

Islamic Financial Innovation: Tools and Trends

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In a business context, innovation is of two types: model innovation and process innovation. Model innovation involves developing new instruments and methods (inputs) to achieve new objectives (outputs), which in turn must bring new business and hence improve profitability. Process innovation is, in general, an incremental process that utilises existing instruments and methods in new formats and permutations to achieve desired objectives, goals and outcomes in a more efficient and cost effective way. From the business point of view, innovation takes place if a desired outcome is achieved by utilising the same existing instruments and methods

without increased efficiency or cost effectiveness, as long as the new format and permutation result in increased profits.

Islamic banking and finance provides an example of process innovation, as it attempts to achieve the economic effects of conventional financial products by employing Islamic legal contracts and methods in product development. Most Islamic financial products employ classical Islamic nominate contracts to develop financial products that attract either shari'a sensitive users of financial services or those who are willing to pay a higher price probably because the mainstream financial institutions exclude them due to the higher credit risk they pose to such institutions.

The higher price that a shari'a sensitive user of financial services is willing to pay contains what is known as shari'a premium. The higher price that an Islamic financial institution may charge someone excluded by the conventional financial services industry accounts for the risk premium that an Islamic financial institution must charge to remain profitable. Over the last twenty-five years, the incidence of shari'a premium has gradually gone down, reflecting the decrease in the willingness of shari'a sensitive users of financial services to pay more for having access to shari'a compliant products. Also, with the increase in the size and sophistication of Islamic banks and financial institutions and a greater awareness of risk, Islamic banks have gradually moved away from the riskier clients. This has resulted in Islamic banks and financial institutions becoming more mainstream in their product offering, marketing strategies and customer orientated approach. This has also increased competitive pressure on Islamic banks and financial institutions, which in turn calls for more product innovation.

Islamic Financial Innovation Defined

Islamic financial innovation, the way it has been practiced, can be defined as the process of utilising Islamic legal contracts in new ways to develop financial products that are in compliance with shari'a and at the same time have the ability to replicate the economic effects of conventional financial products.

Utilisation of shari'a's rules and regulations for achieving secular outcomes has generated a debate on authenticity and innovation in Islamic finance. According to this critical view, the process is as important as the end result. Hence, it is important that the process of Islamic financial innovation must not add any prohibited components i.e.,

Haram + Haram ≠ Halal

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It is also important to note that it is not necessarily the case that the adding of two halal components will always lead to a halal outcome. A revised definition of Islamic financial innovation in light of the above, may involve developing new products and institutional models for Islamic finance which would lead to a new financial (and economic) model, that is able to efficiently compete with conventional (interest-based) banking and finance. Shari'a compliancy, in such a framework, is only a necessary condition for the sustainable success of Islamic banking and finance. A sufficient condition is the commitment of the industry towards social responsibility. Therefore, the objective of Islamic financial innovation is to develop financial structures (products and institutions) that are not only shari'a compliance but also offer a distinct social value.

Examples of Islamic Financial Innovation

Islamic alternative investment products have grown gradually. Among these alternatives, hedge funds have proven to be

beyond the seed capital (of US\$50 million each) provided by the Government of Dubai. This is primarily due to some widely publicised failures and frauds in the hedge fund industry in the West. Negative publicity of short-selling, following its suspension from a number of Western financial exchanges, and other similar factors (that are deemed as responsible for accentuating the current financial crisis), have also not helped the cause of Islamic hedge funds.

Private equity (PE), on the other hand, has flourished in the emerging markets, particularly in the Middle East and North Africa (MENA), where Islamic investors have over the last two decades assumed significance and influence. Pioneering PE companies like Emerging Markets Partnership (EMP) and, most notably Abraaj Capital in Dubai, have emerged in the Middle East, offering both Islamic and non-Islamic PE.

