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Investment and Financial Product Development in Islamic Banking

Dr.Adil Abdulsalam Ashhoob Abdulsalam[1]*

[1]Assistant Professor, Aljafara University, Libya

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Abstract

The purpose of this paper is to study of Investment and financial product development in Islamic banking on investment financing in Islamic. This study employed descriptive survey design. The population of this research consisted of commercial banks offering shariah compliant products. The study used secondary data. Loans advanced to customers were collected. Data was analyzed using Statistical Package for Social Sciences (SPSS) and results were presented in frequency tables and figures. The data was then analyzed in terms of descriptive statistics like frequencies, means and percentages. The study findings indicated the relationship on how Islamic banks use their investments as loans advanced to customers to finance Islamic banks products. Islamic bank products are the independent variables. The investment is the dependent variable. The products included motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing. The study also indicated that there were various modes of financing used by Islamic banking such as profit and loss sharing. The subject of Islamic financial product development covers various aspects of studies. However, this study aims to analyze the Shariah aspect of Islamic financial product development and discuss the issues arise in the process based on secondary resources. The output of this study should contribute to the advancement of procedure for Islamic financial product development, particularly from the Shariah aspect, as it is the most imperative tool for the Islamic financial institutions to meet their increasing concern about profitability, liquidity, assets value, risk management as well as product acceptability. The study proves that and provides ample spaces for developing Islamic product development, an area in which Islamic financial institutions should focus their resources. The inconsistency can be explained by more investors using other Islamic banking products for financing more than mortgage financing. Overall, it was possible to conclude that the Islamic banking products have spread in the banking sector as all the financial products have been used to a high percentage across the years. The study recommends that the more time may be required for the unique characteristics of Islamic financial instruments to be completely accepted and understood by both bank personnel and customers. It is also recommended that the terms and conditions of acquiring a loan be made more appealing and considerate for more investors to approach the banks for assistance as the Shariah restricts the type of businesses for which Islamic banks can provide financing. For example, they are not permitted to participate in certain prohibited investments or joint venture projects considered to be detrimental to the individual, society, or the environment.

Keywords: *Islamic Banking, Financial production and development, Shariah*

Introduction

What triggers curiosity in Islamic finance is the absence of interest, which is the backbone of Western or Conventional banking and financial systems. Islam prohibits interest, known as riba, not as law of the land but as divine orders leaving no space whatsoever to argue or put a case forward otherwise (Al-Qamar & Abdel-Haq, 1996). It is compulsory for Muslims to completely avoid riba in their commercial and non-commercial daily activities. It is even suggested that a shadow of interest will make a transaction haram.

*Corresponding author's ORCID ID: 0000-0002-9871-2908
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Apart from interest, other prohibitions include uncertainty, risk taking, ambiguity and investment in unethical and haram businesses. These prohibitions make up a wide part of activities of conventional banks. Under Islamic faith, all these prohibitions are believed to be signs of immorality and exploitation. In contrast, the Islamic banking operates on the principles of profit loss sharing and financing is done as participatory mode rather than lending mode. The Islamic banking and finance are a system designed to allow Muslims to deal with their financial affairs in accordance with their faith. The theoretical model is appealing and is carefully designed to avoid interest and other prohibition; however, implementation of the Islamic banking and financial system has not always been successful in practice (Shepherd, 1996). The banking and financial services industry is highly competitive and an inferior product will be discarded by the customers. The product offered must be sound in all regards in order to protect and enhance the reputations of those institutions that associate their name with it. Moreover, new generation of well-informed consumers demanding differentiated and sophisticated products. In the light of the facts, banking and financial institutions should focus their resources and talents on serving the customer in order to ensure continuous presence in the market.

