Evolutionary Islamic Banking Service

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Abstract

This paper develops a conceptual framework that explains how an Islamic banking product (can) evolves into various and heterogeneous service practices in different contexts of its application. In theory, there is an argument that a service should continuously evolve into various practice environments to fulfil the requirements of various contexts and thus sustain. In practice also, the regulators such as the State Bank of Pakistan adopted an evolutionary regulatory framework that calls for designing and development of Islamic banking products that evolve into the emergent market needs. The proposed framework in this paper, describes a five steps evolution in an Islamic banking product, namely i) Model Contracts ii) Bank-level specifications iii) Branch-level Specifications; iv) Customer-level specifications v) and Feedback Evolution. The framework advances our understanding of how an Islamic banking product does or should evolve into to the practice environments of banks to effectively enact the evolutionary regulatory frameworks in the Islamic banking industry.

Keywords: Islamic Banking, Product, Evolutionary, Regulatory Framework.

1. Introduction

In different regions, Islamic banking is operating in various revolutionary or evolutionary regulatory frameworks (SBP, 2008). A revolutionary regulatory framework prefers to apply centrally designed structures to overall Islamic banking industry to be followed firmly to establish a planned system of desire. It is more like a prescriptive framework, which is adopted by Pakistan in the early 1980s to islamise the Islamic banking sector (SBP, 2008). Pakistan was not sufficiently successful with this framework in its first attempt (SBP, 2008 and 2010), as only 4 percent of the Islamic banking sector in transformed. In contrast, the evolutionary framework establishes a system that transforms itself gradually through insights from experiences from actual practice. Since 2003, Pakistan also adopted an evolutionary framework to re-establish the Islamic banking after having a dissatisfactory outcome of the revolutionary regime (Saeed, 2012). Within the current evolutionary framework an Islamic banking, an institution continuously adapts their products to create islamically acceptable services to tackle the constant innovations, compete in local and global markets, and remain compliant with *Shariah* (Moin, 2008). The adaptation is the process of change in the contents of a service product in compliance with the *Shariah*.

The Islamic products design strategies should also vary and fit within the broad Islamic finance regulatory frameworks. In UAE and Bahrain the process is entirely left to the financial institutions. In Sudan, the government provides some guidelines (SBP, 2010). In UK the Financial Services Authority (FSA) treats the Islamic finance as similar to conventional finance with no special favours or obstacles (Ainley *et al.*, 2007). The State Bank of Pakistan's strategy in Pakistan is unique and is based on the experience it gained from the earlier launch of Islamic finance (SBP, 2010).

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The SBP, which is the Islamic banking regulator in Pakistan has now recognised the importance of having dynamic frameworks. It allows Banks to design services that meet the diversified needs of the markets and remain compliant with *Shariah* (SBP, 2008). The regulator issue minimum prudential regulations and model contracts through the Islamic banking department and the rest of the service design process lies with the product development departments and their *Shariah* advisors in Banks.

Current literature in Islamic finance contributed to advance the finance and legal contracting theory for Islamic finance (e.g., Ahmed, 2006; Ayub, 2008; Ebrahim, 2000, 2012; Iqbal and Molyneux, 2005; Iqbal and Mirakhor, 2008; Kuran, 1995; Usmani, 2002a, 2002b). Islamic finance models such as those based on *Shirkah, Bai, Ijarah and others* are, in essence, contracts, which forcefully concentrate on the finance and physical assets' ownership and its legal transaction. However, these Islamic finance models do not offer any design for the evolution in actual service creation environments at the operational level. These models proposed that the designers centrally develop planned designs, in product development departments and apply these in multiple local environments to create services. This approach is not sufficient because the actual value in any service, so in Islamic banking, is contextually determined by the customers (e.g., Vargo and Lusch, 2008a and 2008b). Multiple service creators in each service case therefore adapt to each other to create this value-in-context (Vargo, Maglio and Akaka, 2008). Therefore, the planned designs, developed by the product development departments, cannot completely specify the actual service contents that emerges in multiple practice environments. In the legal context of Islamic finance, Ahmed (2006) while forcing the necessity of standardisation of legal systems for Islamic finance also recognised the emergent nature of operational/product application level environments and suggested to leave a room for it within product documentation as:

