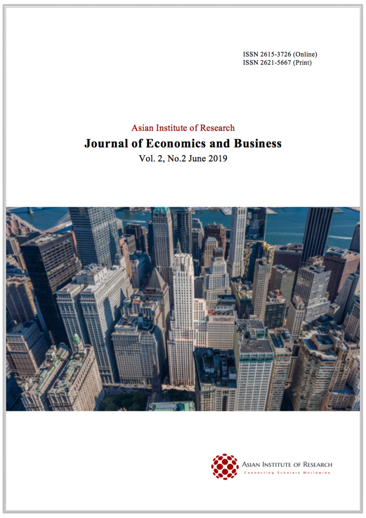

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Islamic Structured Products: Innovation or Replication? A New Discussion on Contemporary Application and *Shari'āh* Issues

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Abstract
Islamic structured products (Islamic SPs) are similar to conventional SPs, but with a difference that the former is *Shari'āh*-compliant; whereas, the latter is not. A question, therefore, arises whether Islamic SPs are a real innovation or a mere replication of conventional SPs. This paper juxtaposes Islamic SPs with the conventional SPs and critically examines the concept and current practices of the Islamic SPs by Islamic banks. The paper adopts a qualitative method to analyze the related literature thoroughly and discusses *Shari'āh* contracts employed in structuring Islamic SPs. The research finds that the Islamic SPs are designed to merely meet the growing *Shari'āh*-observant investors' needs without due consideration to the higher objectives of Islam (*maqāsid al-Shari'āh*). The research also finds that notwithstanding Islamic SPs are *Shari'āh*-compliant, they are, however, an outright replication of the conventional SPs, which is more likable by the practitioners since it accrues less cost compared to inventing new SPs, which is more costly and time-consuming. It is, however, acknowledgeable that although a *Shari'āh*-compliant trademark is sufficient to continue doing Islamic banking business, the plethora of investment injected into the replicative SPs hardly manifest any contribution to the real economy, and is far-flung from the essence of Islamic banking and finance that advocates for economic justice, social impact, and financial freedom. Therefore, the research suggests that Islamic SPs be overhauled to inculcate the spirit of Islam in the Islamic banking business.

Keywords: Islamic Structured Products, *Shari'ah* Contracts, Urbun, Amalgamation, Economy

1. Introduction

1.1 Background of the study

Islamic Structured Products (ISP) are proliferating in Islamic finance. In April 2006, the first Islamic dual currency structured investment product was approved under the guidelines on the offering of Structured Products (SP). SP was introduced in 1980 for the institutional investors only. Since 2006, it began to be offered to the retail investors where it is purchased during the initial offering. The value of SP is derived from the performance of various underlying assets such as stocks, index, commodity, interest rate, foreign currencies, or a combination thereof. Because of its multiple features, SP embraces various risks such as credit risk, liquidity risk, call risk, interest rate risk, foreign exchange rate risk, yield curve risk, and volatility risk (SLCG 2009).

SP is an investment whereby its repayment is derived from the development of its underlying assets. The repayment structure of SP is different from ordinary products such as shares, bond, and bank deposits. It is based on the performance of the underlying assets. Such assets are often combinations of traditional securities such as equities, commodities, bonds, and one or more derivatives components (Vanini and Pohl 2015). An SP can be defined as a security, which possesses bond-like elements and resembles derivative instruments.

The volume of SP offered in Asian Market, including Singapore, South Korea, Japan, Hong Kong, and China, have exceeded USD750 billion (CFA Institute Research Foundation, 2015). Japan was home for the biggest stock exchange in Asia and the third largest in the world contributing to the sale of SP of more than USD 570 billion at the end of 2015 (Wu and Pitts 2017). Vanini and Pohl (2015) conclude that between the periods of 2012 to 2014, at least 80% of the SP performed well and generated a positive return. These products generated a median return of 5% to 15% per annum depending on their category and year. In the year 2017, 13,490 SPs were issued in the market with a total notional value of approximately USD 50.2 billion; whereas, in 2016, only 9,362 SPs were issued (Morrison and Foerster 2018). 72% of the issuance comes from Equity indexes such as stock (11.88%), ETF (6.42%), and the basket of Stocks (3.69%). Wu and Pitts (2017) highlight the advantages of SPs offered to investors. These advantages are tax efficiency, currency protection, leverage, transparent pricing, and complexity. Looking at the demand and necessity of SPs, Islamic scholars innovated and devised the Islamic SPs (ISPs) to satisfy the growing needs for ISPs among the *Shari'āh* observant investors. Fundamentally, ISPs have similar mechanisms as the conventional SPs except that the ISP employs the permissible *Shari'āh*-compliant contracts. In ISPs, the contracts must adhere to the *Shari'āh* principles and avoid the prohibited elements such as *ribā* (interest), *gharar* (uncertainty), and *maysir* (gambling) (Rahman & Kassim, 2017).

Since the Islamic SPs stems out of the conventional SPs, the real question that arises here is whether the Islamic SPs are a real innovation by the Islamic scholars or a mere replication of conventional SPs? This paper, therefore, attempts to answer this question in the light of the *Shari'āh*. The opinions of the prominent *Shari'āh* scholars have been analyzed about the Islamic SPs. The paper discusses both the conventional and the Islamic SPs to develop a robust understanding of its process flow. After that, it discusses the *Shari'āh* issues on the Islamic SPs and provides resolutions in the view of the esteemed *Shari'āh* governing authorities such as Accounting and Auditing Organization of the Islamic Financial Institutions (AAOIFI) and various others.

2. Problem statement

Hitherto, Islamic SPs has not received adequate attention from the industry practitioners and academicians. This is evident from two dimensions. First, there is a dearth of literature about the discussion of and deliberation on Islamic SPs, which means that it is not popular enough to be widely discussed in the literature. Second, the fact that Islamic banks are offering limited SP investments such as Interest rate-linked, Equity-linked, and FX-linked Islamic SPs, manifests the procrastination in the development of the Islamic SPs. Besides that, there are various issues in the prevailing Islamic SPs such as interest rate benchmarking, the amalgamation of contracts, and leveraging. Most importantly, Islamic SPs are regarded by many as a mere replication of the conventional SPs where the prevailing Islamic SPs are designed to take advantage of the so-called Muslim market and that it is far away from its attempt of achieving the higher objectives of Islam vis-a-vis *maqāsid al-Shari'āh*. These issues ought to be addressed because not addressing them will only cast skepticism not only on the Islamic capital market, instead, on the Islamic finance industry as a whole. The indecisiveness of the matter will only add more confusions to the prevailing perplexities. Thus, this research embarks on to critically analyze the prevailing Islamic SPs and the underlying *Shari'āh* contracts, subsequently, examining the conventional SPs to perform a comparative analysis. It is hoped that the discussion will help decipher the above-deliberated issues, hence, deriving robust conclusive remarks.