However, Islamic PE is a recent phenomenon in the Islamic markets, especially in the Middle East and the Gulf Cooperation Council (GCC) region. Although Malaysia is another important Islamic financial market, the size and number of Islamic PE transactions remain small. Serious players have emerged in the Islamic financial market in the Far East (Malaysia, Brunei and Singapore) who are contemplating of setting up Islamic PE platforms for the ASEAN region. In the GCC region, it is fast emerging as an important asset class, in line with a growing trend in favour of alternative investments in the region. According to some estimates, alternative investments by ultra high-net-worth individuals in the GCC region grew by over 22% in the last ten

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the weakest link. Devout Islamic investors have by and large kept themselves away from this asset class. Consequently, most managers of full-fledged Islamic banks shy away from investing their proprietary money in hedge funds and become nervous by the prospect of having to sell an Islamic hedge fund. The performance of Islamic hedge funds has not helped to change the negative attitude towards this asset class. The most widely publicised success story of an Islamic hedge fund is related with the Al Fanar Islamic hedge funds, managed by the US fund management company Permal (and seeded by Saudi Development and Economic Company – SEDCO). Their performance, however, remains at best mediocre.

Although the four Islamic hedge funds launched by Dubai Shariah Asset Management (DSAM) – a joint venture between the US-based Shariah Capital and Dubai Multi Commodities Centre (DMCC) – have done fairly well since their launch in 2008, they have not been able to attract wider investments

years. Islamic PE is rapidly assuming importance in this growing sector. Out of about 60 Middle Eastern institutions involved in private equity, at least 20% have practised Islamic PE.

Although Islamic investment banks (the likes of Arcapita, Bank Alkhair and Bank Al Salam in Bahrain) were involved in PE deals before the current financial crisis, establishment of Islamic PE funds is very recent. Since 2006, there has been significant growth in Islamic PE funds in the GCC region; both in terms of number and size. However, the history of Islamic PE funds does not go beyond the previous decade. Most of the funds set up were of a modest size, with the exception of Abraaj Infrastructure and Growth Fund and Siraj Hospitality & Tourism Fund, which had US\$2 billion and US\$500 million in committed capital, respectively.

The reason for this late entry of Islamic finance into PE is primarily explained by the relatively minimal exposure of the



region to local PE deals. This is not to say that the region did not have exposure to PE deals at all. In fact, until the mid 1990s the Middle East was the second largest source of capital for international PE funds. Most governments in the GCC area had significant investments in PE funds and deals in the West. However, it is only recently that the region has witnessed the growth of PE funds (conventional and Islamic) managed by local management companies.

The third important alternative asset class – real estate – has always been an Arab's friend, mostly a loyal one but unfortunately deserting him in times of difficulty. Although some Islamic real estate trusts (REITs) exist, Islamic investors prefer to feel the bricks and mortar for themselves. The current downturn in the real estate market in the GCC countries (particularly in Dubai and Kuwait) has, however, confirmed Islamic finance's over-exposure to this asset class.

Among the three above-mentioned alternative asset classes, the latter two fit well in the Islamic culture. Hedge funds are at best misunderstood and mostly considered as an untamed horse. Many Islamic investors would like to be in love with it but would refrain from riding it, fearing injury and collapse.

It is interesting to note that shari'a concerns surrounding hedge funds have by now been resolved with the help of an increasing number of scholars. There are now more than one shari'a compliant method of short-selling, a technique crucial for the success of long/short Islamic hedge funds. The days

are gone when shari'a scholars could not understand the mechanics of short-selling and, hence, would take the conservative stance of disallowing it. There is now a growing recognition that short-selling is not a shari'a concern, if done properly. It is deemed a regulatory issue. If the regulator is happy with shari'a compliant short-selling, then it should also be acceptable by market players.

A Focus on Islamic Structured Products

Many Islamic institutional investors and high-net-worth (HNW) families have been shown to accept structured products which offer the economic results of hedge funds, sometimes with principal protection and at times without it. Most of the successful offerings of Islamic structured products have been those offering exposure to commodities. Ever since Deutsche Bank sold a commodity-linked Islamic structured product with reference to platinum, aluminium and crude oil to Abu Dhabi Commercial Bank, a number of such products have emerged on the scene. Given the excellent performance of some commodity futures programmes during the current economic downturn, Islamic structured products built around commodities should attract investments from savvy Islamic investors who are used to earning high returns.