"That standardized contracts do not get entrenched and rigid. Contracts should be flexible enough to adjust to changing businesses and environment. The flexibility is desirable at both the transaction and market levels. The contracts should be flexible enough so as to adapt to individual transactions. Each transaction has unique features, which need to be taken care of in the documentation. The implication is that the documents will have a core portion and one that is left blank for filling in for individual transactions. The contracts and documentation should be flexible enough so as to evolve to match the changes in the market conditions and environment. This is particularly true in a world witnessing financial innovations and change" (Ahmed, 2006, p. 94)

Hussin *et al.,* 2013 also came to the conclusion that the Islamic finance are closely integrated with the broad macroeconomic systems and real sector which affect it to adapt. Apart from these acknowledgment and need of adaptation to specific environments, the existing Islamic finance models do not *explain any process or mechanism* that could enable the banks to enact the evolution in their banking products. This paper therefore posted the question of how to design an Islamic finance service that continuously adapt to the operational level environment of Islamic banks. Next section discuss a conceptual framework that explain how the Islamic banking products can successfully be evolved into various practices as desired by the evolutionary frameworks in the Islamic banking industry.

1.   The Proposed Evolutionary Islamic Banking Framework

The approach to the development of Islamic banking products is such that the every bank establishes centrally located products development departments (PDDs). A PDD adopts prudential regulations and model contracts from Islamic banking division and adapts the same to design various depository and financing products. These products, in essence, are not products but are designs (write-ups, process flows and contracts) that are to be used in future in multiple branches to create actual services through its repeated applications.

As one can imagine, the service design activity occurs temporally before the service practice activity (Pandza and Thorpe, 2010), designers can only create a vision and a pre-design explaining how the service should be practiced. But this vision and pre-design cannot provide complete details of changing environment. As depicted in Figure 1, designers at time 0 can only pre-design for the nearest service encounter at T0, because they can have more symmetric information about the design and its environment. However, information fades with temporally distant service encounters at T1 and T2, where asymmetric information exists; information about the products value in the future is faded.

Figure 1: Visualising Service Encounters

| Time: | 0 | 1 | 2 |
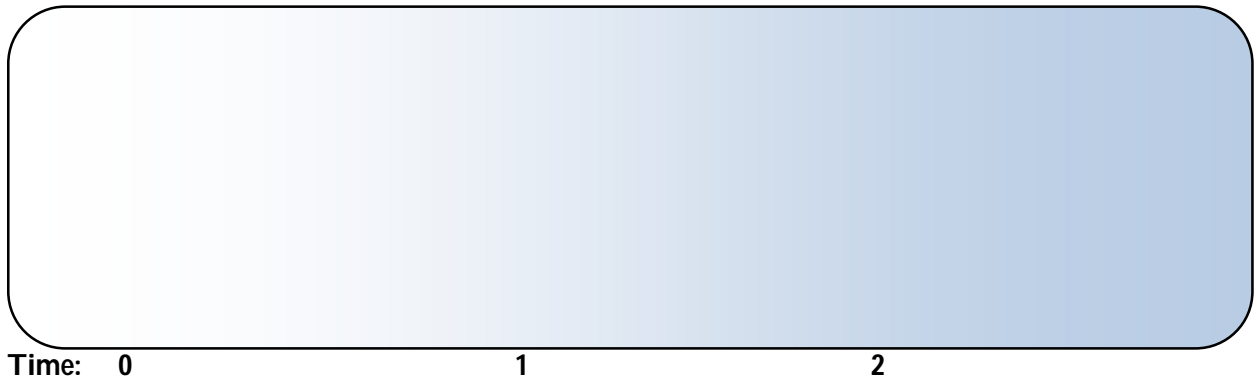
The critical limitation of current Islamic finance models is the absence of design for evolution; adaptation of design in accordance to *Shariah* and consequent evolution each service practice. The research found services evolving at service practice. The designers can therefore defer parts of design to points closer to service encounters in time and region dimensions. For instance, designers at bank headoffice cannot predict details of all possible service encounters that could happen in regional branches. They keep the design abstract and the service community locally design it as it emerges during service practice at branch level. Local designers closer to service encounters adapt the design according to the service community's actual contextual requirements. The evolution in service occurs at service encounter points (Chase and Tansik 1983; Shostack 1982; Surprenant and Solomon 1987), where various service creators and customer integrated their resources to create actual services. The practitioners adapt designs in response to the emergence both in 'real time' as well as in feedback loops at service encounters in the service practice. Real time adaptation is inclusion and exclusion of service components during service encounters by the service community to adjust to the emergent situation. The feedback loop is adaptation when practitioners learn from an encounter and adapt the design for next practice points. The cyclic service evolution at the operational level in Islamic banking is depicted in Figure 2.

