Journal of Development Research and Studies, Volume (11) / Issue (1), June 2024, p492-p503

Innovative Financial Products in Islamic Finance

- Case Study on International Sukuk -

Oussaghir Louiza*[1],

[1] University of Mohamed El Bachir El Ibrahimi of Bordj Bou Arreridj, Algeria, Studies and Reasearches in Rural Development Laboratory, louiza.oussaghir@univ-bba.

Received : 30/04/2024 Accepted :30/06/2024 Published:30/06/2024

Abstract :

This study aims to highlight the importance of innovative Islamic financial products in financing Islamic institutions, and International Sukuks were chosen as a model.

The study relied on the descriptive and analytical approach by describing and analyzing data on international sukuk during the period 2004-2021.

The study concluded that are many Islamic financial innovations have been introduced, the most important of which are International Sukuk of various types, in which trading witnessed significant growth during the study period, It has contributed to the funding of several organizations in several sectors and several countries

Keywords: Innovations, Financial Innovations, Innovative Products, Islamic Financial, International Sukuk .

JEL Classification Codes: O16, G23.

*Coresponding Author

Financial Innovations In The Islamic Financial Industry -Sukuk as a Model-

1. Introduction:

Financial innovations have appeared a long time ago and have developed according to current developments in the global financial and banking arena. This has led to the emergence of new products, mechanisms and markets in the financial and banking market.

The application of these financial innovations has gone beyond traditional finance to be applied in Islamic finance, which is characterized by several characteristics that may hinder its application, especially legality. However, Islamic financial innovations have been created that are consistent with Islamic controls, which have developed according to the development of the Islamic financial industry.

Sukuks are considered one of the most important Islamic financial innovations that have gained great acceptance in the Islamic world, and the volume of their issuance has developed significantly, especially in recent years.

In the light of this previous proposition, the features of our research problem are clear, which can be formulated as follows:

How Innovative International Sukuk Contribute to the Financing of Islamic Institutions ?

From this point on, we ask the following questions:

- How financial innovations emerged?
- What are the strategies used to innovate Islamic products?
- What is sukuk? What are the indicators of the development and growth of sukuks?

Study hypotheses:

The hypotheses of the study are

- First: Islamic financial products are innovated by creating new products that are not known in the market
- Second: International Sukuk are considered one of the most important Islamic financial innovations whose issuance volume has developed significantly.

Objectives of the study:

This research paper aims to achieve the following points:

- Learn about financial innovations and Islamic financial innovations;
- Clarifying the basic principles of the Islamic financial industry ;
- shed light on concepts of Islamic financial innovations;
- Presentation of SUKUK's and highlighting their growth and evolution in the Islamic financial industry.

Research methodology:

Due to the nature of the subject, and to be familiar with all its aspects, we had to adopt the methods used in economic research and studies, including the descriptive and analytical approach, which allows us to collect information and data and analyze them according to the requirements of the study.

Research plan:

To answer these questions, we divided the research into the following axes:

The first axis: Financial Innovation, Theoretical Background.
The second axis: Innovations in the field of Islamic finance.
The third axis: International Sukuk.

2. Financial Innovation: Theoretical Background

Financial innovations have made a quantum leap in the financial industry, which has led to the emergence of many innovative financial instruments.

2.1. Definition of Financial Innovation:

Innovation is the integrated areas of change that include a new idea, product, service, process, marketing method, management or organizational practice, new way of organizing the workplace, or new external relationships that the organization adopts and applies to improve its performance to achieve success in improving its business results. (Gendouz, 2017, p. 10)

In financial terms, innovation is:

- anything that is new and unknown in financial methods, instruments, institutions, or securities that provides new alternatives for decision makers. (Abdelkhalek , 2021, p. 174)
- a process that contributes to a qualitative leap in the financial fields at the macro and/or micro level, by finding solutions to various financial problems or hindering the development of the financial fields by meeting and satisfying existing needs and/or exploiting idle opportunities or resources. (Ben Mansour , 2014, p. 4)
- Delivery of new products, services, processes and organizational structures that meet the needs of financial professionals in order to reduce risk and costs. (Frame & White, 2009, p. 01)

Financial Innovation can be defined as:

new ideas, solutions and tools in financial system which offer new product / services/ instrument/ organizational and also market, or reduces costs and risks, and implementing modern technology.