Islamic structured products in themselves are a growth area. A number of Islamic as well as conventional banks now offer a variety of Islamic structured products, covering

traditional as well as alternative asset classes. These Islamic products are being offered in three forms: (1) structured deposits; (2) structured notes and certificates; and (3) hedging solutions. The structured deposits are primarily offered to premier clients (both HNW and corporate) of Islamic banks. The structured notes are sold as over the counter securities or through exchanges; such as Dubai International Financial Exchange (DIFX) and the Luxembourg Stock Exchange. With the start of a fully-recognised Islamic derivatives market in Kuala Lumpur, exchange tradability of Islamic structured products is bound to improve. Islamic hedging solutions are being offered by a number of Western investment banks in the form of profit rate swaps, currency swaps and other Islamic derivatives.

An attractive feature of these structured products is that they offer principal protection – something highly desired when the general market trend is downward. They became immediately popular amongst the HNW clients of banks like Dubai Islamic Bank (DIB) when it started distributing Islamic structured notes manufactured by Western banks such as Deutsche, Goldman Sachs and lately RBS.

Another important reason for their popularity is that selling these products represents a natural progression to what Islamic banks have been doing for last three or four decades. Profit sharing investment accounts (PSIAs), especially unrestricted, offered by Islamic banks are very much in line with the underlying structures of Islamic structured products. Based on the principle of mudaraba

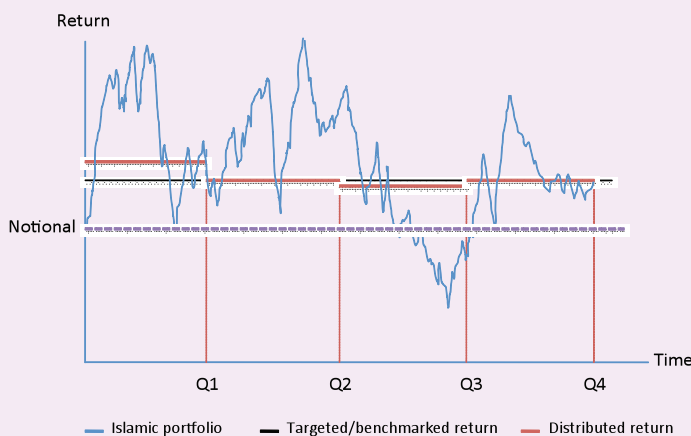
(an investment management agreement that allows Islamic banks to offer variable return deposits), PSIA's behave very much like principal-protected structured products (see Box 1 for explanation on how PSIA's work).

Box 1: Profit Sharing Investment Accounts

PSIA's are of two types: unrestricted (depositors' money may be mixed with shareholders' capital to be used for general banking and investment purposes) and restricted (the depositors' money is used for specific projects and investments). In both cases, although theoretically depositors must be fully exposed to profit and loss made by the bank on their investments, Islamic banks in practice have devised a mechanism around Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR) to ensure that depositors receive a return similar to a targeted market rate of return and are not exposed to any short-term loss.

Thus, if in an accounting period the PSIA portfolio outperforms the targeted return, the Islamic bank can distribute only the targeted profit (or slightly more than this) – retaining the rest in PER and IRR. Conversely, if the PSIA-portfolio underperforms, the Islamic bank will make the shortfall by having access to PER and IRR. The following Figure depicts this behaviour.

PSIA's are principal-protected by their very nature (as required by many regulators in many cases for unrestricted ones) or by device in the case of the restricted PSIA's. The way principal-protection is achieved in PSIA's, however, is not as transparent as is the case for most of the Islamic structured products offered by the institutions around the globe. While there has been a lot of ambiguity over the ownership of funds in the PER and IRR until recently when Islamic Financial Services Board formally clarified the situation, the regulators require that the mechanisms for attaining capital-protection in Islamic structured products should remain transparent and understood by investors.