2.0 Material and Methods

The imperative of islamic financial investment and product development

It is clear that in the rapidly changing financial environment in which the Islamic banks are operating, it is vital that every player of this sector attempt to ensure both its short-term competitive and long-term strategic presence. Islamic banking institutions as well as Islamic banking consultants need to be continually innovative and create new ideas and new products. Procedure for financial product and service development is the most imperative tool in order to meet their increasing concern about liquidity and risk management so as to ensure the value of the assets created by them as well as sustained growth and profitability for the business (Noman, n.d.). Product development is an important area in which Islamic banking and financial institutions should focus their resources. There is already a pool of Islamic banking institutions and consultants in the Malaysian market but the study on how the institutions carry out their product development process is still in absence. Hence, this article is a preliminary review dedicated to analyze the Shariah aspects of Islamic financial product development and issues surrounding the area in the Malaysian context. It is hoped that more studies will be undertaken on the topic in the future. Malaysia has opted to have a dual financial system that consists of Islamic and conventional financial systems. The dual financial system has proved to be viable as more competitive and sophisticated Islamic financial products have been introduced into the Islamic banking industry and gained popularity and even preference amongst the customers. In other words, the Islamic banking products in a dual financial system tend to be wider in range, bigger in number and more sophisticated compared to them counterparts in a single Islamic system3 (Bakar, n.d.). It is observed that much of the Islamic products are introduced into the market place by adapting and reengineering the conventional products – following the success of the conventional products (Gainor, 2000). This is a considerable innovation and value-added put by the Islamic financial institutions but it may bring about skepticism on the substance of the products and criticism on the institutions and system if this reengineering process is substantially practiced. Islamic banking and financial institutions should be able to foresee the needs of the market and roll out Islamic financial prefects and services in advance of conventional products to ensure constant growth and competitiveness of Islamic banking and financial products. However, “Islamic banking products and services tended to duplicate the conventional ones, resulting in these products losing value and causing some confusion in their interpretation” (Business, 2005). Hence, it is essential for the Islamic banks to move beyond the adaptation of conventional products and stimulate new ideas that will help the Islamic banking and financial industry nourish.

2.1 Aspects of Islamic financial investment and product development

The standard product development process comprises of five main stages i.e. market intelligence, resources allocation, team selection, marketing and distribution, and research and development (Khan, 2002). The product development is a comprehensive process and should involve committed and competent people with various backgrounds. Gainor (2000) suggests that the Islamic financial product development team may include Shariah scholar, Islamic financial advisor, asset manager, custodian and registrar of administrative services, lawyer, directors, distributor/selling agents/marketing group, customer and project coordinator. The authors have recognized seven main aspects that should be observed in developing Islamic financial product development. They are:

1.Shariah (Islamic law)
2. (Governing) Law
3. Tax structure
4. Accounting standard
5. Technical system
6. Finance
7. Marketing

However, the core of Islamic financial products is the Shariah compliance. The Shariah scholars are responsible in giving fatwa on the product with the underlying supporting evidences to the Islamic investors. The product must be Islamically acceptable and economically viable in all aspects. This illustrates the criticality of Shariah analysis which must be carried out in order to ensure the marketability of the end-product. Hence, the Shariah scholars must be involved in the whole process from beginning and not only at the end of the process (Gainor, 2000). They must be adequately informed to clear doubts, if any, surrounding the product.

2.2 Islam and the theory of interest

The early contributions on the subject of Islamic banking were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on Islam and the Theory of Interest (Qureshi, 1946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing. Ahmad (1952) in his book Economics of Islam envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds. The principle of mudaraba based on Shariah was invoked systematically by Uzair (1955). His principal contribution lay in suggesting mudaraba as the main premise for 'interest less banking'. However, his argument that the bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical. Al-Arabi (1966) envisaged a banking system with mudaraba as the main pivot. He was actually advancing the idea of a two-termitaria which would enable the bank to mobilize savings on amudaraba basis, allocating the funds so mobilized also on amudaraba basis. In other words, the bank would act as a mudarib in so far as the depositors were concerned, while the 'borrowers' would act as mudaribsin so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.

2.3 Profit and loss sharing (PLS) theory

Islamic scholars treat PLS instruments, mudarabah and musharakah as a central pillar of the Islamic banking model. In mudarabah banking, the Islamic bank accepts funds from depositors under risk-sharing arrangements. The Islamic bank either directly invests these funds in profitable investments or extends them to entrepreneurs on a risk-sharing basis. The Islamic bank shares the profit or loss made on mudarabah ventures with its depositors. In musharakah banking, the Islamic bank contributes the depositors' funds to a joint enterprise with the client (an entrepreneur). Generally, the Islamic bank allows the client to manage all the affairs of a Musharakah business. The Islamic bank and the client mutually share the profit or loss made on the Musharakah investment. In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS, especially in case of Mudaraba that does not provide any control rights 14 to the financier (the Islamic bank in this case). Fiqh literature on this issue is quite outof-date and needs serious reconsideration. For example, Saleh (1986) lists three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower. The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract. The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. There is a need for construction of standardized PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

3.0 Research methodology

This section outlines the methods and techniques used in this study. Methodology is a related set of assumptions that reflect how a researcher views reality and how this reality is articulated through research. Choice of method is reflective of what the researcher wants to uncover. To concretize research methodology this chapter shall cover research design, population, sample size, instruments and data analysis.