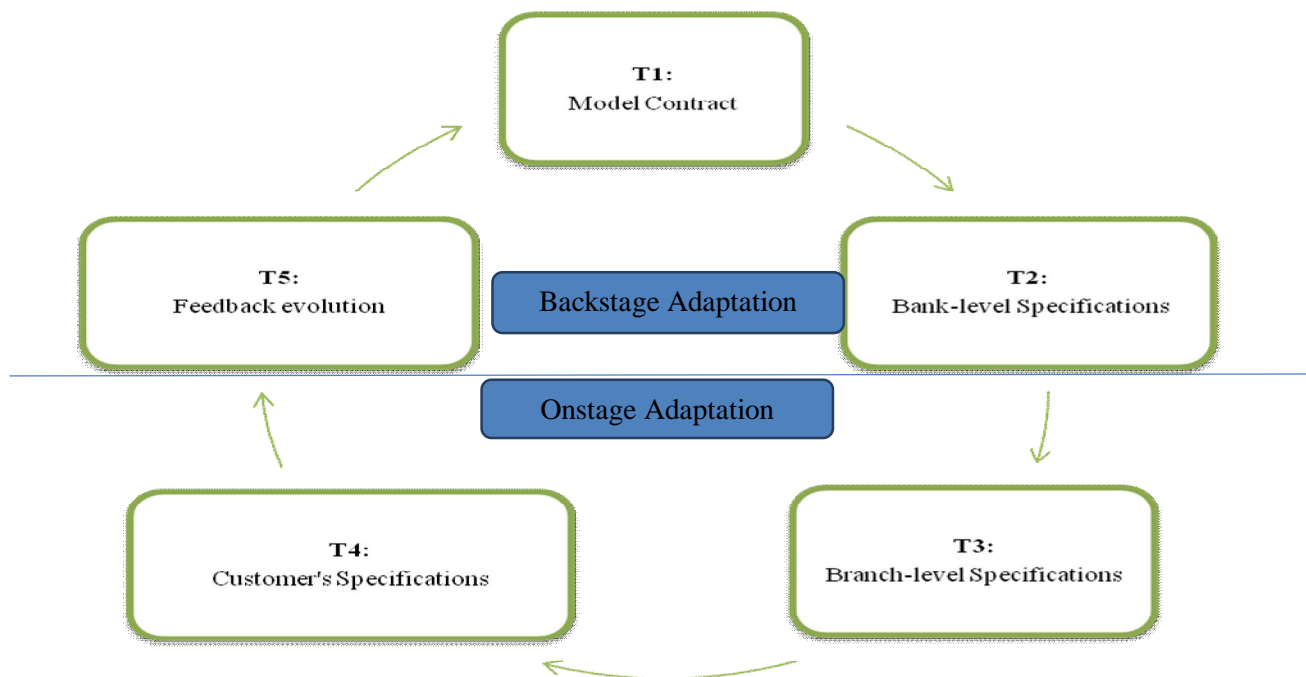**Figure 2 the framework for evolutionary Islamic finance service.**

Figure 2 illustrates evolution points at service encounters. A specified design at T1 occurs when product development commences; financial institutions build abstract designs based on model contracts provided by regulators of the time and region. At this point, designers specify known aspects of design and defer other aspects not known to them at that point. At T2 when the specified design reaches different banks, they adapt these into different products. Branch management adapts it to fit the local environment: available roles, resources, and rules to suite its own region, time and institution at T3. The third design adaptation occurs at T4, when employees and customers at service encounter points further adapt the design to suit customers and aiding parties. For example if an auto finance customer at service encounter say that he wants to purchase a second-hand vehicle from his friend in another city, who can then be included as party in the service creation.

The design then becomes actionable, ready to be used as script to enact actual banking service practice. However, the evolution continues as the practitioners design for the emergent service community members, their roles, resources, rules and objectives. For instance, we can observe that banks' branches in urban areas replaced the manual process of depositing bills with computerised kiosks, by exuding the role of bill collector. However, in some rural areas the role of utility bill collector continued. Thus, the design for 'bill collection service' is adapted for the emergent context of urban branches, but remained the same in rural areas. This happens because different regions, times and sectors do not have the same expertise, resources and objects to assume a uniform design for every service encounter, as assumed in current Islamic finance models. Even if the financial institution maintains uniform roles, resources, rules and objects across time and regions, it is problematical to assume the same for other service cocreators, customer and aiding parties, who in most cases remain unknown at the time of specified design T1. At T5, the feedback evolution of designs occurs when and where practitioners raise quarries related to different aspects of the services or the auditors find an imbalance in the legal control of service practices. The answers to these quarries and audit points enhance designers' own learning, causing adaptation in subsequent designs. This process of evolution occurs as loop in every application of the product into service practice and thus cause the emergence of very unique banking practices in every instance.

