

A Practical Approach to Product Development

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1. Introduction

This paper covers a variety of matters that should be considered in the development of Islamic investment products. While it is not intended to be comprehensive, it covers areas from the inception of the idea through to the ultimate delivery of the product to the end user. The paper covers what we do, why we do it and how we do it. It is written from the practitioner/Islamic investment banker's perspective and attempts to address the issues in a practical "hands-on" manner. The author intends on sharing his personal views and experiences in the Sharia compliant product development area.

2. A Threshold Consideration

For Islamic banks and those already dedicated to serving this marketplace, the issue of whether or not to serve this market is moot. The Islamic bank may well be grappling with strategic matters related to how it can best serve the marketplace and grow its business. Product development is an important area in which the Islamic bank will focus its resources.

For others, a threshold issue is whether or not to devote their resources in serving this marketplace in the first place. I have often met with business people contemplating serving the Islamic market. Some may take a "wait and see" attitude. Others believe it advisable to commit today and develop a capability and track record that will help enable them to be a leader in this niche business.

The practical aspects of product development become relevant when a prospective participant chooses to make a dedicated strategic commitment of resources to the Islamic marketplace.

3. Product Development – In General

A. Definition and Overview

The term "product development," for purposes of this paper, is defined as "the internal **process** that a financial organization adapts in order to create a financial product or service for delivery to its customer." Since no one process fits all organizations or products and services, the definition is necessarily broad. The process may differ depending upon such factors as the financial organization's target customer, its experience and expertise, internal resources, corporate

culture, regulatory environment and any number of other internal and external factors.

The process may be quite refined in an organization that has extensive experience. The process may be developing almost by trial and error for others who are new at it. It is however a process that can and should be modified and further improved upon going forward.

The product development process includes several stages from the idea generation or conceptual stage through to the implementation and follow-up stages. While some reference may be made to specific products or services, the core concepts discussed will generally apply to all Islamic products whether it be Islamic mutual funds, unit trusts, closed ended funds, portfolio management, leasing products/transactions, real estate related products, securitized paper, Islamic indices, capital protected products and other traditional and not so traditional (the flavour of the month) Islamic products.

B. Soliciting Views of Others

In anticipation of addressing the esteemed group at Harvard University, I took the opportunity to ask a number of professionals, "What does the term product development mean to you in the context of your organization?" Some whom I posed this question to operate in the Islamic banking industry, others work with conventional financial services firms and a few are employed outside the financial services industry all together. The following responses shed some light on the relevant subject matter.

- 1) Most believe that the preferred approach is to develop the product in response to the values, needs and desires of the customer. However, engineers (financial or otherwise) often fail to listen to what the customer wants. Organizations sometimes retain outside specialists that generate product ideas by researching the values, needs, and wants of the targeted customers.
- 2) A second approach first focuses on internal brainstorming by "really smart people" within the organization. Their objective is to develop a product that should appeal to the customer. In some regard it may be said that the developer is seeking to create the demand for the product or responding to a perceived demand.
- 3) An approach some consider best is to use a combination of (1) and (2) above where there is some input from the end user coupled with internal expertise regarding financial engineering, marketing and other disciplines within the project team.

- 4) The longer the time period from the inception phase to the rollout phase, the more difficult it is to predict from the onset whether the market will be receptive to actually purchasing the product. The “flavour of the month” may have changed if one is too slow in responding. Coming to market too soon (i.e. before the customer can truly appreciate the product) may also prove problematic. Timing is therefore important. External events also influence the timing of a particular type of product, such as the publicity surrounding Long-Term Capital Management’s affairs and the impact this negative publicity had on hedge funds in general.
- 5) While there are certain generalizations that may be made regarding a grouping of similarly situated potential customers, the targeted customers of the product distributor are likely to require some segmentation in terms of factors such as age, sophistication, demographics, risk tolerance, etc. Target the right product for the right type of customer.
- 6) Some geographic markets (i.e. the United States with respect to Islamic products) are underserved and one may wish to commence tapping this opportunity by offering straightforward and simple solutions. This could be in contrast with a provider that perceives a new more exotic product is necessary to capture the attention of a more mature marketplace (e.g. the Gulf Cooperation Council states region).
- 7) Product developers can find themselves in a predicament where the customer is demanding a type of product without adequately appreciating the risks involved. This situation persists even though the product provider goes to great efforts to educate his customer. The issue of “suitability” is one that the Islamic provider must focus on since it owes a high moral obligation to its customer.