2.2. The proximate factors for the emergence of the financial innovations:

The emergence of financial innovation dates back to The period after the Second World War with the 1960s when financial markets changed from a stable state to a state of risk and instability, which led to the need to abandon traditional tools and find new and sophisticated tools to meet the needs of world economies and reduce the financial problems that threaten them, including: (Ben Mansour , 2014, p. 5)

- The collapse of the Bretton Woods Agreement, which resulted in violent fluctuations in exchange rates, which led to the development of forward exchange contracts and the search for a mechanism to hedge against the risks of its fluctuations.
- The increase in the strength of inflation in the early 1980s and the associated rapid rise in short-term interest rates.
- Successive global stock market crashes have prompted investors to seek protection for their financial assets.
- The fierce competition among financial and banking institutions to create new financial instruments that provide solutions to financing and risk management issues.

2.3. Innovative financial products and services:

A number of financial products and services have been created for business, corporate and Real estate finance, which are summarized below: (Baadash , 2017/2018, pp. 68-69)

- **Business Finance Innovations:**

During the 1970s, the financial markets experienced fluctuations and structural changes that led to the complexity of designing financial products. The following table shows the most important of these products:

Table 1. Innovative products for corporate financing and services

Year	Products and services
1200	Future delivery contracts
1836	Issuance of preference shares for the first time
1974	Emergence of new high-yield, high-productivity markets
1982	S&P Traded Equity Futures Indices
1989	First exchange-traded funds
1924	Creation of the first modern mutual funds
1995	Introduction of an online banking service
1997	The Invention of the Modern Credit Default Swap

Source: (Baadash , 2017/2018, p. 68)

- **Innovations in real estate finance :**

The first mortgage-backed securities were issued in the United States in the 1970s. As demand for housing grew beyond the ability of government agencies to provide sufficient liquidity for mortgage lending, U.S. federal agencies Fannie Mae, Ginnie Mae, and Freddie Mac securitized portfolios of U.S. government-guaranteed mortgage debt that were purchased by U.S. thrifts.

The major mortgage securitizations are summarized below:

Table 2. Innovative Real Estate Finance Products and Services

Year	Products and services
1769	Coverage of the first bond issue by Frederick the Great of Russia
1911	The invention of the private mortgage insurance
1970	First securitization issued by Ginnie Mae
1983	Introducing collateralized mortgage obligations
1986	Creating channels to invest in mortgages

Source: (Baadash , 2017/2018, p. 69)

3. Innovations in the field of Islamic finance:

Financial institutions in the Islamic system have tried to keep pace with their conventional counterparts in developing their financial products without compromising their characteristics.

3.1. Definition of Islamic Finance Innovation :

It is defined as:

- It is the process of developing Shari'ah-compliant financial products through the use of Shari'ah contracts and formulas in a new way. (Humayon, 2003, p. 02)
- A set of processes and activities involving the conception, design and implementation of innovative financial instruments and the formulation of creative solutions to financing issues, all within the framework of the guidelines of the Holy Shari'ah. (Gharbi, 2009, p. 223)
- to keep up with the development processes by designing and issuing new products that help the Islamic financial and economic system to meet the challenges in accordance with the provisions of the Islamic Shari'ah. (Kashida & Kashida, 2021, p. 639)

Innovation in the Islamic finance can be defined as follows:

the development of advanced and modern Islamic financial products based on creative solutions in accordance with the provisions and principles of Islamic law.

3.2. Islamic financial innovation rules:

Financial innovation relies on a set of Islamic principles: (Saidi & Badrouni, 2023, p. 237)

- **Based on the Islamic faith:**

It represents the general basis on which Islamic financial products are based on observing what Allah has legislated in transactions by prohibiting what Allah has permitted and forbidding what He has forbidden.

- **Excludes usurious interest rates:**

This is an essential requirement in existing and innovative Islamic financial transactions, as it prohibits both the giving and receiving of usury.