For example, Islamic banks in Malaysia have been offering two types of unrestricted PSIA's (called General Investment Accounts and Special Investment Accounts). Following the success of restricted PSIA's, offered by CIMB Islamic, many banks are now contemplate to offer restricted PSIA's, which are structured similarly to "Islamic structured deposits." Consequently, there are now two types of Islamic structured deposits being

offered by Islamic banks in Malaysia – restricted PSIA's and structured products offered to retail customers in the form of structured deposits. Examples of the latter are CIMB All-Star Structured Products range and Maybank's Al Sayf Structured Islamic Deposits (see Table 1 below).

As Table 1 suggests, Islamic structured products in their present form are a very recent phenomenon, but have gradually appeared as a regular product offering by Islamic bank in the last five years. They are now being offered by Western banks such as HSBC as well as Islamic banks owned by conventional banking groups such as CIMB and Maybank. In the Middle East, the products manufactured by Western banks are being distributed by the likes of DIB in the UAE and National Commercial Bank (NCB) in Saudi Arabia. However, homemade Islamic structured products in the Middle East are still rare.

Shari'a Issues in Islamic Structured Products

The two broad categories of Islamic structured products on offer in the market are: (1) the so-called A-Z shari'a compliant structured products, with both the structure and the underlying asset fully shari'a compliant; and (2) the so-called Islamic bridge products, with a shari'a compliant structure exposing investors to the economics of non-shari'a underlying assets.

The popularity of both types of Islamic structured products has steadily grown. Western banks tend to specialise in the Islamic bridge products while the likes of CIMB Islamic (and some other Islamic banks) prefer to favour the purer form. It is interesting to observe that despite criticism by some shari'a scholars, the use of Islamic bridge products in on the rise. A simple sketch of Islamic structured products is given in Figure 1 below.

The whole structure is based on a master murabaha agreement, which is governed by an investment agency agreement between the bank and investors. This structure can be used for developing Islamic structured deposits or notes and certificates. While structured deposits are a retail product, notes and certificates are new forms of Islamic securities, which are being sold over the counter as well as through exchanges.

This is a robust structure that can be used to affect principal protection (through a first murabaha that uses the price equal to "Notional"), range accrual,

multiple returns (e.g., x percent in year 1, y percent in year 2, and z percent afterwards) and a variety of risk-return profiles. All this is possible because of the master murabaha agreement between the issuer and the third (related or unrelated) party that serves as the buyer in the murabaha sale. The flexibility of the master murabaha agreement is crucial in structuring such products. It allows the buyer (issuer in this case) and seller (the related

or unrelated party) to enter into a series of murabaha transactions to generate a variable return benchmarked to another asset or index. Many advocates of such products favour this use of murabaha because it makes it possible to diversify the use of benchmarks in Islamic finance, which otherwise has relied upon on the London Interbank Offer Rate (LIBOR) and its regional or national variants.

Table 1: Some of the Islamic Structured Products on Offer

	Institution	Year	Product nature	Underlying	Islamic contracts
1	HSBC	2003	Guaranteed-equity bonds linked share basket	Equity	Rolling Murabaha
2	HSBC	2004	Islamic CPPI	Equity	Arboun & Murabaha
3	HSBC	2005	Dynamic asset allocation strategy product	Equity	Rolling commodity Murabaha
4	HSBC	2005	Dynamic asset allocation strategy CPPI product	Equity	Arboun & rolling commodity Murabaha
5	BNP Paribas	2005	Equity linked structured product	4 Islamic mutual funds, namely, Oasis Crescent Global Equity Fund, Al Fanar Europe & US Large Cap Fund, Amana Growth Fund, and Wellington Hegira Global Equity Fund	
6	Noriba / UBS	2005	Currency-linked structured product	Two currencies (\$ and Euro)	Commodity Murabaha
7	Deutsche Bank	2005	Commodity-linked Islamic structured note	Platinum, aluminium, and crude oil	Murabaha, Wakala and Salam
	Deutsche Bank	2006	Islamic structured products range	Various – almost all asset classes	Wa'ad & Murabaha
8	Deutsche Bank	2009	Islamic structured products platform (called Al Mi'ayar)	Various – almost all asset classes	Wa'ad & Murabaha
9	CIMB Islamic	2007	All-Star Islamic structured products range	Equities	BBA & rolling Murabaha
10	Maybank	2008	Al-Sayf structured Islamic deposit	Commodities	BBA & rolling Murabaha