C. The Market Environment

I would like to stress the point made that the Islamic product provider has a special moral obligation to its customer. The customer may or may not be a “sophisticated investor” and education is important. Education for all of us is important – the customer and the provider. The Islamic marketplace is still a relatively new industry and reasonably immature while at the same time dynamic. The industry is attempting to grow up fast.

Education on financial matters is critical because if the customers do not really know what they want, the product developers have a difficult task in responding to the customers’ needs. The product developer also must ask the right questions to potential customers in order to effectively draw out the values, needs and wants of the customer. This is a key issue in product development for many businesses and I believe it is very much applicable to Islamic banking

today because of the immaturity of the market and the global nature of our industry. As the industry continues to innovate and barriers to growth are removed or lessened (e.g. regulation), many more investors will gradually attain the comfort level they require in order to participate.

The Islamic marketplace is diverse and global, making it difficult to collect accurate and meaningful data on many attributes such as its current size and correspondingly, what the short term and long-term future might well look like. Some place the market size at \$100-\$150 billion growing at 10% - 15%. I do not seek to dispute these figures but I would like to examine the basis on which the figures are derived. I am aware of one analysis by Failaka International Inc. that contains supporting data indicating Islamic equity funds have grown at over 50% per year since 1996 and total assets under management are between \$5-7 billion, from only \$800 million in 1996.

The Islamic marketplace is clearly a niche growth area offering enormous potential. Great strides have been made over the last five years with the introduction of a variety of quality equity funds managed by world-class organizations, capital protected products, other specialist products and indices such as the Dow Jones Islamic Market Indexes and the FTSE Global Islamic Index Series. We can look forward to web based delivery channels sparking interest and growth.

D. Why Product Development is Important

Product development is not just important, it is a critical in order to retain customers and compete in today's financial services environment. The obvious reason that product development is important is that it is a catalyst in creating interest and energy in the development of the Islamic financial services industry as this industry seeks to reach its full potential. Effective product development creates a synergy between the customers and the providers. Both gain valuable insight from the interaction and this assists the provider in better understanding the needs of its customers. A satisfied customer is often a repeat customer and a great source of referrals.

The financial services industry is highly competitive and an inferior product will be rejected. The product must be sound in all regards in order to protect and enhance the reputations of those institutions that associate their names with it. In some regions where Islamic banking is prevalent, regulatory barriers are being loosened and competition is increasing. This increased competition is generally favourable for consumers and will create pressure on those institutions that are not customer focused.

The majority of those providers who will prosper in the industry are those who focus their resources and talents on serving the customer. Product development is an integral component in the quest to serve the customer.

E. What Constitutes a “Successful” Product?

Bottom line profit is important in business in order to allow the organization to prosper, grow, retain qualified employees, serve the community and the like. Bottom line results are not the only measurement tool. Whether an Islamic product is successful must be measured in the context of the strategy and goals of the provider organization as a whole. There will be short term targets and longer term goals that need to be well thought out and understood.

A certain level of assets under management and fees generated may be set as targets. Other goals such as market penetration, expertise gained and the acquisition of long-term intangibles should be considered. Management assessment tools such as a balanced score card analysis may be undertaken. Whether a particular product is “successful” can be better answered when one understands why it is in the Islamic marketplace in the first place.

4. Research & Development

A. In General

The term “research and development” is somewhat analogous to product development. Both include the development aspect. I would like to briefly discuss the research component.

To me, the term “research” conjures up a picture of men in white jackets with test tubes in the laboratory testing a new concept or a new application of an existing concept. In a manner of speaking, these technicians are brainstorming. Earlier in this paper there was mention of really smart people brainstorming in order to determine what the customer “might” or “should” want. How do we in Islamic banking today generate our product development ideas? How do we brainstorm? How might we stimulate or otherwise improve the research process with respect to Islamic products and services? If one agrees that product development is critical, then it appears one would agree that these questions are of paramount importance.