- **Avoidance of gharar and Ja'ala:**

Halal is required in Islamic financial transactions by ensuring that the money is collected legally and its use is free from any Shari'ah prohibition, while avoiding the creation of new financial instruments that resemble ja'ala, gharar, or eating people's money in vain.

- **Profit and Loss Sharing:**

Participation in the outcome, whether profit or loss, rather than interest, should be the basis for developing new Islamic financial mechanisms or products.

- **Economic efficiency:**

Achieved by expanding risk-sharing investment opportunities, and reducing information acquisition, brokerage and commission costs.

3.3. Approaches to the development of Islamic financial instruments:

To create new Islamic products, the following approaches can be used:

- **Simulation Approach:**

It is represented by following the popular products in the market and imitating them through the mediation of commodities, which helps in determining the required result of the Islamic financial product, which is usually the same result achieved by the conventional product without taking into account the Shari'ah ruling. It does not require any effort and time in research and development. (Gharbi, 2009, p. 234)

- **Modification Approach:**

By relying on legitimate financial products to obtain new products, where one product is used to obtain a new product, or several acceptable products after reconsidering their legitimate aspects. (Ben Lashahab & Boussalem, 2017, p. 300)

- **Originality approach:**

It is based on continuous research into the actual needs of customers, working to design appropriate products, preserving the originality of Islamic financial products, and allowing them to benefit from the products of the conventional financial industry as long as they meet the requirements of Shari'ah credibility. (Gharbi, 2009, p. 235)

4. International Sukuk:

Investments Sukuk are the most important financial products created by Islamic institutions and have gained great popularity worldwide in both Islamic and Western countries.

4.1. Definition of Sukuk :

Sukuk is Securities structured in such a way as to provide returns to their holders in accordance with the Shari'ah approach. (Lakoui & Bornan, 2022, p. 337)

or Documents or securities of equal value representing common shares of ownership of existing assets or to be created from the proceeds of subscription, issued by an individual, organization or government in accordance with the participation formula and traded on the financial market. (Abdul Samia Al-Zuhri, 2023, p. 37)

From these definitions, we conclude that Sukuk are securities issued according to the principles of Islamic law, which provide a return to their holders.

4.2. Sukuk divisions:

Sukuk have several divisions, which we summarize as follows: (kamali & abdullah, 2014, pp. 58-60)

- **Ijarah (lease) structure:**

Sukuk derive their value from the fact that they certify ownership of profit-generating underlying assets. Initially, sukuk were based on the ijara structure wherein the value of the assets to a special purpose vehicle and then rents them back from him. SPV issues Sukuk Certificates and sells them to investor. which in turn issues and sells sukuk to the investor, using the proceeds to purchase the underlying assets and lease them to their owners for the benefit of their campaign.

In case of default default or maturity of sukuk, the originators undertakes to purchase the underlying leased at a pre-agreed price based on a formula. Currently this is the most preferred structure as it addresses both shariah requirements as well as business expectation.

- **Musharakah structure:**

The musharakah (joint entreprise) structure is used when there are not enough assets to match the sukuk issuance amount. In the musharakah structure the assets are co-owned by the sukuk halders and the originator. Co-cwnerships of the underling sukuk assets between the isser and the originator is vital from the shariah perspective as that will allow one partner (originator) to purchase the co-ownership interest of the issuer in the underlying sukuk assets, at apre-agreed price on default or maturity of the sukuk. The proceeds from the sale of assets via the issuance of the sukuk are passed to the originator. The originator manages the assets and the revenues generated from the assets are passed back to the sukuk holders. The application of this structure has decreased significantly after 2008.

- **Wakalah structure:**

In a wakalah (agency) structur, the originator sells the beneficial interest in its portfolio of assets-e.g., underlying assets in lease contract, or murabahah or istisna contracts, real estate, exclusive rights, shares (listed, non-listed) to the sukuk holders and then in the capacity of agent manages the portfolio and provides returns to the sukuk holders. In a combination of such a portfolio it is a shariah requirement that at least one third of the portfolio should consist of fixed tangible assets or real estate underlying ijarah (lease) contracts. This structure has been widely used by financial institution that wish to use their existing portfolio for the purpose of raising funds via sukuk. The concern raised by shariah scholars is that the agent should not be obligated to maintain the value of the underlying portfolio equivalent to the face value of the sukuk but that his role is limited to making the best effort to maintain its value.