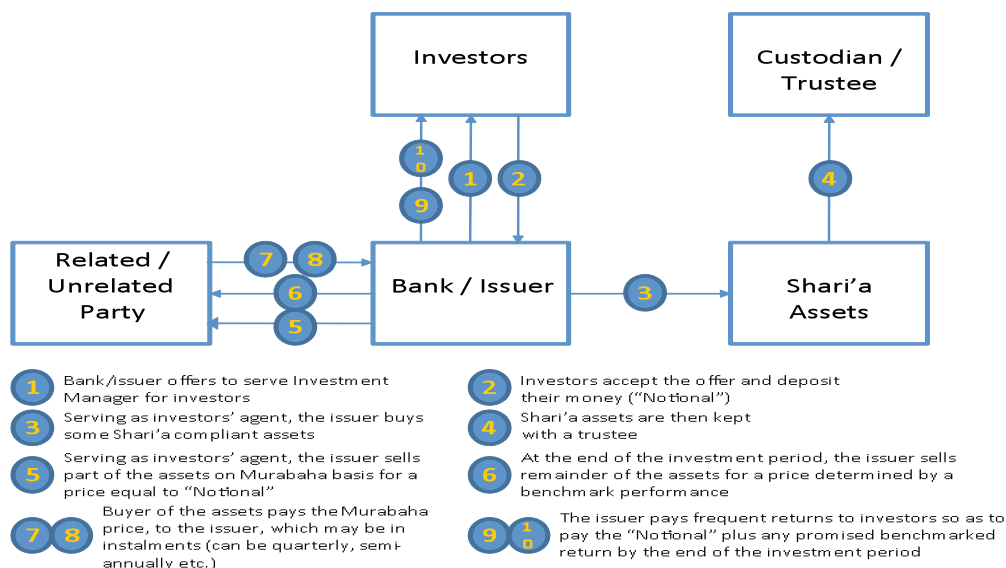
Controversy Over the Use of Wa'ad (Undertakings)

Some analysts have rather naively criticised the use of wa'ad (undertakings) in Islamic structured products. Deutsche Bank was the first bank to explicitly base its Islamic structured products on wa'ad, the use of this extremely useful concept has helped strengthen the Islamic financial services industry and increase the product range. In fact, almost all Islamic financial products have to rely on wa'ad to make the underlying structures legally binding. From the retail banking operations based on murabaha and ijara wa iqtina (hire purchase) to sophisticated products such as Islamic put options, short-selling, swaps and other derivatives; wa'ad is extensively used to affect the economic outcomes these products aim to emulate.

Following the false controversy created over the use of wa'ad in Islamic structured products, the use of wa'ad in such products' structure has become implicit. The master murabaha agreements used in such products are indeed no more than unilateral and independent undertakings (wa'ad) to buy and sell on the basis of murabaha by the transacting parties, i.e., the issuer and the related/unrelated party in Figure 1.

There are some other important shari'a issues that must not be ignored while structuring Islamic products. One of these is the issue of guarantee by the investment agent. While the Shari'a Standard on Agency issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) allows for an investment agent to give a guarantee in a role other than being an agent, it is important that the counterparty to the issuer in murabaha transactions is an unrelated company. In most cases, it has cost implications for the structure. Hence, the

Figure 1: A Sketch of Islamic Structured Products



contemporary shari'a view is that the related counterparty must be owned at least 33% by the unrelated or unconnected shareholders.