B. Adaptation or Islamization

Much of the research and development that has worked its way into existing products in the marketplace has been generated from adapting conventional products. It may follow that if a product was successful in the conventional marketplace, then if successfully engineered as to not be inconsistent with Islamic Sharia, it should be successful in the Islamic marketplace. This appears logical if it is true that Islamic investors are similarly situated to conventional investors with the critical exception of a Sharia compliance requirement. However, query if it is appropriate to characterize investors as “Islamic” or “conventional” in the first place.

This paper in no way is intended to be critical or supportive of a heavy reliance on the adaptation of conventional financial products. One may properly contend that there is considerable innovation and value-added in reengineering or adapting a conventional product in order for there to be created a new product that incorporates a Sharia compliant structure. Others may voice some scepticism regarding a mere transformation that, in their view, is in substance substantially similar to the conventional product.

C. Innovation

Considerable ingenuity and innovation is often exerted in adapting conventional products for it is by no means an easy process. The substance of the underlying transaction must be scrutinised as well as its form. Certain structures such as equity ownership or a partnership interest cannot be labelled as Islamic or conventional structures. The point here is not semantics but rather how do we think “out of the box?” How do we also move beyond the adaptation of conventional products and stimulate new ideas that will help our industry flourish. The following comments provide some of the possible answers.

- 1) Sharia scholars are among the most qualified group of persons to stimulate ideas and creative thinking and this is clearly happening. The scholars are studying the practical application of concepts in many areas (e.g. equities, options and other risk management tools, capital protection, takaful, arbitration, and the use of trusts).
- 2) Specialist practitioners, including Islamic Financial Advisors, are an integral driver in this process. They exert considerable efforts in seeking new solutions. They work closely with the Scholars and both gain from each other’s views and perspectives in pioneering new concepts that work.
- 3) Universities and other institutions of higher learning are a rich source of research and innovative original thinking. They are incubators of knowledge and a vital link. I hesitate at listing some of these esteemed universities and institutions for the fear of omitting some out of ignorance. I have had the pleasure of having first hand experience with Harvard University, Loughborough University, and Islamic Research & Training – Islamic Development Bank. There are many others that are making outstanding contributions to the industry.
- 4) Governmental bodies have done much to support the industry, create opportunities and provide leadership. Some that come to mind include Bahrain, Abu Dhabi and Malaysia.

- 5) Customers/investors are a great source of ideas, especially at the institutional level. As the industry flourishes and customers become more educated and aware, the customer will increasingly be an initiator of new ideas. Product developers will need to listen to the customer.

D. Relying on Basics may be Best

Innovation in product development does not necessarily mean the creation of a new exotic offering. Innovation may take the form of a new application of an existing structure or perfecting techniques as technological advances and other developments arise. An example of the former is creating a capital protected product through a Baia Arboon structure. An example of the latter is refining the process of purifying dividend income with respect to a constituent company in an Islamic index.

A new novel product may not be desirable to the target customer who wants an understandable straightforward investment product. What good is a product that does not sell because investors do not understand it? One must also consider the range of products and services that will be offered and perhaps conclude it appropriate to offer a balanced portfolio solution, such as an Asset Manager type solution. There are challenges in effectively managing any product over its life cycle so keeping matters straightforward and focusing on service may be the best approach.

There are of course always new opportunities that need to be analysed. For instance, the product development group might look at exchange traded funds, wrap accounts, folios and Interpretive Letter #867 issued November 1999 by the U.S. Comptroller of the Currency which discusses Murabaha financing and conclude they should develop a strategy to bring these concepts to the Islamic marketplace.

5. The Process

A. In General

Product development is very much a process. It should be comprehensive, well documented and fully understood within the organization. It must have internal cooperation and support from all those whose contribution is important. The buy-in of the people selling the product and upper management are especially important. The adage, “the chain is only as strong as its weakest link” holds true so make sure you have strong links.

The process should be logical and orderly. Responsibilities must be clearly assigned and commitments adhered to. All aspects are important from the generation of the concept, through the manufacturing and packaging, and all the way through to the launch.

After a product is launched it may be that the ongoing responsibility no longer falls within the product development area. Ongoing maintenance may be shifted to another unit, such as fund administration or an operations group. Relationship management with the customer clearly plays an important role. The ability to monitor and the procedure to ensure monitoring should be built in and accounted for during the product development process. An Islamic product must be closely monitored throughout its existence for compliance with Islamic Sharia, especially if there is any uncertainty related to an exist strategy.