- **Mudarabah structure:**

In cases where the originator does not have any assets, the mudarabah structure is used. In a mudarabah structure the proceed raised from the sukuk holders are passed on to the originator to invest in a shariah compliant pre-agreed business plan and then pass the return from such a business to the sukuk holders. The originator who is appointed as manager undertakes to buy the underlying assets of the mudarabah sukuk on default or maturity. This structure has also been used by financial institution to structure sukuk on their existing shariah- compliant portfolios. The point to be noted here is that there cannot be any obligation on the modarib to maintain the value of the underlying sukuk assets in the portfolio equivalent to the face value of the sukuk. There should not be any kind of guarantee provided by the mudarib in this structure in case of devaluation of assets or default on repayments.

- **Structure of Murabahah:**

It is a deferred sale, These sukuk structures are available in Malaysia but not in the Middle East. The shariah scholars in the Middle East do not approve the mutharabah sukuk structure in cases where the sukuk portfolio is made up of murabahah receivable and secondary trading is present. A few murabahah sukuk that were permitted in the Middle East did not have the provision of secondary trading. The shariah scholars in the Middle East do not permit traiding of debt at a premium or descout. By contrast, in Malaysia, the murabahah sukuk are popular and Malaysian shariah scholars have approved sale of debt (bay al-dayn) at a negotiated price. In the Middle East, sukuk with a murabahah component are being structured as of late, and to address the shariah concern of Tradability, at least one third of the sukuk assets need to tangible in nature (e.g., lease assets).

4.3. Stages of Sukuk Issuance:

These steps consist of: (Ahmed Gunduz, 2022, pp. 28-32)

- **Phase 1: Structure of the commoditization process**

Preparing a complete conceptualization of the organizational , legal and Shari'ah structure to be used in the Sukuk process, studying the feasibility of the project or assets subject to the Sukuk, which may be income-generating assets or Sukuk to finance an investment project, structuring the Sukuk according to Islamic financial contracts and determining the mutual relationships between its parties.

- **Phase 2: Organizing the issuance of Sukuk**

Here, the Sukuk is offered to the public through a direct public offering for subscription or through a private offering for sale to a specific group of selected investors.

- **Phase 3: Investment of Proceeds**

The sukuk proceeds are invested for the purpose for which they were issued, and the sukuk holders are entitled to their share of profits or rent, depending on the type of sukuk.

- **Phase 4: Instrument Trading**

Once issued, Sukuk become secondary market instruments and can be traded.

- **Phase 5: Amortization of Sukuk**

We mean distributing the project assets to the sukuk holders or selling them to the issuer and distributing the proceeds of their sale to the sukuk holders at market value, either at the end of the project or periodically.

4.4. Growth And Evolution Of International Sukuk:

The growth of the sukuk industry has been driven by the need to develop infrastructure in the Middle East and South East Asia. Over the years, the sukuk market has growth by 10 % to 15% annually . (kamali & abdullah, 2014)

The sukuk market continued a steady upward growth from year to year, as shown in the following figure:

table.3. Global sukuk Issuances and sukuk Outstanding Trends (USD billion) (2004–2021)

