CHAPTER 3

Islamic retail banking products

3.1 Introduction

Innovation, which is considered to be an essential requirement for the sustainable development of the Islamic banking and finance industry, has not been amongst the top few items on the agenda for most IFIs. Different IFIs, depending on the scholars sitting on their Shari'a supervisory boards, are following different ways and means to achieve their targets. They are often successful in achieving such targets as whatever they do is somehow unique to what others are doing, therefore, they are gaining a competitive edge over other institutions, without any need for innovation. As we know the Islamic banking and finance industry is currently passing through the most challenging period of its short history. According to Shari'a scholars, the reasons are mostly attributable to the global recession and competition amongst providers of Islamic financial services operating in different parts of the world. Less regulation, lack of standardisation and increasing controversy are further adding to the situation. The result is less innovation and sluggish development of the industry on the whole.

Increasing defaults at the retail level and restructuring at the corporate level has forced many institutions to follow a policy of playing safe and to remain conservative. In this chapter, we will discuss the significance and the prospects for innovation in structuring different Islamic retail banking products in the context of the GCC, with particular reference to the UAE.

3.2 Liability products

Islamic liability products, such as current accounts, saving accounts and term investment deposits, offer almost the same features as their conventional counterparts. Due to certain Shari'a restrictions, marketing of such products faces challenges; however, as a result of certain innovations, offering Shari'a-compliant liability products has been successful in the past few years.

The successful launch of Mashreq Millionaire (a conventional savings product with a chance of winning cash prizes) followed by a Shari'a-compliant product launched by the National Bonds Corporation (a mudaraba based Islamic savings product which offers the chance to win cash prizes out of the mudarib's own funds), became the driving force towards innovation, resulting in the efflorescence of many Shari'a-compliant liability products which offer cash prizes in addition to the profit payable to the depositors. The Bank, on the one hand pays the profit to the customers in its capacity as the mudarib and on the other hand pays out certain periodic cash (or in-kind) prizes (from its own funds) to customers on the basis of a computerized lucky draw in its personal capacity. The institutions offering such products include, among others, Abu Dhabi Islamic Bank and ADCB-Meethaq (Islamic widow of Abu Dhabi Commercial Bank).

Most recently, the issue of giving Islamic current account customers certain privileges, as is the case of current accounts operated within a conventional bank, was raised to the Shari'a boards of different IFIs. However, all such structures and proposals failed to convince Shari'a scholars who consider this as riba as current accounts is looked upon as a 'Qard' (loan) for the bank, for which the bank cannot offer any additional benefits to the depositors of the current account. Many customers, in order to avail such benefits and privileges, opt for a conventional current account instead of opening and operating an Islamic account. Hence there is a gap for further development and innovation with respect to liability products in the Islamic retail space.

3.3 Asset products: Home finance – istisna, ijara and forward lease

The recent growth in the housing industry, especially in the GCC, resulted in the active involvement of IFIs in the home financing business. Shari'a scholars provided different Shari'a structures for home financing such as ijara and murabaha for ready properties and istisna – forward lease and istisna – parallel istisna in the case of the off-plan properties. Under the structure, the IFI becomes the actual buyer (both in cases of simple purchase and/or istisna) and thereafter leases (on a normal lease basis or on a forward lease basis, as the case may be) to the customers. Such ijara is (or in the case of forward lease becomes) ijara muntahi bittamleek (lease to own).

The lease-to-own model has proven to be an innovative idea and has resulted in great commercial success. Unlike murabaha, which does not allow a floating rate and diminishing musharaka, which has its own limitations and issues, ijara based products, provided more flexibility and variation. Home finance is the only area where the innovation has played an important role and has resulted in certain innovative products such as the forward lease structure with its multiple variations such as step-up and easy start. Such variations allow the customers the flexibility of paying small instalments in future or in some cases provided a way of making upfront payments, easing the financing at a later stage. Once the recession is over, further innovation and development in home financing products can be expected.

3.3.1 Murabaha

Murabaha is accepted by most Shari'a scholars as a permissible mode of financing for retail banking. Deferred price payment facilitated the financing of assets such as motor vehicles, white goods and even real estate assets. Murabaha financing of motor vehicles and white goods has been successful due to the short financing periods and small financing amounts. Both the aforementioned products have been successful in the GCC region.

The development of real estate murabaha financing was more challenging due to the Shari'a restriction of fixing the price upfront and due to the longer tenures and larger amounts involved in the transactions.

3.3.2 Tawarruq

Shari'a Standard number 30 i.e. Monetization (Tawarruq) published by AAOIFI refers to tawarruq, which is not approved by many Shari'a scholars due to strong similarities with bai al ina. The Islamic Fiqh Academy of the OIC further strengthened their opposition to tawarruq through its announcement of tawarruq as a Shari'a repugnant product.