B. A Checklist – simple and effective

A checklist is a useful tool. It can help us to plan and coordinate the project. It can help us in identifying potential bottlenecks. It can help those involved to focus. It can help us learn from experience as we periodically refine the process and the checklist. It helps give us comfort that we have been comprehensive, especially when we are under stress. It makes our compliance people happy.

No detail is too small for this planning checklist, including something as simple as establishing a bank account and designating the authorized signatories on that account. The following types of items may be found on the checklist along with due dates and the individual(s) responsible for completing each task: the name of the Fund, a budget, a Terms Sheet, Sharia review and fatwa, entity jurisdiction, classes of shares, status of core legal documents (Memorandum and Articles of Associate, Investment Advisory Agreement, Management Agreement, Islamic Advisory Agreements, Placing Agreement, Custodial Agreement, prospectus, etc.), marketing brochure including translation, launch schedule, stock exchange listing requirements, and the selection of directors.

C. Planning

Upfront planning will pay considerable dividends later. Upfront planning may even demonstrate that the product should be delayed or scrapped all together. Never lose sight of the customer and stay customer focused. Try and understand their values, likes, dislikes and tailor the product. It is possible to create a product that will appeal to a wide audience such as institutional, retail and high net worth individuals. This could be done through different equity shares and fees structures or other techniques.

A basic blueprint should be developed. A one or two page Terms Sheet could be prepared for circulation. It might contain the basic structure, highlight any potential Sharia issues, set forth the investment objectives, name the service providers, fee structure, tenure of the product, and the benchmark by which performance will be measured. Differentiation through the salient features can be highlighted.

Prepare a budget and make sure all necessary internal resources have been secured. Line up and secure your external resources. It is likely some form of outsourcing will be necessary but this depends upon the organization and its competencies. Target a launch date while setting milestones.

D. The Internal Team

Harnessing internal resources from within the organization is important. I believe a team approach is best since it helps pool resources and expertise. The internal team may include upper management, Sharia counsel, the product development department, marketing, legal, compliance and internal audit, back office, fund administration, relationship management, treasury, accounting, and asset management.

One must hire quality personnel, continuously train the personnel and invest in their professional growth, encourage an environment of cooperation and retain those employees in which so much has been invested. Get the right people for the right job. Teamwork is essential and I do not mean lip service type teamwork but rather a real spirit of cooperation and cohesion. Again, responsibilities must be clearly defined and understood.

E. When do you get the Sharia Scholars Involved?

The essence of a Sharia compliant product is the Sharia compliance. Certainly before the product goes out the door, Sharia signoff must be complete. Investors often ask for the fatwa and perhaps other underlying documents supporting the representation that the product is not inconsistent with Islamic Sharia.

Do you get the Scholars involved at the beginning, the middle, the end, or throughout the process? As a general rule, open timely and meaningful communication between the Sharia Scholars and the product developer will produce the best result. I believe communication throughout is the best choice. However, for some products the input may not be too time consuming as the structure presented is well known and therefore perhaps not even at issue. Since it is clearly a two way street between individuals, the Sharia Scholar may express his views on the most efficient means of communicating matters.

In summary, keep the Scholar fully informed, give him adequate lead time, if at all in doubt make sure you ask, and seek to develop an extremely close and open relationship. Do not even think about launching a product without final clearance on Sharia matters.

F. Putting Together the Project Team

The project team and the internal team are essentially the same where the organization does not outsource and builds the product internally from A-Z, including the Sharia clearance. This is an unlikely scenario but is not impossible. Through outsourcing one obtains the best in class and is able to focus on its own core competencies while acquiring the core competencies of others. This concept is generally well understood and accepted in the industry today.

The goal is to bring together a smooth and efficient harmonic team, much like a renowned orchestra. All members should be committed and competent and you should manage the integration of internal and external skill sets, resources and expertise. The following team members may participate.