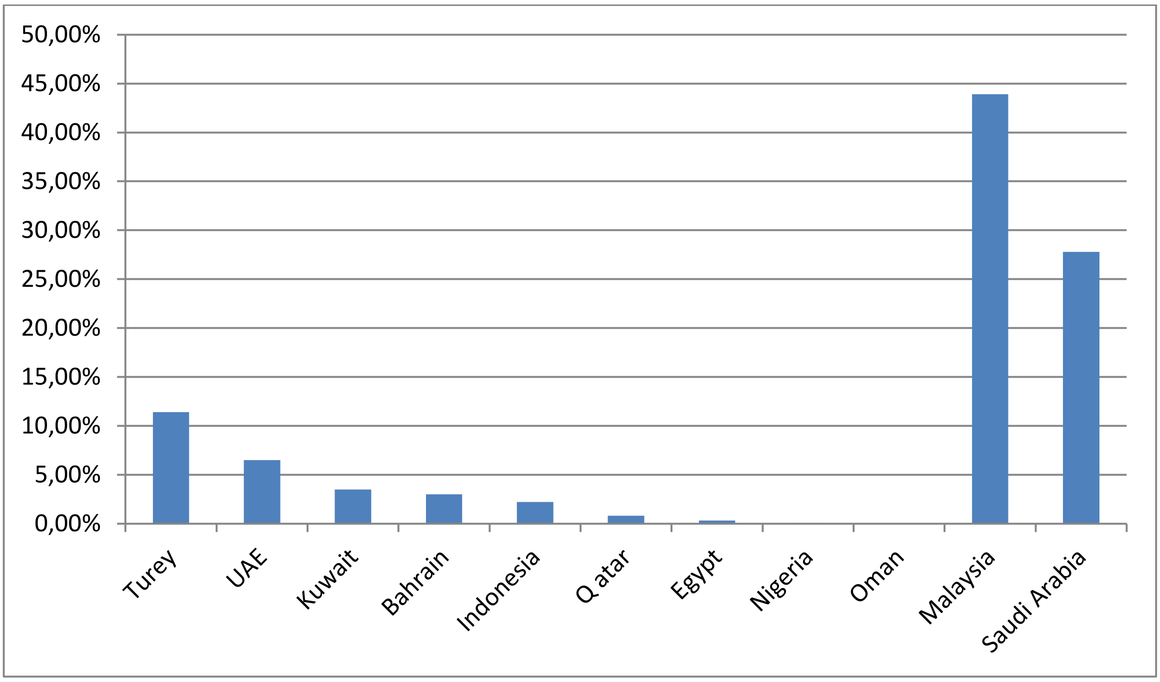
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Sukuk Issuances	10	15	30	40	14	20	42	77	135
Sukuk outstanding	20	40	100	120	170	175	180	205	280
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Sukuk Issuances	120	118	52	65	100	130	150	160	170
Sukuk outstanding	320	340	345	350	410	425	490	680	750

Source: (Ifsb, 2022, p. 26)

According to the table3 The sukuk market continued a upward growth from 2004 to 2021, supported by a resilient global risk appetite and favourable external conditions, despite the emergence of fast-spreading variants of COVID-19. sukuk outstanding reached USD 775 billion in 2021 (see fig 1), representing a y-o-y growth of 12.5%. The overall issuances by end-2021 also maintained momentum, with a y-o-y growth of 4%, reaching USD 185.4 billion. While there were country-specific variations in the level of issuances in 2021, the overall global trend for the sukuk market remained positive.

The Corporate sukuk Issuances by Jurisdiction of the Originator in 2021 to the following countries, as shown in the following figure:

Fig.1. Corporate sukuk Issuances by Jurisdiction of the Originator (%) (2021)



Source: (Ifsb, 2022, p. 28)