Research Design

A research design is the structure of research. It is the glue that holds all the elements in a research process project together. A design is used to structure the research, to show how all of the major parts of the research project work together to try to address the central research questions.

3.1 Target Population

Newing (2011) describes a population as the set of sampling units or cases that the researcher is interested in while Burns and Grove (2003) describe population as all the elements that meet the criteria for inclusion in a study. The population of this study was all commercial banks offering Islamic banking products in gulf country. They comprise of two fully fledged Islamic banks (Gulf African Bank and First Community Bank) and six conventional banks that offer partial Islamic banking (Barclays banks, National Bank, Chase Bank, Imperial Bank, Diamond Trust and Standard Chartered Bank).

3.2 Sampling Technique and Sample Size

The study sample comprised of eight commercial banks which offer Islamic banking products. This means that a census was employed in order to include all commercial banks in Kenya which offer Islamic products.

3.3 Data Collection Instrument and Procedure

Secondary data was utilized in this study. This means that all the study variables utilized quantitative data. The data obtained from the annual reports of the banks and also from banks‟ internal sources. To compile the data, a secondary data collection template was used.

4.0 Data Analysis

Data Analysis is the processing of data to make meaningful information (Sounders, Lewis & Thornbill, 2009). Burns and Grove (2003) define data analysis as a mechanism for reducing and organizing data to produce findings that require interpretation by the researcher. According to Hyndman (2008) data processing involves translating the answers on a questionnaire into a form that can be manipulated to produce statistics. This involves coding, editing, data entry, and monitoring the whole data processing procedure. After data was collected, it was prepared in readiness for analysis by editing, handling blank responses, categorizing and keying into Statistical Package for Social Sciences (SPSS) computer software for analysis. SPSS was used to produce frequencies, descriptive and inferential statistics which were used to derive conclusions and generalizations regarding the population. Inferential statistics included regression analysis. Regression analysis was done by use of an econometric model which is laid below.

$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \mu$

Where; Y= Loans advanced to customers for Islamic bank products X1= Motor vehicle financing using Islamic bank finance X2= Mortgage services financing using Islamic bank finance X3= Asset financing using Islamic bank finance X4= Real estate financing using Islamic bank finance X5= Trade financing using Islamic bank finance X6= SME finance using Islamic bank finance. α = constant $\beta 1, \beta 2, \beta 3, \beta 4, \beta 5, \beta 6$, = beta coefficients μ= error term.

The regression results were evaluated and interpreted as follows; the coefficient of determination (r squared) was evaluated to determine the explanatory power of the model. The F statistic was evaluated to determine the overall significance of models. A reported p value less than the critical value of 0.05 was construed to mean that the overall model was significant. The sign of the beta coefficient was used to determine whether the relationship between the dependent and independent variables is positive or negative. The significance of the independent variable was determined by the t statistics and the associated p values. A reported p value less than the critical value of 0.05 was construed to mean that the independent variable has a significance relationship with the dependent variable

4.1 Gender of the Respondents

The study sought to find out the gender spread of respondents. Figure 4.1 shows that 75% of the respondents were male and 25% were female. The findings imply that the bank is a male dominated field. According to Ellis, Cutura, Dione, Gillson, Manuel and Thongori (2007), in spite of women being major economy, and notably in agriculture and the informal business sector, men dominate in the formal sector citing the ratio of men to women in formal sector as 74%:26%.

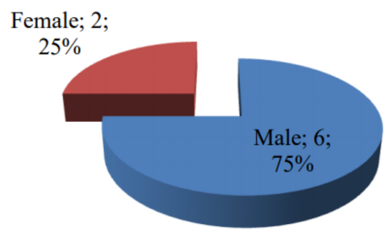

Figure 4.1: Gender of the Respondents

4.2 Level of Education

The study sought to determine the level of education for the bank managers. Figure 4.2 shows that 62% of the respondents had attained university level and 38% had post graduate level. The findings imply that the respondents had high level of education in this sector and perhaps this observed level of education may have had a bearing on the quality of our responses.