However, after having been published in the Sharia Standards, Shari'a scholars may allow such transactions which follow the standard in letter and spirit. After a few transactions being approved on the aforementioned basis, tawarruq may also find its way to the remaining institutions where it is not permitted as a mode of personal finance. Standardisation as well as effective regulation may be the key to resolve the issues pertaining to products like tawarruq.

Tawarruq has been widely used for many years, as an Islamic product for the purposes of fulfilling the cash requirements of customers. Furthermore, even if the Shari'a boards of certain institutions do not permit tawarruq as a Shari'a-compliant product, they do allow tawarruq to be used for customers who want to pay their conventional debts through this mode of finance.

3.3.4 Services ijara

Islamic personal finance has witnessed consistent development and innovation especially in the GCC. Many Islamic banks have been using commodity murabaha as the basic tool for personal finance products. Due to certain controversies and debates on the Shari'a-compliance of tawarruq, an institution, which are led by those Shari'a scholars who do not favour tawarruq, have used innovation to structure certain personal finance products which are based on the Shari'a concepts of murabaha and ijara. Ijara which aimed to provide certain service packages such as rent finance, travel finance, event finance, medical finance and education finance, could not achieve the same results as tawarruq, as in the majority of cases, the basic requirement is immediate and the service provider cannot wait for documentation and other requirements to be fulfilled.

In many institutions, the service ijara product with all its variations, only attracted the attention of a few customers and has remained almost akin to a dead product from a commercial viability perspective. Due to the limited number of transactions, most of the institutions offering such products have also started to look for alternatives. The main concept of the ijara based product was to acquire certain services from the suppliers/service providers and then provide the same to the customers on an ijara basis. For example, if a customer planned to travel to Europe with his family and is inclined towards getting the travel package financed by some institutions, then the customer will bring the quotation to the bank with a request for financing the same package. The customer promises the bank that once the bank has acquired the travel services package from the travel agency / service provider, then the customer will lease such services from the bank on agreed terms.

Shari'a allows for the lease rental to be paid as per the payment terms agreed between the customer and the bank. Then the bank acquires the package from the travel agency and leases it to the customer under a lease agreement. An almost identical mechanism is used in the case of other variations of the services ijara product such as medical finance, education finance, rent finance and event finance. A well regulated environment would have been ideal for the success of such a product; however, it could not achieve the expected results.

3.3.5 Salam finance

One of the leading Shari'a scholars of the contemporary world, Dr Hussein Hamid Hassan floated the idea of using salam as a retail cash financing product, to cater for the day to day cash needs of the customers of the Islamic banking and finance industry. He had, in the past, used the salam structure for certain huge corporate deals. Although it was a challenge to overcome the difficulties in fulfilling the Shari'a requirements such as documentation, delivery, storage, etc., unlike the corporate deals where the customer is actually in the business of growing, producing or trading in the goods and/or commodities which are the subject matter of the salam sale, Dr. Hussein devised a structure which provided the solution to the aforementioned problems. Dr. Hussein had also foreseen the possible objections from different quarters including the Shari'a scholars. Therefore, in order to achieve wider acceptability, the structure was presented in the meeting of the Unified Shari'a Committee of the UAE (a body of the Shari'a scholars having representation from all Islamic banking and financial institutions of the UAE). Although the aforementioned committee also includes scholars who favour tawarruq, the committee did not accept the metals of the London Metal Exchange to be the subject matter of the salam sale as it was nearly impossible for the seller and the buyer to actually possess the commodities and have direct control over it. Interestingly, the same commodities are being used in the tawarruq model, and the sale and purchase transactions are considered to be compliant on the basis of constructive possession. Moreover, the committee decided against the agency element of the salam structure, which is an integral part of a tawarruq transaction. In order to avoid further controversy and to achieve global acceptability, Dr. Hussein and other scholars, agreed to the committee guidelines for removing the agency element as well as London based commodities from the structure.

The structure involved a salam sale between the customer and the bank whereby the customer (as the seller) sells the commodity/goods to the bank (as buyer). The bank (being the buyer) pays the price upfront to the customer, whereas the customer delivers the goods in instalments as per the schedule of delivery agreed between the customer and the bank. In order to ensure that the customer is able to arrange for the delivery as per the schedule, the customer is required to arrange for a sale undertaking to be issued by a supplier of the salam goods/commodity, whereby the supplier promises to sell the goods/commodity to the customer once the customer exercises its right to require the supplier to sell the commodity to the customer at a pre-agreed price.

