“Islamic banking”; wrought to you by non-Islamic banks !

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Many conventional banks have now started offering “Islamic products”. The reason is clearly, strong demand for such products. While facts about the rate of growth of such demand may not be available, there are some reports that this rate may exceed 15% annually.

It is expected that, as demand increases more and more conventional banks go into the market for Islamic banking.

One would have hoped that this demand growth would have resulted in expansion in the business of the “dedicated” Islamic banking institutions, or the emergence of new one’s. Never the less, this does not seem to be the case. Explanation of that is beyond the scope of this paper.

There are many reasons, however, to believe that the phenomena is here to stay. It is, therefore, imperative that guidance is given so that a minimum degree of *Shariah* commitment is maintained, and “rules of the game” are held up in a way that the integrity of the basic model of interest free banking is intact. Because of the writer’s involvement in some of these schemes, I want to share with the readers some thoughts:

1- If Islamic banking products are to be offered by a conventional bank they, have to be offered through an independent department. This department need not be completely autonomous and disconnected from the bank. It is necessary, however, that such department holds its own books and is made a profit center. The position of that department in the organizational structure of the bank reflects management commitment to the idea. However, this department must have the basic level of authority to respond, timely to the evolving market. No hope for any bank to gain "legitimacy" and persuade the outside world of its view to *Shariah* limits without this.

2- The most important aspect of *Shariah* in such an activity is the separation of the "finances" of this department from the rest of the bank. It is, therefore, essential that such department should be managed as a bank within the bank. This means that:

a) The department has its own books, keeps its own accounts independently from the rest of the bank.

b) It has its own assets and liabilities,

c) It has its separate treasury and an ALCO of its own.

Although its end-of-the year results will be consolidated into the balance sheet of the bank, maintaining separate account though it is not necessary to show profitability, but also to assure clients of the "purity" of its business.

3- Certainly this department will need to deal financially with the rest of the bank, as much (or may be more) as it needs to deal with other banks. There is no restrictions on the "size" of such engagement, given that the mode is acceptable from *Shariah* point of view. For example, such department may not be able, at least initially, to match its assets and liabilities. Funds may occasionally need to be appropriated from the treasury of the bank. There is nothing wrong with that if it is done on the basis of, say, Mudarabah or Musharakah. The first mode means the bank treasury will assume that the Islamic department is a manager, receiving an agreed upon portion of the profit. In the second, both bank's treasury and that department will go into a partnership sharing the profit on a pro-rata basis. Certainly,

calculating the profit which is subject to division is not a simple task. Going into details of the *Shariah* aspects of this issue may be beyond the scope of the current paper. However, profit sharing may be based on the over-all performance of the department calculated on a daily basis.

4- Experience shows that attracting deposits and more of them is not the greatest challenge to any new entrant into Islamic banking, due to the strong demand for such services globally. Rather, finding good investment opportunities that are acceptable from *Shariah* point of view is the real hurdle for fast growth. A lot of effort must be put into creating assets for the new department.

5- Some *Shariah* supervision is a must. One may say that most of the known Islamic banking products have already been cleared by numerous *Shariah* boards. This is correct. It remains, however, that an in house *Shariah* supervision is more "reassuring" to the clients of the bank. It goes without saying the reason **de etre** of

Islamic banking is the *Shariah* restrictions on finance. Unless people are convinced that these restrictions are abided by, the bank will not build creditability. The greatest asset for any Islamic banking venture is legitimacy, which can only be attained through a strong visible commitment to *Shariah*.

6- Pricing of Islamic banking products may turn out to be a major difficulty for any “dual” banking institution. This is because risk assessment and measurement for the Islamic products is incompatible with conventional banking products. To many bankers,

Murabaha profit margin should be significantly higher than, say consumer lending. This is because of the seemingly higher interest rate risk (since it is fixed) and default risk (because no penalty for delayed payment can be imposed).

Only experience, however, can show whether such view is correct. The author did come across a Murabaha portfolio in one Car installment company, which is lower in bad debt, higher in return than any banks consume credit portfolio, although the former is larger than the average of any bank consumer lending activity in that country.

There is no denying, however, that Mudarabah and Musharakah are riskier than any conventional bank finance. How much return is enough to justify these risks, the answer, to many conventional bankers, is non. It is important to note that new variants of

Musharakah, but particularly Mudarabah, are being developed. The main factor is risk reduction.

7- "Cannibalism" is a word which will be heard frequently in a dual banking institution. Certainly the most important reason for entry into Islamic banking services is market share. Any bank would then expect that a net increase in its volume of business will take place. However, a bank working in an "Islamic environment" will find that a lot of bank client will just move places i.e. from conventional to Islamic in the same bank. It is important that the marketing campaign of the new department target other bank's clientele, at least initially. This particular point may create a lot of conflict within the bank itself. Unless clear signals are sent by the top management, it may turn out to be very exhaustive.

8- Finally what will make or break any major entry into Islamic banking by a conventional bank is; training. There are those who think that a good banker is good in any banking system. Nevertheless, Islamic banking is more than just a skill, it is a way of thinking. It takes some time for conventional bankers to grasp the philosophy of Islamic banking. Any resources directed to training is "money well spent". This may turn out to be the easiest part. The hard part is designing an effective training program.

A common flaw in such programs is an "overdose" of *Shariah* knowledge. Too much figh knowledge only confuses bank employees and entice them into a "do it yourself" fatwa. It is essential that they are well trained in the Islamic theory of contract.

It is not important that they know every detail of the jurisprudence on exchange company and finance.