- 1) Sharia Scholar – The Sharia Scholar was discussed previously. Sharia clearance and adherence is critical. The Sharia Scholar is an indispensable member of the team furnishing leadership and authoritative guidance. The Sharia Scholar will also be providing the fatwa and should be consulted throughout the life of the product as required.
- 2) Islamic Financial Advisor - The Islamic Financial Advisor may be the sponsor, coordinator, or its role may be limited in scope to specific areas. The role of this team member may include interfacing with the Sharia Scholar(s), assisting in the application of the fatwa and Islamic financial techniques and solutions, and providing guidance on general and specific business matters with respect to assuring the compliance and promotion of the product.
- 3) Asset Manager – The selection and monitoring are important. Meet the people involved and understand their experience level and track record. Look at their methodology and approach. If an external party, look closely at the organization including things like its internal compliance, its reputation, its competitors, disruptions caused by internal restructuring. Ask for references and check around with others that may be more informed.

Whether an asset manager has experience in managing Islamic compliant investments may also be a consideration. Ask about the manner in which they have adapted and learned. There may be benefits in selecting an asset manager with experience in managing Islamic compliant investments and some familiarity is helpful.

- 4) Custodian, Registrar, Administrative Services – This is not an insignificant decision by any means. There are differences. There are specialists with regard to certain areas of expertise. There are some that are less expensive than others but you will probably find that you get what you pay

for. There are providers that are international and some more localized in nature. Do your homework and it will make your job easier in the long run. Using the same provider for multiple products or funds can create efficiencies.

- 5) Lawyer – This will involve assistance regarding compliance with the law of the land as opposed to Sharia law. Decide what you want in a lawyer. I suggest selecting one that is commercially oriented, has some familiarity with Islamic concepts or at least recognizes that he or she needs to invest time in order to get up to speed, and is responsive. I believe in keeping several relationships and selecting the lawyer that is best suited for the engagement based on all the facts and circumstances.
- 6) Directors – In a separate entity structure, there will need to be directors, trustees, a general partner or some other position of overall legal authority. There has been considerable press given recently to the role and function of independent directors and this should be given some consideration.
- 7) Distributor/selling agents/marketing group – The personnel charged with the selling are indispensable. If the product cannot sell, it will suffer and eventually die.
- 8) Customer – The customer is part of the team. We are creating the product for the investor. Do not lose sight of this.
- 9) Project coordinator – This person helps to pull the whole thing together. He must have the proper authority. He needs to be a good manager, work well with people in championing a common cause, work well under pressure, have good common sense and be aware of what others are doing and the issues that may arise. It is also helpful if he is a good problem solver.

6. Other Matters

A. Distribution

Distribution in the industry needs to be strengthened. We have a global audience and this is one issue. Another related major impediment is regulation. Regulation per se is good where it is intended to protect investors, as opposed to preserving anti-competitive internal inefficiencies.

Which distribution channels one utilizes is a strategic decision that is incorporated within the product development process and is integral to the process. The Internet and web based deliveries are changing the landscape.

Product labelling, brand management, brand recognition, and advertising need to be properly planned and executed.

Should we be only targeting Muslims? The products we produce are not really “Islamic products” but rather products that do not in their totality require rejection based on Islamic Sharia criteria. Seek a broader audience with a quality product and superior service.

B. Other Matters

There are perhaps as many different considerations to be aware of as there are products and organizations developing the products. A few matters that I am often asked are listed below.

- 1) What is the best choice of domicile (e.g. Cayman Islands, Luxembourg, etc.)?
- 2) What is the best choice of structure (Limited Liability Company, Master Feeder, Mudaraba, Musharaka)?
- 3) In anticipation of growth, what structure offers the most flexibility in terms of distribution (e.g. a UCITs or Undertakings for Collective Investments in Transferable Securities under the European Community 1985 Directive)?
- 4) What are the rules regarding distribution over the Internet?
- 5) Should we list the Fund?
- 6) How do we best create liquidity for investors?
- 7) What is the best way to reach the Muslim population in the United States?

7. In Summary – Pulling it Together

Product development in the Islamic financial services industry is a comprehensive process. It requires additional steps be taken when compared to a conventional product because of the additional and special requirements of the Islamic investor.

Product development is preferably customer driven. It is best to determine the values, needs and wants of the customer by reaching out and performing the proper analysis. Results of market research are then acted upon in a timely and responsive manner.

A team approach to product development works best. All members of the team (internal and external) play a critical role in assuring the investor receives the best possible product. There are no quick answers. Product development in our industry is difficult work but it is extremely rewarding and can be fun.

Best wishes to you in your endeavours and may God bless you.

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