Islamic finance — surviving innovation

Islamic finance has been a steadfast component of the financial services industry, albeit niche in some countries but continues to remain a visible feature. This article explores the strength of Islamic finance in the era of innovation in financial services and what should be considered to facilitate its growth. As the conventional financial services industry shifts and evolves rapidly in terms of global payment regulations, cryptocurrencies and fintech, HARI BHAMBRA analyzes how Islamic finance can survive the pace of innovation.

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In some jurisdictions, Islamic finance has been emulating the conventional financial services sector including banking, wealth management and insurance but its most prominent demand, and perhaps most authentic service offering, is investment activities, with funds and portfolios around the globe being structured to attract investors looking for Shariah/ethical investments. Shariah compliant investing is conducive to facilitating investments into different sectors which are Shariah compliant including assets, real estate and private equity. Innovation has great opportunity in this segment as investment activities where profits and losses are shared are the most in line with Shariah compliance.

It is also often mentioned about how the Islamic finance sector needs greater regulatory and legal reforms to facilitate its growth; however, this pertains to the infrastructure typically required for banking/deposit-taking institutions where financial stability and safety net mechanisms are required.

As per the IMF, citing the work of the IFSB, the ongoing stability of this sector needs better safety nets including crisis management models, which are compulsory for the conventional banking sector. Such debates are common where Islamic finance has been used in the conventional banking context; issues of safety mechanisms will clearly raise academic debates about the extent to which such safety nets remove the principle of profit and loss-sharing from Islamic finance.

This issue of regulatory reforms is a complex one largely driven by financial regulations, tax regulations and the classification of Islamic structures, all of which are variable across jurisdictions.

However, in the context of investment activities, limited regulatory reforms are required to enable adequate levels of product disclosure to be provided in respect of the manner in which any investments are to be made and to ensure appropriate portfolio diversification.

Perhaps one can therefore focus on the potential for sustainable growth in this segment. Islamic investment activity requiring profit and loss-sharing represents greater authenticity in Islamic finance and allows greater flexibility to select Shariah compliant investment assets. Where Islamic finance has emulated conventional finance (such as in the banking context), regulatory issues become more problematic.

The sustainability of any industry is determined by how responsive it is to change and in this regard, how responsive Islamic finance is to innovation and potential demand in the light of recent innovations of cryptocurrencies and fintech.

Shariah compliant cryptocurrencies

Cryptocurrencies (an example is bitcoin) are a new form of monetary exchange which represents complex algorithms which are 'mined' using advanced technology.

Cryptocurrencies/bitcoins are available to be bought either through mining or from bitcoin/cryptocurrency exchanges.

As cryptocurrencies do not use a central counterparty, there are some concerns that financial transactions are taking place independently from any centralized financial structure with limited regulatory oversight.

Notwithstanding this, the appeal of cryptocurrencies is growing and the possibility of an asset-backed form has been tested and launched in the market.

OneGram is a UAE-based Shariah compliant product incorporating three basic criteria for trading: i) the absence of interest, ii) it must be a profit and loss-sharing model and iii) it must be asset-backed which minimizes speculation as OneGram is an asset-backed by physical gold. Such products gradually shift the sector back toward a commodity-backed currency, building greater stability.

Financial technology or fintech

Fintech is new technology and innovation that aims to compete with traditional financial methods in the delivery of financial services, in particular blockchain databases which have the potential to reduce the cost of transacting in a financial system. Growing technology platforms are being created to facilitate financial transactions.

Islamic finance can be a key beneficiary and provider of fintech as seen by pioneering Shariah compliant fintech providers such as Yielders in the UK which is a Shariah compliant fintech crowdfunding platform offering real estate investment opportunities.

Conclusion

In summary, waiting for regulatory or legal reforms to facilitate innovation and growth in Islamic finance may not be the stimulus needed.

Innovation from within the industry may be better placed to facilitate growth in the industry and prompt regulatory and legal reforms to accommodate the prevailing structures in the market.

Islamic finance is strategically placed to keep up with the pace of innovation by innovating within.