3. Research objectives

The purpose of this study is to critically examine and explore the concept of Islamic SPs (ISPs) and its current practices in Islamic banks. Hence, the objective is:

1. To identify whether or not the Islamic SPs are a result of the scholar's innovation.
2. To examine the similarities and differences in Islamic SPs and conventional SPs.
3. To explore *Shari'āh* issues within the Islamic SPs and its resolution.

4. Research questions

Islamic SPs are under constant criticism by many *Shari'āh* scholars, industry practitioners, and academicians. As such, this research attempts to answer the following questions:

1. Are the Islamic SPs a result of Islamic scholar's real innovation, or is it a replication of its conventional counterpart?
2. If it is a replication then what is the way forward?
3. Do Islamic SPs truly conform to the *Shari'āh* principles, or is it a legal stratagem to fulfill the growing investors' demand?
4. What are the *Shari'āh* issues with the Islamic SPs?

5. Methodology

This research aims to expound on a thorough explanation of the conventional and Islamic SPs. To do that, the study employs a descriptive analysis approach to deliberate on the conceptual comprehension of the SPs. The primary source of data gathering is from the current works of literature, library research, and scholarly databases such as Ebsco, Scopus, Google Scholar, ProQuest, and Directory of Open Access Journals (DOAJ). Besides that, the study collects data from the prominent Malaysian Islamic banks such as HSBC Amanah, CIMB Islamic, Bank Muamalat, and Maybank Islamic to scrutinize the Islamic SPs offered by these Islamic financial institutions.

6. Limitations of the study

Islamic SP is a relatively new phenomenon in the Islamic capital market. It has yet to evolve and retains a plethora of potential for further development. However, for the time being, the study notices a lack of literature, and therefore, the study may have fallen short in addressing some of the prevailing and perhaps potential issues on Islamic SPs. As such, the researcher requests the academicians to enhance this study further. More importantly, despite the dearth of literature, this research was not adversely affected and yields staunch conclusive results.

7. Literature review

7.1 Conventional and Islamic SPs

According to Bullard (2015), SPs can be broadly defined as a pre-packaged product based on a series of derivatives. Investors can get exposed to a range of different underlying assets such as single stock, a basket of stocks, indices, commodities, debt, and forex. According to BNP Paribas, SPs are "a savings or investment products where the return is linked to an underlying asset with pre-defined features such as maturity date, coupon date, and capital protection level." According to Druilhe (2016), the SPs is packaged using three main components bond, one or more underlying assets, and financial instruments linked to the underlying assets. Securities Industry Development Corporation (SIDC), in its training notes, defined the term "SPs" as financial products created by financial institutions specifically for their institutional and individual clients. It has a risk and reward profile designed to achieve a specific set of objectives. SPs are hybrid investments that combine traditional security with one or more asset classes into a single structure. In Malaysia, according to the Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework (LOLA), SP means any investment product that falls within the definition of "securities" under the Capital Markets and Services Act 2007 (CMSA), which derives its value by reference to the price or value of an underlying referred asset. The underlying asset encompasses security, index, currency, commodity, other assets, or a combination of such assets (SIDC, 2015). Hasan (2010) summarizes that no single definition can undoubtedly cover the full spectrum of SPs. However, it could be defined as investment products that neither resembles any particular asset class nor any standardized financial instrument. It is a refined product designed and synthesized to meet the specific needs of clients. According to the Securities Commission (SC) Malaysia, there are 69 SPs that has been lodged in Malaysia by various banks. From the total 69 SPs, six of them are Islamic SPs (Securities Commission (SC) Malaysia, 2019). Below is the list of the six Islamic banks in the lodgment listing.

Table 1: Islamic SPs in SC's lodgment listing

Issuer Bank	Name of SP Programme	Size (RM Billion)	Lodgement Date	Expiry Date
RHB Islamic Berhad	Islamic SP Programme 1	5	19 Aug 2015	18 Aug 2018
HSBC Amanah Malaysia Berhad	Islamic Structured Investments Linked to Multiple Assets	5	14 Jan 2016	13 Jan 2019
Bank Muamalat Malaysia Berhad	Islamic Structured Investment Products Program	0.05	5 Jan 2018	4 Jan 2021
CIMB Islamic Bank Berhad	Islamic SP Programme-2	5	23 Apr 2018	22 Apr 2021
RHB Islamic Bank Berhad	Islamic SP Programme 2	5	10 Aug 2018	9 Aug 2021
Hong Leong Islamic Bank Berhad	Islamic SP Programme	5	10 Oct 2018	9 Oct 2021

Source: Securities Commission (SC) Malaysia

Islamic SPs are gaining popularity among investors since it is *Shari'āh*-compliant. It caters for those investor base that are willing to diversify their portfolios. It is noteworthy that, having fundamentally similar mechanisms as the conventional SPs, the Islamic SPs use only the permissible *Shari'āh*-compliant contracts (Rahman & Kassim, 2017). Hassan (2010) highlights that the most crucial element in designing the Islamic SPs lies within the nature of the contract. Similarly, Islamic SPs must adhere to the fundamental guidelines in Islamic finance such as being free from *ribawi* elements, features resembling *gharar*, and must be fair and just to the parties in the contract.