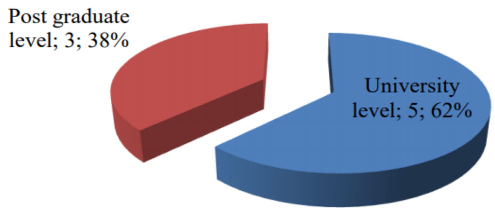

Figure 4.2: Level of Education

4.3 Bank Commenced Operation

The study sought to find out the number of years since the banks commenced operations. Figure 4.3 reveals that 38% indicated more than 5 years, 37% indicated between 3 to 5 years and 25% indicated between 1 to 2 years.

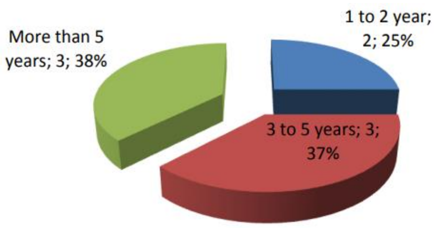

Figure 4.3: Bank Commenced Operation

5.0 Descriptive statistics

This section presents the descriptive results. The results are presented by the trend analysis.

5.1 Loan Advanced to Customers for Islamic Banking Products

The study sought to determine the loans advanced to customers for Islamic banking products. Figure 5.1 indicates that loans advanced to customers for Islamic banking products have gradually increased from year 2016 to 2019. The increase may be explained by low interest rates charged and fair terms and conditions on borrowing.

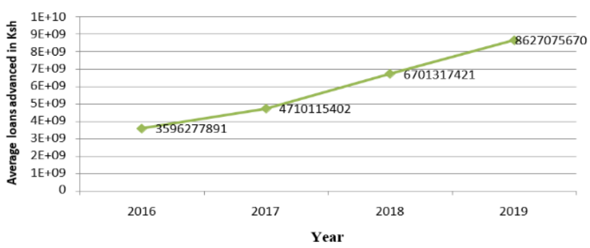

Figure 5.1: Trend Analysis of Loans Advanced to Customers

5.2 Islamic Banking Products

This section presented the Islamic banking products offered in banks.

Motor vehicle Financing

Results on Figure 5.2 illustrates that there was a gradual increase of motor vehicle financing in the year 2018 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2017 could be because the country was healing from world trade issue and crisis in economy of country and people were ready to start ventures all over again and the decrease in following years.

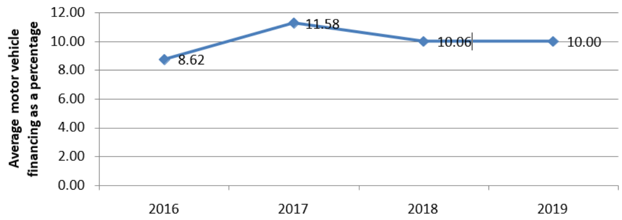

Figure 5.2: Trend Analysis of Motor Vehicle Financing

5.3 Asset Financing

Figure show that there was a gradual increase in the year 2017 and then followed by slight decrease in the following years. This may be as a result of many investors turning into mortgage financing more than asset financing as indicated in the trend analysis for mortgage financing.

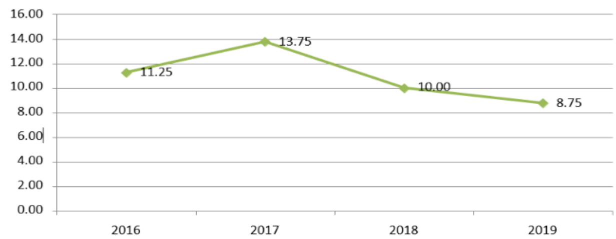

Figure 5.3: Trend Analysis of Asset Financing

5.4 Trade Financing

Figure illustrates that there was a slight increase in percentage for trade financing in the year 2017, followed by a gradual decline in 2018 and a rapid increase in the year.