2. Evidence of Evolutionary Islamic Banking Service

Currently, the evaluation and development of the framework is continuing. The data is gathered through in-depth narrative interviews. The analysis revealed patterns that support and enhance the framework presented in previous section. Some data chucks of qualitative interviews are presented here to show empirical evidence that backup the concept. For instance, the manager of working capital describes the pattern of evolution at service practice:

'Our menu of services grows as new needs of the customer emerge. New services come as modified versions [adaptation in designs] of the earlier services with new facilities, options and benefits for customers [inclusion in service]… and could also withdraw some features of earlier services [exudation] which do not remain attractive…IFSP7.

Inclusion and exclusion in service components is a continuous process of adaptation. Circumstances of members of service community differ and their different value propositions and capabilities result in varying contributions i.e. roles, resources and rules, which forces the pre-design to evolve at service practice. The service absorbs new actions and processes and exudes others.

The manager of business development and strategy describes emergence in the object of service and explains how this affects service practice:

In mudarabah leasing we invest money in fixed assets of businesses [object of service], if the customer inform us about any new type of assets [emergent object] he want us to invest in. We evaluate the new opportunity and restructure our service to adjust for such opportunity. We send such design to headquarter for approval, where the result could come as approval of our recommended service design or disapproval with recommended changes.…This practice broadens the scope of our service…As recently we did for financing imports of CNG pumps… IFSP1

This narration describes how opportunities emerge in the market, triggering the service community to adapt the service to benefit. However, adaptation is cautious to comply with *Shariah*. A customer describes how emergence in roles and resources resulted in adaptation:

.../Utility bills and universities fees collection services evolve because both customers and the bank accustoms with new ways of doing things [emergence in roles]...ISFC2

Evolution in roles and resources of the service community impact the structure of service practice. Evolution is observable in the same service compared at two different times, as described by the senior officer of operations:

With emergence of new methods and tools of doing things, the service become more sophisticated. If you compare the banking of 1976, when I joined the bank, and now (2010), you will see that almost 90 percent of the service structure is different. Like we do not have that manual typewriters to prepare the ledgers, handwritten passbooks to maintain record of cash withdrawals, coins issuance against cheque process [exudation in service roles and resources] All these practices are now replaced with ATM, debit card, internet transfer and mobile banking [Inclusions in roles and resources] ...IFSP3

Regulators of different regions, sectors and time adapt the rules to adjust the legal control of each service cocreator in the ESP, as described by the manager of credit and marketing:

The prudential regulations continuously change, even some time 2 or 3 times in a month they send us SROs [Statutory Regulatory Orders], mentioning to replace some documents or wordings in contracts...similarly, organisation policies and standards evolves with time which impact the ways we provide service [Emergence in rules and legal control] ......however you will see these changes are different in different countries, and in different financial sectors... IFSP2

Evolution in service and service constructs varies in different times, regions, sectors and even in different service portfolios:

There is no doubt that service evolves over time, however you cannot say that this evolution is uniform in all the regions where we operate. Like our recently build kiosk system for accepting utility bills works successfully in urban areas but not in our rural branches, because the customers in rural areas cannot operate these systems. Similarly some sectors like capital market investments service more rapidly evolves then the conventional depository services. IFSP4

The data reveals that service emerges when customer, financial institution and aiding parties come together to form the 'service community' to cocreate service. This value in the service object binds and motivates the service community to contribute and integrate their actions grouped in roles, usufructs embedded in resources, within the distributed legal control established through formal and informal rules.

3. Implications and Conclusion

This paper presents the concept of evolutionary Islamic banking service based on the need for evolutionary service practices within the evolutionary regulatory frameworks such as that applied by the State Bank of Pakistan. A critical evaluation of the currently available Islamic finance models based on *Shirkah, Bai, Ijarah* and other provide little room for the adaptation and evolution in the service. A robust theoretically and empirically based framework for the evolution of Islamic banking service can proved to be a well-timed and much needed mechanism through which Islamic banks can develop products that meet the emerging markets needs and remain compliant with *Shariah.* The proposed framework can also enable the regulators to be successful in implementing their evolutionary regulatory frameworks.

4.   References

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