It utilizes sale-based *Shari'āh* contracts such as *murābahāh* or *tawarruq*, participatory contracts such as *mudārabāh* and *mushārakāh*, and agency contracts such as *wakālāh bi al-istithmar*. Additionally, the contract of promise such as *wa'ād* and *urbun* is also widely practiced to provide exposure to certain underlying assets. Furthermore, *Shari'āh*-compliant SPs began to emerge in 2007 whereby Maybank Islamic issued its first commodity-linked Islamic SP named 'Maybank Structured Islamic Deposit (Stride-i). Islamic banking and finance emerged as an alternative to conventional interest-based banking. The essence of Islamic banking stems out from the prohibition of the most fundamental elements such as interest (*ribā*), speculations (*gharar*), and gambling (*maysir*). In conventional banking, SPs exists as a specialized financial instrument to cater to the unique financing needs of the investors, which otherwise would not be met by the general investment instruments. With investors resorting to conventional banks to benefit from the SPs, a necessity arose to develop *Shari'āh*-compliant structured investment products to meet the investors' unique needs (HSBC Amanah). In an empirical study on *Shari'āh*-compliant structured investment products, Rahman & Kassim (2017) confirms the necessity to device *Shari'āh*-compliant structured investment products that can meet the investors' needs for their portfolio diversification. In Islamic structured investment products, the value of the product is determined by the underlying asset. Hasan (2010) defines an underlying asset as "any security, index, currency, commodity, or other assets or combination of such assets" (p.191). Demonstrating the peculiar features of the Islamic SPs, Firoozye (2009) acknowledges that Islamic structured investment products provide a rewarding yet leveraged return. In other words, although these products fundamentally function on the normative high-risk high-return theory, it has been successful in safeguarding the investors' capital. Furthermore, Dar (2018) states that it is challenging to meet the ever-evolving and diverse investors' demands through traditional financial products accessible in the financial market. Hence, it is imperative to innovate financial products that comply with the principles of *Shari'āh*, hence, providing investors a sustainable alternative. As has been established thus far, Islamic Structured Investment Products strictly inculcates the rulings and principles of *Shari'āh*. This is what primarily differentiates Islamic structured investment products from conventional SPs. However, besides this distinction, the mechanisms for designing Islamic SPs remains to be the same as the conventional ones (Rahman & Kassim, 2017, p.169). Nevertheless, the distinction mentioned above should not be undermined as Islamic banking and finance operates within the ambit of *Shari'āh*, wherein the former and the latter remains perfectly interlocked.

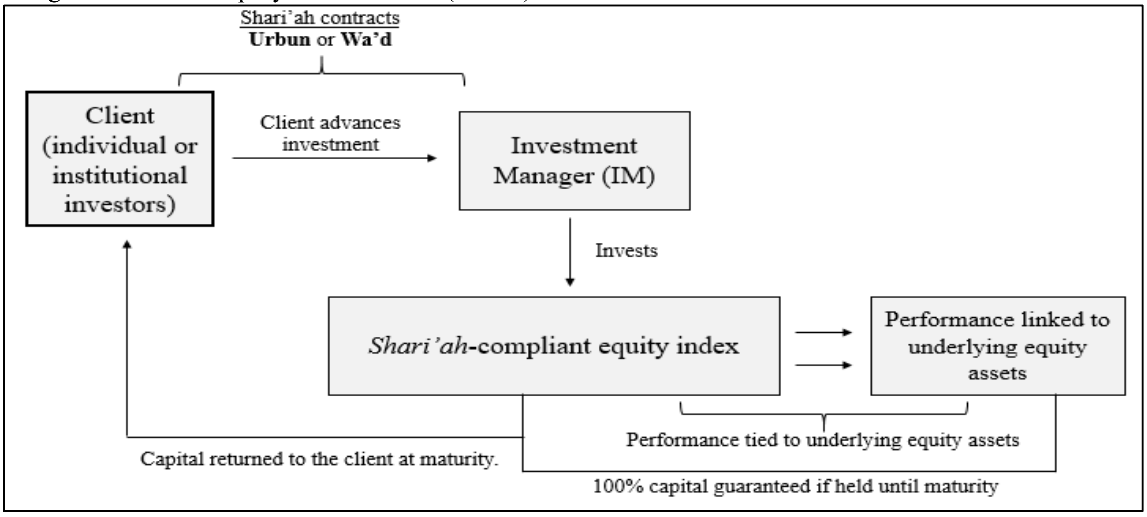
8. Findings and Discussion

8.1 Islamic Equity-Linked Notes (ELN-i)

This is the most commonly used Islamic structured investment product in the Islamic financial market. Similar to the conventional ELNs, the performance of the Islamic ELN is directly linked to the performance of the underlying *Shari'āh*-compliant asset class. This asset class may constitute a single *Shari'āh*-compliant stock, a pool of *Shari'āh*-compliant stocks, or an entire Islamic equity index (International Shari'ah Research Academy [ISRA], 2015). An index comprises of a cluster of stocks, and therefore the index tracks the performance of the underlying stocks. Meaning, the performance of the index is directly linked to the performance of the underlying stocks. So, if the performance of the index rises, it is said to be having an uptrend and vice versa. For example, if an index generates a 5% rate of return (ROR), it means that the underlying stocks have also generated an average ROR of 5%. This type of ELNs is most suitable for those investors that aim to generate a return by investing their capital in equity-based indices while exposing their investment to a regulated risk. As for the *Shari'āh* contracts, each Islamic financial institution uses different *Shari'āh* contracts depending on the investors' risk profile and investment needs.

Figure 1 depicts the modus operandi of the Islamic Equity-Linked Notes (ELNs-i). The client, which can be an individual or perhaps an institutional investor, seeks out the optimal *Shari'āh* contract such as *urbun* or *wa'ād* for investment purposes. After that, the client advances the investment funds to be invested in a *Shari'āh*-compliant equity index. At the end of the investment period, the capital is returned to the client. It is to be noted here that, the *Shari'āh* consultants thoroughly screen the equity index according to the *Shari'āh* screening guidelines. FTSE Russell, for example, is one of the prime global *Shari'āh* equity index. Some other indices are S&P 500 *Shari'āh*, Russell Jadwa *Shari'āh* Indexes, Dow Jones Islamic Market (DJIM) Index, MSCI Singapore IMI Islamic, FTSE Bursa Malaysia, and Edbiz NASDAQ-100 *Shari'āh* (ISRA, 2015).