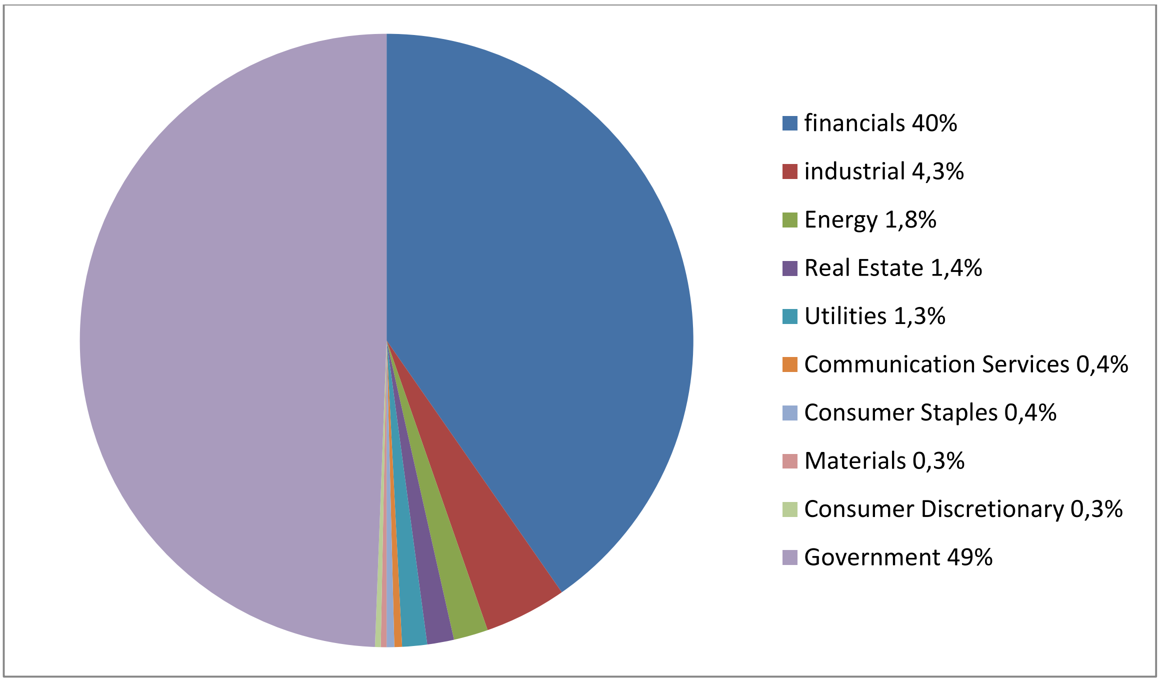
According to the figure The Corporate issuance volume increased in 2021, Islamic countries are among the most important exporters, in addition to Bangladech, and Nigeria .

Malaysian companies recorded the largest volume of issuance of 43.9%, followed by Saudi Arabia in the rate of 27.8%, and Turkey in the rate of 11.4%. On the whole, across most jurisdictions, corporate issuances saw an increase in 2021.

In terms of new entrants, 2021 saw the first corporate issuance from Nigeria, a USD 24 million, seven-year sukuk. (Ifsb, 2022)

The Global Sukuk Issuances are distributed across the following sectors, as shown in the following figure:

Fig.2. Global Sukuk Issuances by Sector (%) (2021)



Source: (Ifsb, 2022, p. 30)

According to the figure The Global Sukuk Issuances are distributed in 2021 across the following sectors: Financials, Government, Industrial, Real Estate, Energy, Utilities, Communication services, Consumer Discretionary, Materials and Consumer staples.

the largest percentage in terms of overall volume of issuances in the rate of 49% by government sector, followed by Financials sector in the rate of 40%, and Industrial sector in the rate of 4.3%.

Structural distribution of international sukuk for 2021 shown in the following table:

table.4. Global Short Term Sukuk Issuances For The Year 2021,

(Usd Millions)

	Amount	%
Hybrid Sukuk	2563	4.73
Hybrid Sukuk – Ijarah/ Musharakah	252	0.47
Hybrid Sukuk- Wakalah/ Murabahah	3913	7.22
Sukuk al Wakalah	15872	29.30
Sukuk Al Salam	1358	2.56
Sukuk Al Musharakah	470	0.87
Sukuk Al Murabahah	12572	23.21
Sukuk Al Mudharabah	6901	12.74
Sukuk Al Ijarah	10245	18.91

Source: (Market, 2022, p. 46)

According to the table The Sukuk Issuances,Structure in 2021 across the following Structures: Sukuk Al Mudharabah Hybrid Sukuk, Sukuk Al Murabahah, Sukuk Al Musharakah, Hubrid Sukuk – Ijarah/ Musharakah, Hubrid Sukuk – Wakalah/ Murabahah, Sukuk Al Ijarah , Sukuk Al Wakalah, and Sukuk Al Salam.

Sukuk Al Wakalah accounted for the largest share of the total issuance with 29.30%, followed by Sukuk Al Murarabah with 23.21%, while the Sukuk Al Ijarah at 18.91% and Al Mudharabah Sukuk at 12.74%.