At each delivery date (as per the delivery schedule), the customer purchases the commodity from the supplier and delivers the same to the bank. In order to ensure that the bank is also able to dispose the commodity upon delivery by the customer, the bank arranges a purchase undertaking whereby the broker (not the same supplier of the commodity) undertakes to purchase the salam goods/commodity as per a schedule which matches the delivery dates mentioned in the sale undertaking issued by the supplier in favour of the broker. This arrangement ensures timely delivery by the customer to the bank, as well as the instant disposal of the same from the bank's perspective.

Apart from the theoretical approach of the above structure, it has some practical issues due to which it has been very difficult to implement. One of the main problems was the issuance of the sale undertaking in favour of the customer. In most cases, the customers are common members of society who are not involved in the sale and purchase of commodities. In addition to this, they do not have any relationship with suppliers and brokers. On top of this, suppliers and brokers only deal with huge transactions and are not involved in small transactions, which poised yet another problem. In tawarruq based transactions, the customer normally appoints the bank or a third party related to or arranged by the bank as their agent to sell the commodity in the market.

Dubai Islamic Bank (DIB), which had planned to launch a salam based cash financing product to retail customers, was advised to remove the agency element from the structure and to use any commodity which is locally available, so that the customer and/or the bank are able to take actual possession and control over the commodity. Further adding to the innovative structure, the bank's retail team brought in the idea of using refined sugar as the subject matter of salam, as millions of tons of raw sugar is brought into the country and sold to distributors after refinement.

In order to overcome this problem, another leg of the transaction was devised, whereby the customer would appoint a third party as its agent to purchase the commodity from the suppliers as per the delivery schedule. Such a third party will be available for all the customers of the bank to act as their agent at a specified fee.

After having solved the problem of the relationship between the customers and the suppliers, the next challenge was the restrictions from the Shari'a scholars that the salam goods/commodity must be locally available and the customer, if it requires to do so, may take the actual delivery of the salam goods/ commodity. As mentioned earlier, the institutions practicing personal finance on a tawarruq basis do not have any such restriction. As a result of the aforementioned restriction, it was a challenge to find a locally available commodity, or brokers and suppliers dealing in the trading of the same. DIB started working with certain producers and importers involved in the import and production of certain fungible commodities. Finally, they made arrangements with suppliers and distributors involved in the import of raw sugar, processing and distribution.

Although the product has been launched and has successfully attracted a large clientiele, it still faces challenges as far as procedures and dealings with the suppliers and brokers are concerned. Some of the retail bankers are still of the view that if using the London Metal Exchange (LME) platform becomes permissible from a Shari'a perspective, salam personal finance will become a more viable product for institutions providing Islamic finance solutions. Moreover, locking the price for the salam finance period will become easier, as the fluctuation seen in LME commodities is much less than the other fungible commodities.

Innovative structures of salam still face a lot of challenges and do not enjoy a level playing field with its counterpart – tawarruq (monetization) based products.

Proper regulation as well as standardisation are definite solutions to the aforementioned problems.

3.4 Credit cards

Credit card is an area where the Islamic banking and finance industry needs to focus vis-à-vis innovation and development. The models currently used are subject to strong criticism and controversies by Shari'a scholars. Business experts also do not consider the models used currently as enough to provide a basis for a successful and profitable retail product. Opinions of the scholars vary from using similar conventional credit card models to service based cards, however, this product has not been as successful as the conventional credit cards.

Both Islamic and conventional credit cards are dependent on global players such as Master, Visa, American Express and Japan Credit Bureau. The business of such players is mainly based on the conventional system. Due to the unavailability of an alternative, IFIs don't have any choice other than to interact with the same global players on terms and conditions acceptable to such players. Many scholars and experts have time and again raised their voice for better interface and introduction of at least one new player which provides the basis for Shari'a-compliant credit cards. However, based on the size of the industry and the potential for credit cards, it is not feasible to incur huge costs on such a venture. Innovation is required to introduce a model which on the one hand is capable to cater for public needs and requirements and on the other hand proves to be a successful business proposition. Shari'a experts have been discussing certain structures based on ijara, murabaha as well as salam. However, none have been considered appropriate to replace the current models in vogue. A model which involves takaful is also undergoing a litmus test in Bahrain. Its success will depend on the wider acceptability amongst the Shari'a scholars, commercial viability and effective structure and product development.

3.5 Conclusion

Standardisation at the level of international bodies such as AAOIFI, International Islamic Fiqh Academy, IFSB and the Islamic Fiqh Academy of the OIC may help innovation, as institutions will be forced to differentiate themselves from their competitors, and this may result in the sustainable development of the industry. Regulation at the government level may also play an important role for more innovation in the field of Islamic banking, finance and insurance. The current loose regulatory regime allows institutions to do pretty much anything which is permitted by their respective Shari'a boards. The regulator's involvement with standardisation at the local level, will provide all institutions with a level playing field, and encourage innovation and development amongst them.