Figure 1: Islamic Equity-Linked Notes (ELN-i)



Source: Author

8.2 Interest Rate-Linked Notes (IRLNs)

In conventional banking, interest rate-linked notes are a type SPs where the performance of the instrument is dependent upon the underlying interest rate index usually linked to the KLIBOR. This type of investment instrument provides "some credit protection" (ISRA 2015, p.675). HSBC Amanah offers an Islamic interest-rate linked Islamic SP. The product is HSBC Amanah Principle protected Range Accrual Interest Rate Linked SP. As the name implies, the product offers a capital guarantee if held until maturity while earning a "regular profit payment higher than fixed deposit" (HSBC Amanah). CIMB Islamic offers an interest rate-linked Islamic structured investment product which is a 7-Year Callable Islamic Range Accrual NID-i. To reiterate, the performance of this class of SP is linked to the interest rate. Although the words "Islamic" and "interest-rate" might seem oxymoronic, the necessity of having a full-throated Islamic banking system gave rise to the fixed income instruments despite being frowned by the *Shari'āh* (Bennett, 2011). Rigorous financial engineering went underway to device Islamic structured instruments so that it provides fixed-returns to the investors while remaining within the ambit of *Shari'āh*.

The differences between conventional and Islamic SPs can be seen in the contracts employed by Islamic banks. Although Islamic banks benchmark the Islamic SP against the interest rate, they, however, use *Shari'āh* contracts such as *wakalah bi al-istithmar*, *wa'ād*, commodity *murābahāh*, and commodity *musāwamāh* (HSBC Amanah). These are the most widely used *Shari'āh* contracts. It is noteworthy that the underlying assets within the Islamic SP is *Shari'āh*-compliant even though the performance of the same product is linked to the interest rate or KLIBOR. Similarly, evaluating the issues in Islamic SPs, Hasan (2010) argues that since the LIBOR is being used for price determination then "there should not be any *Shari'āh* issues in using the index in this manner, even if the index is not *Shari'āh* index" (p.204). Interest rate-linked notes work the similar way as the equity-linked notes except that the former is linked to the market interest rate while the performance of the latter is dependent on the equity index.

8.3 Commodity-Linked Notes

Another type of Islamic SP is a commodity-linked note (CLN). The return is linked to the performance of a commodity or basket of commodities over a specified period. Investors will get the initial principal amount plus a return (if any) based on the percentage of change in the underlying commodity. The only difference between CLN applied in Islamic with its conventional counterparts is the commodity to be used has to be *Shari'āh*-compliant (ISRA 2015).

8.4 Bond-Linked Notes

As the name implies, it is a type of SP where the coupon is tied to the performance of the underlying bond. Investors of bond-linked notes (BLNs) are exposed to the issuer's credit risk. It offers attractive yields in a stagnant or bullish market. Nonetheless, investors may suffer a loss resulting from the unwinding of the BLN before the maturity date. In Islamic SPs, its performance may be linked to sukuk indices (ISRA, 2015).

8.5 Credit-Linked Notes

A few notable scholars have ruled out the permissibility of the credit-linked notes (CLN). It is because its mechanism is perceived as betting against the capability of a particular issuer to pay in certain circumstances, depending on the default of individual entities. CLN is a type of SP where the principal repayment and coupons are tied to the creditworthiness of the issuer and a third party which is also known as the reference entity. During the life of the CLN, investors receive regular coupons. At maturity, investors will receive the principal repayment provided that the reference entity does not experience a credit event during the life of the CLN. A credit event is an event which triggers settlement under the credit default swap (CDS) contract.

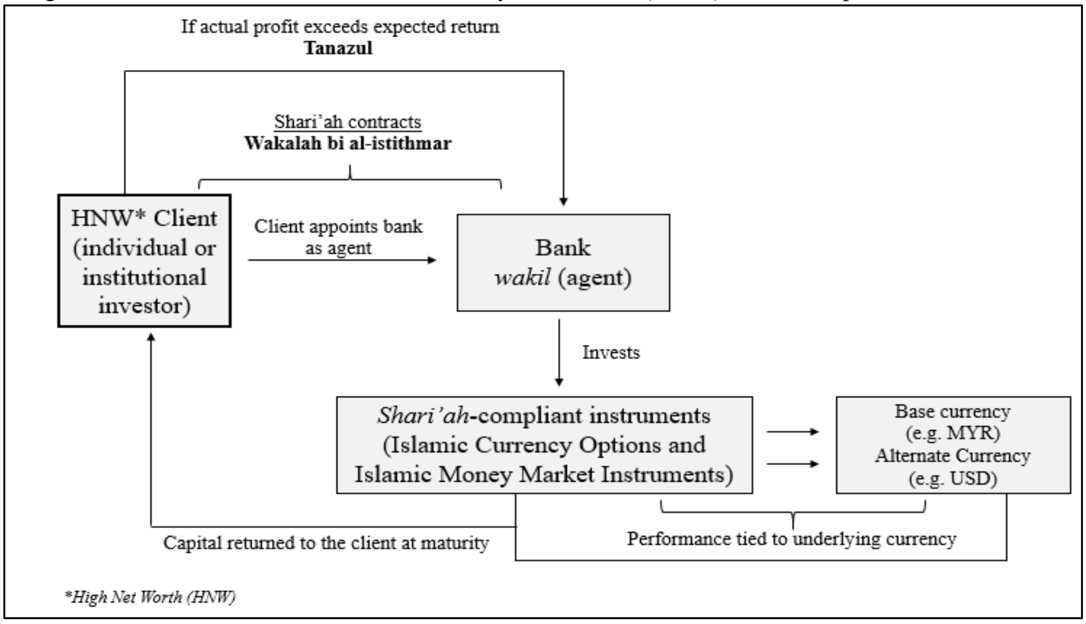
If the issuer faces a credit event, the investor receives a bond issued by the reference entity at a value less than the principal invested. Typically, a CLN is a note with a credit default swap (CDS) where the issuer sells the CDS to the bank and receives an annual fee which is then used to pay investors of the CLN (ISRA, 2015). In case the issuer cannot pay the investors, the CDS also allows the bank to transfer the risk of default on the note back to the issuer. It is because of this reason the scholars do not allow CLN to be applied in Islamic SPs.