Future of Islamic Financial Innovation

Islamic structured products are going to assume an increased importance in the future in the wake of a slowdown of sukuk issuance and its popularity. Since the start of 2008, global sukuk issuance has witnessed a steady decline. This, along with some shari'a concerns around practices like tawarruq or commodity murabaha (a recent resolution by the International Fiqh Academy of the powerful Organisation of Islamic Conference (OIC) proscribed tawarruq), is bound to pave the way for the further development of Islamic structured products, which may effectively be used as liquidity management tools – something of an Achilles' heel for Islamic treasury operations.

In fact, Deutsche Bank's Al Mi'yar platform (launched in January 2009) aims to address the core issue of Islamic liquidity management by offering tradable Islamic money market products or securities settling with short settlement cycles (T+0). This should enable the issuance of overnight products or other short dated money market instruments and hence enhance the liquidity of the Islamic money markets. Moreover, Islamic structured

products listed on the DIFX TraX Platform offer a potentially excellent opportunity to develop a comprehensive framework for Islamic liquidity management. This will certainly diversify Islamic money market instruments, if it does not entirely replace the existing commodity murabaha practices.

The principal-protected Islamic structured products on global equities and other assets foreign to Islamic investors in different countries are attractive only when domestic or regional markets are not doing well. For example, once the GCC equity market is buoyant and the real estate has come out of its current sickness, Islamic structured products with foreign underlying assets will get marginalised by the local structured products, even if they do not offer principal protection.

Islamic investors have a preferential investment process: invest locally; then regionally; and then either go eastward or to Africa, especially North Africa. If nothing interests them in these regions, they go for Western assets and it is here they look for principal protection. Those institutions which are looking to use regional assets/indices as the underlying basis of Islamic structured products may wish to offer products that are not principal protected, as Islamic investors feel comfortable in taking local risks rather than venturing into foreign risky assets.

However, as alluded earlier, it is imperative for the Islamic financial services industry to come up with new products and institutions that have direct relevance to the socio-economic needs of the communities they aim to serve. In this way, Islamic banking and finance will emerge not only as a business phenomenon but could possibly be used as a tool for social transformation in the 21st century. The suggestion of using Islamic banking and finance as a tool for social reform has added relevance to the countries in the Middle East, which are facing political turmoil and confronting the possibility of the collapse of many well-established regimes. Even in countries such as Pakistan, which faces the tremendous task of a war on terror, Islamic banking and finance can be used to promote moderation in social behaviour and the modernisation of financial relations.

In the last three decades, a number of new Islamic financial products have been developed primarily by applying Islamic nominate contracts in new ways to achieve the economic profiles of conventional products. This has allowed Muslims to have access to financial services in ways that are not contradictory with their belief. It was indeed a mammoth effort in which different stakeholders, including governments, international regulatory bodies, law firms, shari'a scholars, accountants and many more played instrumental roles.

For Islamic banking and finance to become more comprehensive and all encompassing, it must now come up with a new institutional form, in addition to its existing practice.

For Islamic banking and finance to become more comprehensive and all encompassing, it must now come up with a new institutional form, in addition to its existing practice. It is important to emphasise that any new development in Islamic banking and finance must complement the existing practice and it is by no means the opinion of this writer that a new system must be developed to replace the existing practical models of Islamic banking and finance.

Islamic Foundations: A New Islamic Financial Model

Many keen observers of Islamic banking and finance are not entirely happy with the current “banking” based model of Islamic financial intermediation. Several suggestions for a new Islamic model be developed for the savers and users of the surplus funds in society have been put forward. One such model could be called Islamic Foundations. An Islamic foundation is a collective saving and investment programme that allows its members to save together in order to do business for the benefit of all the programme members. This could be a deposit taking institution in itself or may have a deposit taking institution as part of its overall operations.

An example of a conventional foundation is Fauji Foundation in Pakistan, which was set up in 1954 as a charitable organisation, and now is one of the largest industrial conglomerates in the country with total assets of over 250 billion Pakistani rupees (US\$3.5 billion), serving over 7% of the beneficiary population in Pakistan. It has investments in industrial production (e.g., cement, fertilizers, and oil & gas etc.), education, healthcare and financial services.