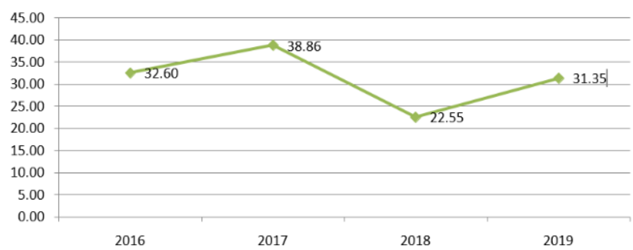

Figure 5.4: Trend Analysis of Trade Financing

5.5 SME Financing

Figure 5.5 show that there was a rapid decrease in SME financing in the year 2017 to hit a low of 8.75%, followed by a slight increase to 11.25% in 2018 and a slight decline to 10% in 2019. This may be explained by the inflation changes in the country hence the businesses were doing so badly thus many investors withdrawing from small business enterprises.

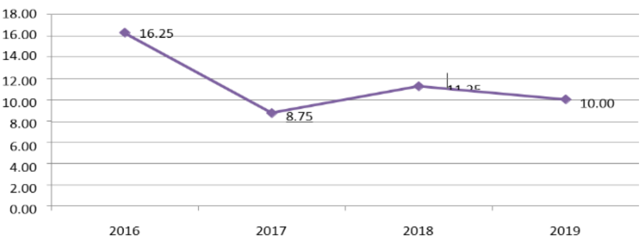

Figure 5.5: Trend Analysis of SME Financing

This is reported by an r squared of 0.865 which means that 86.5% of the variation in loans advanced to customers is explained by motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks. The correlation coefficient of 93% indicates that the combined effect of the predictor variables has a strong and positive correlation with loans advances. This also meant that a change in the drivers of loans advances to customers has a strong and a positive effect on loans distributed to customers.

Table 1: Model Fitness

Indicator	Coefficient
R	0.930
R Square	0.865
Std. Error of the Estimate	2,578,056,699

Analysis of variance (ANOVA) on Table 1, shows that the combined effect of motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing was statistically significant in explaining changes in loans advances to customers in Islamic banks. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05.

Table 2: Analysis of Variance (ANOVA)

Indicator	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.1E+21	6	1.8E+20	27.775	0.000
Residual	1.7E+20	26	6.6E+18		
Total	**1.28E+21**	32			

Table 3 displays the regression coefficients of the independent variables. The results reveal that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However, mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively.

Table 3: Regression coefficients of the independent variables

Variable	Beta	Std. Error	t	Sig.
Motor Vehicle Financing	118,583,069	65,911,985	2.755	0.011
Mortgage	95,001,881	85,225,094	1.114	0.275
Asset Financing	17,593,358	66,246,370	0.266	0.793
Real estate	80,463,376	60,286,155	1.335	0.194
Trade Financing	50,393,063	25,329,811	1.989	0.057

Conclusion

The purpose of this study was to establish the effect of Islamic banking on investment financing in Islamic banks. The research design adopted was a descriptive survey design in form of census. The population of this study was all commercial banks offering Islamic banking products. The study sample comprised of eight commercial banks which offer Islamic banking products. This means that a census was employed in order to include all commercial banks in Kenya which offer Islamic products. The comprise of two fledged Islamic banks (Gulf African Bank and First Community Bank) and six conventional banks that offer partial Islamic bank (Barclays bank, National Bank, Chase Bank, Imperial Bank, Diamond Trust and Standard Chartered Bank). Secondary data was utilized in this study. This means that all the study variables utilized quantitative data. The data obtained from the annual reports of the banks and also from banks‟ internal sources. To compile the data, a secondary data collection template was used. Descriptive statics‟ based on. mean, mode, median and factor analysis was used to analyze the data and make comparison among desired variables. The findings were presented using tables and graphs.

Regression analysis was conducted to establish the relationship between loans advanced to customers and the independent variables (motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks).

The study findings indicate that the goodness of fit of the model was adequate. This is reported by an r squared of 0.865 which means that 86.5% of the variation in loans advanced to customers is explained by changes in motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in 47Islamic banks. The correlation coefficient of 93% indicates that the combined effect of the predictor variables has a strong and positive correlation with loans advances. This also meant that a change in the drivers of loans advances to customers has a strong and a positive effect on loans distributed to customers.

Analysis of variance (ANOVA) results showed that the combined effect of motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing was statistically significant in explaining changes in loans advances to customers in Islamic banks. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05. Regression results revealed that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However, mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively.

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