8.6 Islamic FX-Linked Notes

Similar to other Islamic SPs, this type of product also offers a capital guarantee on a condition that the product is held until maturity or call. The return on this product is linked with "a single foreign currency, a basket of foreign currencies, or FX futures". Unlike other SPs, Islamic FX-linked notes are not immune from criticism of its existence. Scholars differ in their opinion regarding this product. The scholars against this product argue that since this SP is linked with the currency, hence it violates the basic principles of currency such as "medium of exchange, store of value and unit of measurement" (ISRA, 2015, p.675).

For example, RHB Islamic bank in Malaysia offers 'Dual Currency Investment-I (DCI-i)' using the *Shari'āh* contract of *wakālāh bi al-istithmar* (agency contract for investment). RHB Islamic bank indicates that the capital in this investment is not guaranteed; neither protected by Perbadanan Insurans Deposit Malaysia (PIDM). Figure 2 depicts the process flow of a currency-linked Islamic structured investment. A High Net Worth (HNW) client appoints the bank as an agent under a *wakālāh bi al-istithmar* contract between the client and the bank. The bank, as a wakil, pursues investment in *Shari'āh*-compliant instrument which could be Islamic currency options or Islamic money market instruments. Performance of the product is linked to the underlying currency, which is chosen upfront by the client. The bank will determine the profit based on the weaker currency at maturity as stipulated in the terms and the conditions. After that, at the maturity or call, the capital will be returned to the client along with the profit. However, if the actual profit exceeds the expected return, the client agrees to *tanāzul* (waives the right to) of the excess profit. In other words, the client agrees that the bank will retain any excess profit above the expected return.

Figure 2: RHB Islamic Bank's Dual Currency Investment (DCI-i) structured product



Source: RHB Islamic PDS; Diagram: Author

8.7 Islamic SP models

Essentially, there are two stages involved pertaining to the Islamic SP models. First, the channeling of proceeds, and second, the investing of the proceeds. The underlying contracts in the proceeds stage involves *wakālāh* or *mudārabāh* contracts while the investment stage involves contracts based on *murābahāh*, *tawarruq*, *urbun* or *wa'ād*.

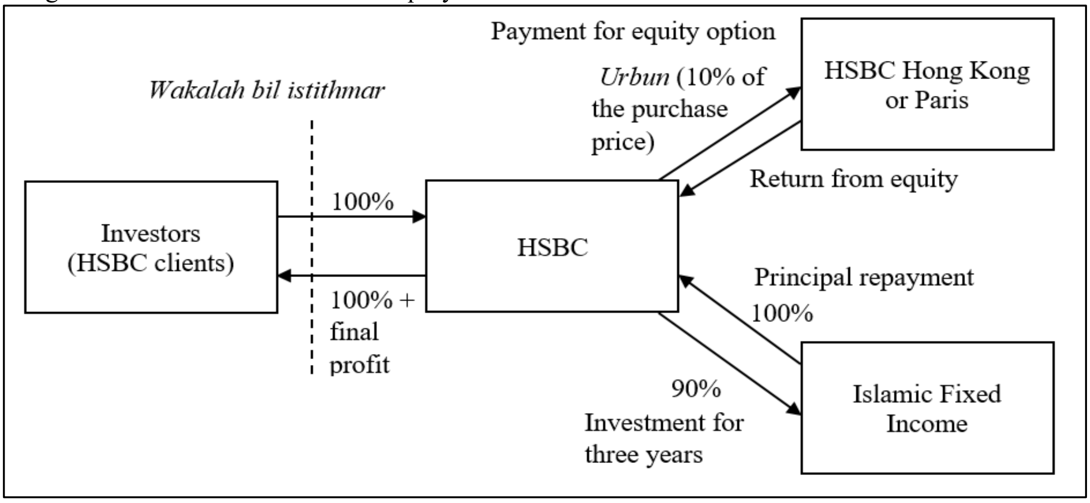
In the first stage, either a *wakālāh* contract is used or a *mudārabāh* for the collection of the proceeds through the sale of Islamic SPs. *Wakālāh* contract is used in the form of *wakālāh bi al-istithmar*, in which, the investor acts as a principal (*muwakkil*) and assigns the issuer/manager as the agent (*wakil*); whereas, in a *mudārabāh* contract, the investor acts as a capital provider (*rabb al-māl*), and the agent acts as an investment manager (*mudarib*) to invest the proceeds in the Islamic SPs. Furthermore, the primary feature of conventional SP is the guarantee of the capital, which is a similar approach adopted by Islamic SPs. Hence, in most structures, a *tawarruq* arrangement is employed to manage the more significant portion (usually 90%) of the proceeds by investing in less risky assets while the other 10% of the proceeds are invested in a profit-maximizing portfolio using the *urbun* contract. This is to ensure the capital is preserved and guaranteed by the investment manager. The contract of *wa'ād* is also used in this stage to structure Islamic SPs.

8.8 Urbun Model

The concept of *urbun*, as mentioned earlier, is employed for investing the smaller portion (i.e., 10%) of the proceeds. Urbun can be defined as earnest money paid by the buyer to the seller in order to secure the purchase of a particular asset in an exchange contract. The paid *urbun* is considered part of the price if the buyer opts or decide to continue with the contract (ISRA, 2015). However, if the buyer chooses to cease the contract, the *urbun* amount may be forfeited vis-a-vis rendered non-refundable at the option of the seller. In conventional SPs, the call option is employed for the smaller portion of the proceeds.

Similarly, in Islamic SPs, the concept of *urbun* is used to for the same reasons as that in conventional. However, the former is impermissible for being conventional, whereas the latter is permissible for being *Shari'āh*-compliant. This concept is discussed in details in the *Shari'āh* issues and solutions section of this paper.
Furthermore, in Malaysia, there are two Islamic SPs that adopts the *urbun* model. First, HSBC Amanah Islamic Equity-Linked Structured Investment-i; and second, Islamic All-Starts Restricted Mudharabah Structured Investment-i. The former refers to purchasing the equity option while the latter refers to purchasing the index. The HSBC Amanah Islamic Equity-Linked Structured Investment-I figure provided below depicts the example of based on the *urbun* model.