A similar kind of model can be adopted for an Islamic Foundation, which should first identify its objectives. Examples of such objectives could be welfare of the elderly, welfare of women and investing in children in need. An Islamic Foundation must attempt to promote good economic agents in terms of efficiency, ethics, social responsibility and charity.

The members of the Islamic Foundation must demonstrate that they are efficient, ethical, responsible and charitable. By way of example, each member must have a logbook,

which would include a monthly account of at least one project conducted efficiently, ethically, responsibly and in a charitable way. While members of the Islamic Foundation must be the direct beneficiaries of it, the goods and services it produces must be sold in the market with competitive prices to make profits for the foundation. The profits must be reinvested within the foundation structure. However, members of the Islamic Foundation should enjoy benefits in terms of free or highly subsidised goods and services. For example, if the Islamic Foundation runs a school, the members’ children must attend it either for free or pay a subsidised rate. Similarly, they must have easy and affordable access to healthcare and other social services. On the other hand, if the Islamic Foundation runs a finance programme, it must give preferential treatment to its members; such as, providing interest-free loans for home purchases and the financing of other durables and household items.

The foundation model is completely different from a banking-based Islamic financial model. It may be based on the waqf (a form of Islamic trust) so that the assets are locked into a structure that creates socially responsible assets. Unlike an Islamic bank, which collects money and finances, goods and services, and in some cases businesses as well; an Islamic foundation is an institution that organises and runs real businesses for the benefits of its members. As examples of such social projects are abound in the West as well as in the Muslim world, there is a need to study these different models in order to develop a new model of Islamic financial intermediation.

The author is aware of some notorious examples of foundations in different parts of the world. The fact remains that they are some are excellent models of social enterprises, when they are regulated and run properly. For examples bonyads (literally meanings foundations) in Iran are often quoted as bad examples of governance. It must, however, be emphasised that many of the problems with foundations are primarily due to either the non-existence or poor regulation of such entities.

There is no harm in using Islamic banks (or even conventional banks) for routine



At this juncture, it is important that the industry develops its own unique selling point as shari'a premium continues to decline. One possible way to achieve this is through the development of alternative Islamic financial institutions with a focus on societal improvement.

payment transactions like payment of bills and even non-interest paying current accounts. However, for savings, investments and social contributions; Muslims can use Islamic foundations. Such Islamic foundations must be tightly regulated and monitored. It is proposed that special arrangements be made to list such Islamic foundations on a stock exchange to ensure that those who invest in Islamic foundations must be able to redeem their investments if they wish to do so. However, to remain within the spirit of a foundation model, the listed stocks must be non-dividend paying and that the investors should have a choice of donating their capital gains back to the Islamic foundation.

In a country like Pakistan, an excellent model in the form of mudaraba companies exists, and there is a need to modify this model to come up with a framework for the proposed Islamic foundations. In effect, the mudaraba model as developed and implemented in Pakistan is an innovative example of a new model of Islamic investment banking.

Conclusion

Islamic financial innovation has dramatically increased as the industry continues to grow. Innovative product development teams have developed sophisticated Islamic alternative assets over the last decade. These innovations have opened up a whole new array of asset classes to Islamic investors enabling them to gain access to the risk and

return profiles of previously untapped areas. This trend is expected to continue as the industry develops. Without a doubt product innovation will be an important factor in the continued growth of the industry.

Innovation in Islamic finance has largely been driven by the need to imitate the economic effects of conventional financial products. This has somewhat been achieved as can be witnessed by the presence of Islamic structured products, hedge funds etc. However, it is essential that Islamic financial innovation incorporates an element of social responsibility in order to ensure its wider acceptability. Shari'a compliance can no longer be the sole factor considered in innovation. At this juncture, it is important that the industry develops its own unique selling point as shari'a premium continues to decline. One possible way to achieve this is through the development of alternative Islamic financial institutions with a focus on societal improvement. These alternative institutions together with traditional Islamic banks, can work in collaboration in order to achieve these objectives.

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