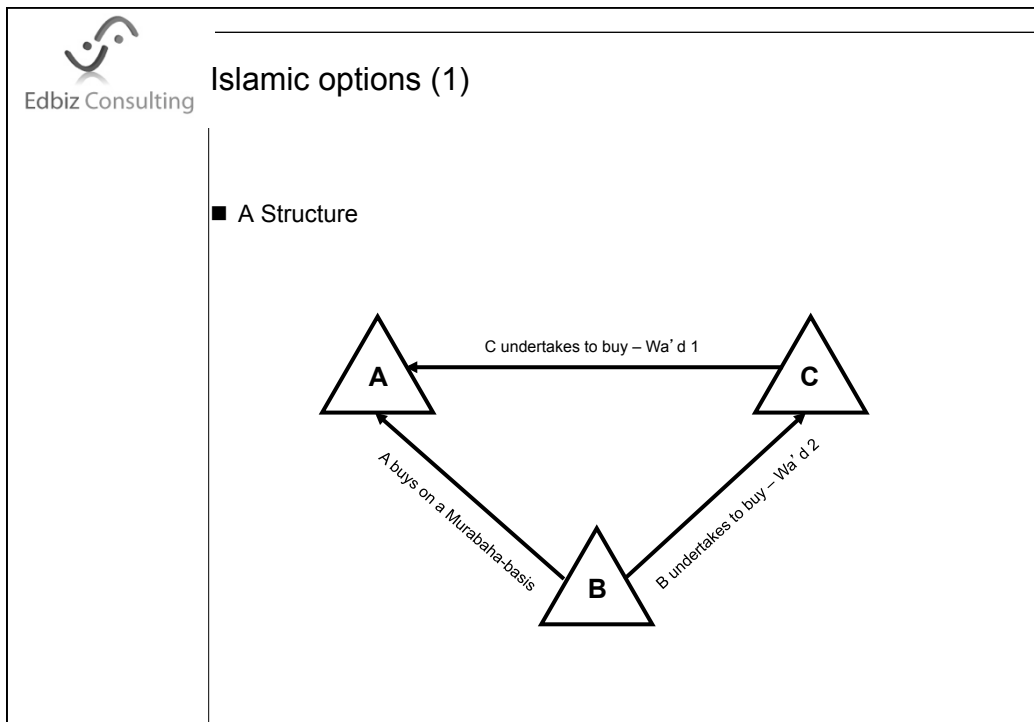



Promises (5)

Promisor	Promisee	Object	Execution date	Price	Comments
A	B	X	T	P	
B	A	X	T	P	Bilateral promise
A	B	X	T	P_1	
B	A	X	T	P_2	Two unilateral promises
A	B	X	T_1	P	
B	A	X	T_2	P	Two unilateral promises
A	B	X	T	P	
B	A	Y	T	P	Two unilateral promises








 Islamic options (3)

■ Payoffs

When $P_f > P_{mar}$	When $P_f < P_{mar}$
A: $P_f - P_{mar} > 0$	A: $P_{mar} - P_{mur} < 0$
B: $P_{mar} - P$	B: $P_{mur} - P > 0$
C: 0	C: 0

 Islamic options (4)

■ Given the payoffs of A, the structure gives downward protection to the buyer of the asset (A)

■ A also benefits from any upward changes in the stock price