Figure 3: HSBC Amanah Islamic Equity-Linked Structured Investment-i



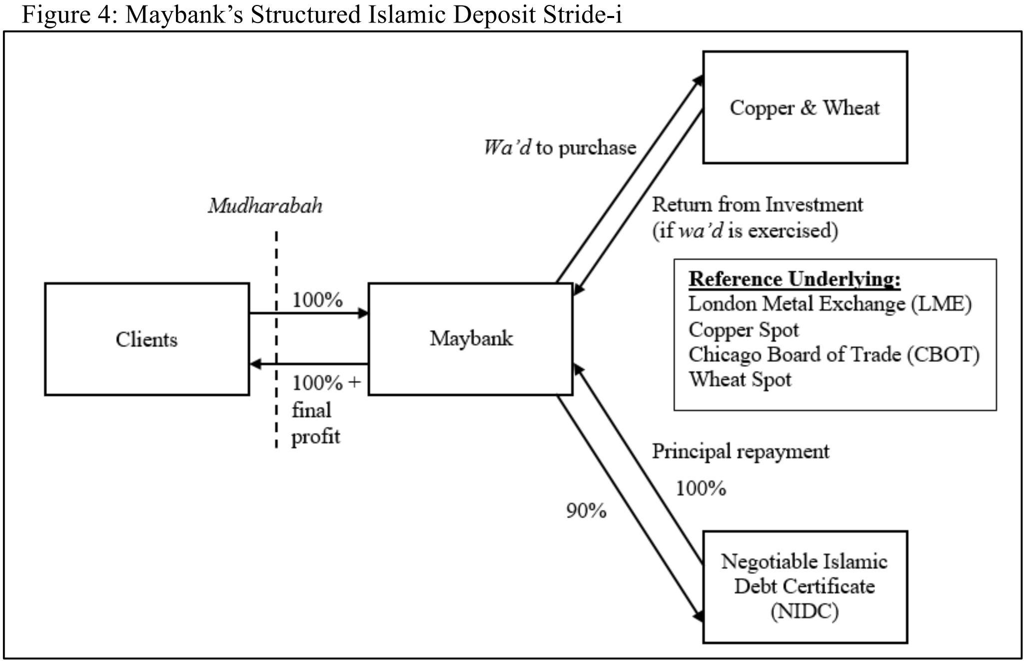
Source: ISRA, 2015, p.679

The portion of 10% of the proceeds is invested in HSBC Hong Kong or Paris by purchasing *Shari'āh*-compliant equities. HSBC pays 10% of the purchase price of equities and deems it as earnest money (*urbun*). If HSBC decides to continue with the investment, the *urbun* will be considered as part of the purchase price. However, if HSBC decides not to continue the investment at the maturity date, the *urbun* will be forfeited and is not refundable. HSBC's decision will be based on the performance of the equity option.

8.9 Wa'ād model

Another concept used for investing the smaller portion of the proceeds is through purchase undertaking (*wā'ad*). The structure is quite similar with previous *urbun* model. The difference exists only in the profit maximization portfolio whereby the investment manager enters into an unconditional and irrevocable purchase undertaking (*wā'ad*) to purchase the Islamic asset such as copper or wheat using the portion of 10% of the proceeds at a specific sale price upon maturity (ISRA, 2015). An example of Islamic SP using the concept of *wā'ad* is Maybank's Structured Islamic Deposit Stride-i, which is depicted in figure 4.

Figure 4: Maybank's Structured Islamic Deposit Stride-i

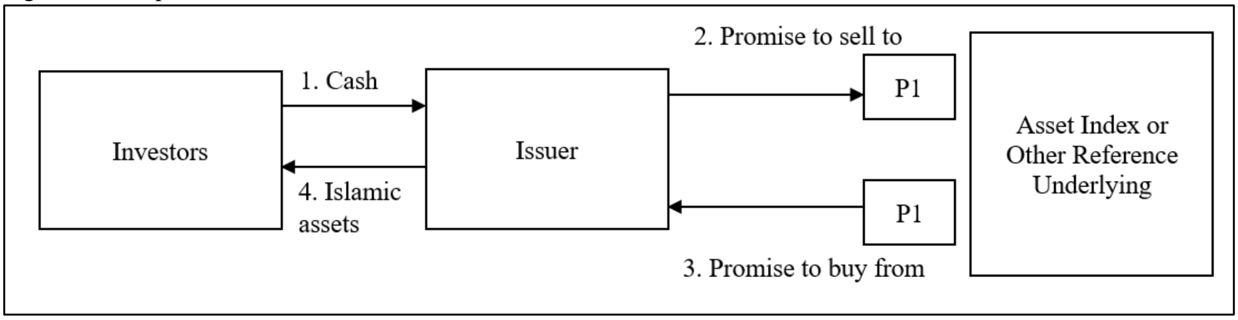


Source: ISRA, 2015, p.679

8.10 Wā'adān model

The third model in Islamic SPs is applying two unilateral promises (*wā'adān*). In this model, the capital is protected by closely monitoring the performance of the underlying asset or index and ensuring that it will not fall below the capital invested amount (ISRA, 2015). Figure 5 below illustrates the mechanism and workflow of the *wā'adān* model.

Figure 5: An operational flow of *wā'adān* model



Source: ISRA, 2015, p.681

The following steps further describe the process flow of the *wā'adān* model.

1. Investors place the proceeds with the issuer and appoint the issuer as an agent to purchase *Shari'āh*-compliant securities. The issuers will hold the securities for the benefit of the investors.
2. The issuer then enters into unilateral binding purchase undertaking (first *wa'ād*) which promise P1 to sell the underlying assets at a specific sale price upon maturity (or at any conditions stipulated).
3. Concurrently, P1 enters into unilateral binding purchase undertaking (second *wa'ād*) which promise the issuer to buy back the underlying assets at a specific sale price upon maturity (or at any conditions stipulated). This event or conditions shall not be similar to the earlier purchase undertaking. Only one of the undertakings will be exercised at maturity.
4. At maturity, the contract will be concluded, and the securities will be sold to P1, upon exercise of first *wa'ād* or second *wa'ād*.
5. The proponents of this model justify that the two undertakings (*wa'ād*) are not inter-conditional between each other. However, the opponents believe that the substance of the model seems to be fictitious, which might expose itself to bilateral purchase undertaking (*muwā'adāh*).