5. Conclusion :

Financial innovation has led to the emergence of a new financing model based on financial innovations that have provided new product, services, instrument, organizational and also market, or reduces costs and risks, and implementing modern technology, that are in line with current developments in the global financial and banking arena.

The Islamic financial industry tried to keep pace with this development by creating financial innovations consistent with the principles of Islamic Sharia, which led to the emergence of many innovative financial products.

Among the most prominent of these financial products are sukuk, which has growth significantly.

Through this research the following results have been reached:

- Islamic Finance innovations differ from traditional financial innovations in terms of characteristics and conditions as they follow Islamic Sharia. Hence, the first hypothesis is wrong
- Sukuk is one of the most important Islamic financial innovations in islamique . This proves the validity of the second hypothesis
- There are many types of sukuk, as Ijarah, Musharakah, Wakalah, Mudarabah and Wakalah.
- The International Sukuk market has grown, especially in the period 2004-2021, reaching 775 billion in 2021.

Recommendations:

Through the results obtained, we can suggest the following recommendations:

- The necessity of developing Islamic financing formulas through the use of financial innovations that are consistent with Islamic Sharia.
- Preparing the legal framework for implementing Islamic financial innovations.
- Conducting a campaign to introduce Islamic financial innovations.

6. References:

1. Books :

- Abdul Samia Al-Zuhri, K. (2023). *Islamic Financial Sukuk - A study on the nature of Sukuk and its accounting nature.* Homysra Publishing House.
- Ahmed Gunduz, A. (2022). *Sukuk: Theoretical and Practical Framework.* Arab Monetary Fund.
- Abdelkhalek , E. (2021). *Contemporary Financial Engineering - A Contemporary Shari'ah Perspective.* Arab Center for Publishing and Distribution.

- Frame, W. S., & White, L. J. (2009). Technological change, financial innovation,band diffusion in banking. Dans A. Berger, P. Molyneux, & J. Wilson, *the Oxford Handbook of Banking* (p. 1). Oxford University Press.
- Gendouz, A. (2017). *Financial Innovation and Introduction to Financial Engineering.* London: E-Kintub Ltb.
- kamali, m. h., & abdullah, a. k. (2014). Islamic Finance: issues in sukuk and proposals for reform. United Kingdom: the international institute of advanced islamic studies and the islamic fondation.

2. Theses:

- Baadash , T. (2017/2018). Financial innovations and the requirements to activate them to improve the supervisory performance of the central bank in managing the banking risks of commercial banks - a case study of the Bank of Algeria. 68-69. University of Algiers 3, Algiers.

3. Journal article :

- Gharbi, A. (2009). Financial Innovation in Islamic Banks, Reality and Prospects. *Journal of Economics and Management Sciences*(09), 223.
- Lakoui, S., & Bornan, M. (2022). Islamic Sukuk and its role in financing development projects. *Journal of Advanced Economic Research*, 337.
- Ben Lashahab , H., & Boussalem, A. (2017). Approaches and Strategies for the Development of Islamic Financial Engineering Products. *Journal of Islamic Studies, 8*, 300.
- Saidi , B., & Badrouni, I. (2023). The role of financial innovation in the development of the Islamic financial industry - Islamic Sukuk as an example-. (M. University, Ed.) Journal of Economics, Management and Commercial Sciences, 16(01), 237.
- Humayon, A. D. (2003). Islamic Financial Innovation: Tools and Trends. Journal of Emerging Economies and Islamic Research, 1(03), 02.
- Kashida , H., & Kashida, f. (2021). The impact of Islamic financial innovation on the profitability of Islamic banks- Standard study for Dubai Islamic Bank for the period 2005-2019-. The New Economy Journal, 12(3), 639.

4. Seminar article:

- Ben Mansour , M. (2014). Financial Innovation in Islamic Financial Institutions between Originality and Tradition. *International Conference on Forums and Applications of Innovation and Financial Engineering between the Traditional Islamic Financial Industry and the Islamic Financial Industry* (p. 4). University of Setif, algeries.

5. REPORT:

- Ifsb, B. I. (2022). islamic financial services industry stability report *2022.* Kuala Lumpur, Malaysia.
- Market, I. I. (2022). *IIFM SUKUK REPORT.*