9. *Shari'āh* issues and solutions

9.1 The usage of conventional indices

The economic effects of both conventional and Islamic SPs may be similar to each other. While Islamic SPs differ from the conventional SPs in terms of mechanism and the contracts being used, the usage of the conventional index in Islamic SPs remain a contentious issue among the Islamic scholars. The index has its calculation methodology and is usually expressed in terms of a change from a base value. The most eminent indexes are the bond market index and the stock market index.

According to Hasan (2010), there are several usages of the index:

1. Only for benchmarking prices: This is acceptable among the majority of contemporary scholars. The benchmarking is a small number and is non-objectionable from the view of the *Shari'āh*. Co-existence with well-developed conventional banks obliges Islamic Banks to use the interest rate as benchmarking until other alternative Islamic benchmarks can be established (Delorenzo, 2009; AAOIFI *Shari'āh* standard no. 27, section 5/2, 2017).
2. Urbun contract: Some Islamic SPs resort to the *urbun* contract to reproduce an option to buy a basket of shares in a specific index or to buy the whole index. According to majority jurists, the purchase of option is not valid due to underlying asset ownership. Meanwhile, Maliki jurists allow it. The AAOIFI *Shari'āh* standard no. 20, has formulated three sub-standards on the index as follows:
   - For transactions based on the mere rising and falling of an index: For example, one of the parties says to another that if the index rises to such and such level, then he is liable to pay the other party such amount. This is a type of gambling, hence prohibited.
   - For options contracts based on the movement of one of the indexes, and this is by agreement between the parties to the sale on purchase of the option. For example, if the index rises in this way then 'I will compensate you so much for each point.' Also, it is impermissible to deal with such option.

- For derivatives transactions based upon the movement of the indexes, and this is by agreement of the two parties to sell a deferred commodity for a deferred price. This is also not permissible to deal in derivatives.

Unfortunately, the benchmarking method is still in the developmental stage for the Islamic Financial System. Banks become a vital part of the government to control the monetary system in a country. An alternative benchmark could be established when the government's approach in managing monetary policy is based on a 100% Islamic economic system. A study conducted by Haron and Ahmad (2000) finds that the profit motive guides customers. If the profit rate of IBs is lower than conventional banks, Islamic banks will lose depositors. On the other hand, if the profit rate is higher than the interest rate, Islamic banks will lose clients/entrepreneurs, whereby they will avoid taking investment from Islamic banks. Due to such fierce competition of attracting more deposits from customers, Islamic banks are forced to use interest rate benchmark for pricing their products. Another research conducted by Hakan and Gulumser (2011) finds that any change in the interest rate affects not only the deposits and loans of conventional banks but also the Islamic banks. Hence, the Islamic financial industry must strive to overcome the criticism of using the interest rate as a benchmark and actively seek an alternative to the common controversial benchmarking mechanism.

9.2 Leveraging and mechanism to leverage

Leveraging is an investment strategy of using borrowed money – for the use of various financial instruments or borrowed capital –to increase the potential return of an investment (Hayes, 2019). It is impermissible to transact per the money leverage system. It amounts to a loan that brings benefit to the broker. It consists *ribā* because the broker is a mediator through whom the debtor takes the loans, and the broker benefits from such loan.

Additionally, for the Forex-linked Islamic SPs, it is essential to mention that doing business with the Forex system could potentially involve many violations of Islamic law such as the presence of *ribā*. However, if the company provides a system that is free from such violations and fulfills the condition of *sarf* (exchanging hand-to-hand) while conducting the transaction, then such transactions render permissible; otherwise, it will be impermissible (Islamweb, 2015). To a similar effect, Hasan (2010) highlights that there should not be any *Shari'āh* compliance issue on leverage if a proper mechanism has been deployed. As long as the mechanism to raise extra money is acceptable and compliant according to the *Shari'āh* principles, the investor should be allowed to gain access to the upside performance of the fund.

9.3 Replicating conventional products

Shari'āh provides flexibility in the interpretation of the matters in question. The scope of the Islamic finance industry has significantly catapulted towards the conventional system. Various Islamic financing products have been successfully structured to perform and achieve similar functions as conventional instruments. Undoubtedly, the replication approach of conventional products was a necessity (*darurāh*) at the initial stage for the development of the Islamic finance industry. This approach, however, was criticized regarding its substance and legitimacy (Laldin & Furqani, 2016).

Replication approach was adopted by the Islamic scholars and practitioners to convert conventional models to Islamic models because innovating products from the grass-root level was time-consuming and costly. Meanwhile, it is paramount that *maqāsid al-Shari'āh* (the higher objectives) be upheld while structuring and innovating new products; otherwise, the public will lose the confidence in the Islamic financial system (Akhtar, 2008). Furthermore, financial innovation should be designed carefully in a way which strives to achieve higher objectives and does not violate Islamic laws (Iqbal & Molyneux, 2005). Since the Islamic financial industry shares many features with its conventional counterpart, the product engineering ought to be more simplistic rather than being complex (Iqbal, 1999). *Shari'āh*-compliant Islamic products do not mean a mere satisfaction of the minimum requirement of Islamic jurisprudence but to structure and orient Islamic finance with Islamic spirit and values (Laldin & Furqani, 2012).

It is, however, noteworthy that, replicating conventional products in a *Shari'āh*-compliant form is not the ultimate objective of the *Shari'āh*; instead, the goal is to strive to become 'alternative' to the conventional finance and not 'replicative.'

9.4 Combination of contracts

There are two types of investment categories in the Equity-linked Islamic SPs. The first part is applied to protect the investment in order to make a profit to at least cover the initial amount that has been invested. The second part is being used to replicate derivatives through employing contracts such as *urbun* or *wa'ād* to buy some of the underlying assets which standardize against some indices.

The proceeds under these contracts are used to purchase certain commodities in order to sell it later to the issuer. The selling price shall be deferred to a specific period because the issuer intends to create an obligation to pay a fixed selling price to secure the capital. After that, the issuer shall immediately give a unilateral promise to buy particular goods from investors at a specific selling price that standardizes against a specific index (ISRA, 2015). Furthermore, it can be seen that at least two contracts are executed. This raises the *Shari'āh* issue of a combination of two contracts in one single transaction. The issue of a merger of different contracts in a single transaction is not new. Almost every modern Islamic financial instrument has been permeated by this pre-agreed hybridization of contracts of various forms in a variety of orders and formats. Thus, some scholars believe that the merger of contracts does not always have to cast doubt on the validity of the product from the *Shari'āh* standpoint unless contracts are concluded on an inter-conditional basis or such combination results in the over-circumvention of a prohibition (El Diwany, 2003).

AAOIFI *Shari'āh* standard no. 25 has established specific guidelines and conditions for contract amalgamation as follows:

1) The merger of the contracts should not include cases that *Shari'āh* explicitly forbids, such as the combination of sale and loan.
2) The combination of contracts should not be used as a trick for practicing *ribā.*
3) The amalgamated contracts should not contradict each other in terms of the underlying rulings and ultimate goals.

Therefore, HSBC Amanah's 'Islamic Equity-Linked Structured Investment-I' is structured using the concept of *wakālāh bi al-istithmār*, and incorporates the concept of *wa'ād,* commodity *murābahāh,* and commodity *musāwamāh* for the hedging arrangement and investment purposes. Hence, all the combination of contracts are acting independently; hence, they are not used as a trick for practicing *ribā*.

9.5 Shari'āh issues in Islamic options

In a call option, the owner (of the call option) has a right but not the obligation to purchase the underlying asset if the price increases; whereas in a put option, the owner (of the put option) has a right but not the obligation to sell the underlying asset if the price decreases. A *Shari'āh* issue that arises here is the fee or premium paid on the promise of purchase or sale of the options. Usmani, as cited in Bacha (1999), clarifies that the impermissibility of options is based on the fees charged for the pledge. However, it is obligatory to remove the promise of paying a premium on the options to make it compliant with the Islamic commercial law. Therefore, as an alternative to the premium, scholars suggest employing "earnest deposit" or *urbūn* to make it *Shari'āh*-compliant. *Urbūn* is defined as a sale contract whereby the purchasing party pays a down payment to the selling party as a promise to purchase a particular commodity. If the commitment is fulfilled, the down payment is regarded as part of the price. If the commitment is not fulfilled, the down payment is non-refundable and retained by the selling party (Kamali, 2000). According to the AAOIFI *Shari'āh* standard no. 20 section 5/2/3/1, the options are permissible but with implementing *urbūn* as stipulated below:

> The conclusion of a contract pertaining to ascertained assets is permitted according to the *Shari'āh* along with the payment of part of the price as 'Arboun (Earnest Money). However, with the stipulation that the buyer has the right to revoke the contract within a specified period in lieu of the entitlement of the seller to the amount of earnest money in case the buyer exercises his right of revocation. It is not permitted to trade the right established with respect to the earnest money (AAOIFI *Shari'āh* standard no. 20, section 5/2/3/1, 2017).

Another issue that arises is the marketability of *urbūn* based options in the secondary market where the buyer intends to sell the options to a third party. As mentioned above, *urbūn* is a sale contract between two parties, and therefore, the seller is obliged to sell the subject matter to the buyer. However, if the buyer decides to sell his right (to precede or recede), then this can be settled only with the consent of the seller (Dali & Jalil, 2006). Furthermore, regarding the issue of trading the *urbūn* based options, AAOIFI in its *Shari'āh* standard no. 20, section 5/2/3/1 states that "it is not permitted to trade the right established concerning 'Arboun (earnest money)." In contrast, Obaidullah indicates that several scholars have made an analogy between options and *khiyār*, concluding that, according to previous scholars, *khiyār* can be inherited. Therefore, it proves that the ownership of *khiyār* can be transferred (Dali & Jalil, 2006); hence, tradeable.

In addition to *urbūn*, *wa'ād* is said to be able to replicate a conventional call option; however, scrutiny of the latter shows some potential issues in practice. Thus, it is argued that the two unilateral *wa'ād* given by the seller and buyer in Islamic SPs may be viewed as a bilateral *wa'ād*. AAOIFI, however, differentiates between two kinds of *wa'ād* –the unilateral *wa'ād* and the bilateral *wa'ād*. AAOIFI resolves that the binding unilateral promise is permissible; whereas, the binding bilateral promise is impermissible (AAOIFI, 2015). Similarly, the OIC Islamic Fiqh Academy also opined in its earlier resolution, which states that binding bilateral promise is impermissible. However, the argument put forth by the supporters of *wā'adān* structure is that the two promises (*wa'adān*) are given unilaterally and the conditions of their realization are also different. Hence, only one promise will be effective at all times because they are independent and unrelated to each other. Therefore, regarding it to be permissible (ISRA, 2015).

Conclusion

The development and innovation of Islamic SPs is a replication of the conventional SPs. This phenomenon is apparent in the view of the various Islamic contracts discussed in this paper. Islamic SPs are a replica of the conventional SPs wrapped in an Islamic covering. Although innovation in devising Islamic SPs are encouraged, it should not be devised to merely differentiate from the conventional SPs in its legal status; rather, the innovation of Islamic SPs must reflect the actual values of Islam that advocates to achieve economic justice, which the conventional banks are missing. Notwithstanding, the research does acknowledge though, that there is undoubtedly a necessity to innovate Islamic SPs to meet the growing needs of the clients otherwise the Muslim affluent will resort to conventional SPs, hence, dealing with *ribā*. The research, however, firmly concludes that the prevailing innovation is not a real innovation; instead, it is merely an amalgamation of the conventional SPs. Therefore, the research attempts to draw attention of the Islamic scholars to enhance and simplify the perplex mechanism of SPs to cater the needs of the affluent clients. It is also emphasized that the designing of the Islamic SPs should be in a manner that is not merely a replication, rather, the innovation of the Islamic SPs must be designed to achieve the higher objectives of the *Shari'āh*. It is noteworthy that, although the amalgamation is not against the *Shari'āh per say*, the replication, however, is devoid of the real objectives of the *Shari'āh* (*maqāsid al-Shari'āh*). Hence, once put in practice without due acknowledgement of its adverse economic effects, these ratcheting SPs will yield similar results as *tawarruq*, which was initially permitted by the *Shari'āh* scholars at the advent of Islamic finance industry on a condition to slowly detach from it. However, stayed everlastingly, and needless to say, there are no notable indications of it being replaced in a near future.

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