Shari'ah requirements for acceptable and successful conversion

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1- What is wrong with conventional banking:

The function of banks is financial intermediation. Through this process, banks channel savings into useful uses for investment and consumptive purposes. They provide a mechanism for pooling funds to undertake large scale indivisible enterprise and they provide ways to transfer economic resources, thus assuring maximum utilization of monetary resources. It is obvious that the more financial intermediation we have the better. More intermediation means better utilization of real resources and hence prosperity of the society. Shari'ah is not against this. On the contrary it is safe to say that Shari'ah encourages economic development orders its followers to endower into wealth creation and the use of economic resources for the creation of more welfare for all members of society. Hence, financial intermediation is simply a means to a desired end.

What is objectionable from Shari'ah point of view is when that financial intermediation is delivered through a process of interest based borrowing and lending, as it the case in conventional banking.

Banks borrow from savers and lend to users of funds. For a private

enterprise bank, the only way to make money, (let alone covering

running expenses) is by charging interest on loans. This is usury

and hence the system of conventional banking is contrary to

Shari'ah injunctions. Islamic Shari'ah is not unique in casting this

stipulated increase as usury. All religions that prohibited usury

know of one definition for it; a stipulated increase in the contract of

loan.

However, it is not imperative for an institution specializing in

collecting savings and channeling them to investment to do this on

the basis of borrower lender basis. This is a mere possibility out of

an array of possibilities. It is a model out of many possible models.

One of them is what Muslims were able to develop under the

prohibition of usury. That is receiving funds on the basis of profit

and loss sharing and advancing credit on both profit and loss and

sale based contracts. Where profit is made, it is made in the real

sector where risks are taken and actual exchanges of goods and

services take place.

2- Why convert:

A commercial enterprise can only survive in the private sector

when it listens and responds timely to the preference of it cliental.

These preferences are expressed through the effective demand in

the market. The market mechanism in the free economy forces

producers to change in response to new market realities. Those

who fail to change usually parish. Banks are no exception.

In the last two decades, individuals in Muslim societies showed a

keen interest in "interest free" banking. At the beginning, new

financial institutions (called Islamic banks) were established for the

purpose of providing interest free banking services. Then

conventional banks realized that their market share can be

enhanced if they offer investors, in addition to their conventional

banking services, opportunities that are in line with Shari'ah. Most

conventional banks where introduced to this "niche" market

through their off-balance sheet accounts. In the beginning it was

mutual funds and private portfolios. Subsequently and for almost

all players in this market it became obvious that the market for

Islamic banking service is so deep that missing it limits the

opportunities of growth in market share.

This is the case now in almost all Muslim countries. Where banks

are for profit business enterprises they respond to a growing

demand by going Islamic. Where banks are part of the public

sector, they afford to just ignore the message of the market.

As banks expand in the direction of offering to the market more

and more Shari'ah complaint products and services, they realize

that they are actually initiating a process that will only end when

all their business is Shari'ah complaint. This is what we call

conversion.

We can say, therefore, that conversion is a "natural" development

of the banking sector created by the free play of the market forces.

As it the case with every business, only those who listen to the

market have a chance of survival, in a truly free and competitive

market.

a) Market induced Vs Religion induced conversions:

The question is frequently raised about the real intention that drives

conversion to Islamic banking by conventional banks. Is it

commercially motivated or religiously motivated. A popular "acid

test" relates to the extent of conversion. If the bank adopts, day

one, a strategy that explicitly mention full conversion to Islamic

banking, then and only then it can be claimed to be "religiously

motivated". Otherwise, Islamization is only "commercially"

motivated. This, as the perception goes, makes "Shari'ah inferior",

not worthy of respect, and makes the management of the bank

suspect. They will go back to conventional if Islamic doesn't make

money.

To me the whole issue is irrelevant. On the one hand, intentions are

important for natural persons. Banks are juristic persons. No matter

how good or bad the intention of the management they are, at the

end of the day, functionaries implementing policies that maximize

profit to share holders. On the other, if Islamization is a good thing,

it should be so at any level. Therefore, full conversion is better than

a mere distribution of an of Islamic investment fund. But they are

both O.K.

More importantly, experience shows that for a bank operating in a

Muslim society as conversion starts it creates a momentum that

stops at nothing but a full conversion. The force of Islamization

becomes unstoppable.

b) Progressive Vs "cold turkey" transformation:

While the aspiration of Muslims to see interest free banking is as old as the appearance of such banks, the concept of conversion is quite new. It goes back to a decade ago when the Saudi NCB adopted a strategy that for the first time mentions conversion as a final objective. The innovative thing in this NCB concept is the idea of "progression". That was a major turning point in the history of banking in our area of the world. It used to be that no effort of Islamization was considered worthy of Shari'ah approval if it didn't "decree" the abolition of all interest based transaction from day one. This what we may call "the cold turkey" approach. The Pakistani experience showed very clearly that "decree" is not sufficient. A system that is so complicated and so essential to the economic life of millions can't be converted overnight. The cost of conversion becomes so high that people create all kind of excuses to delay it or stop it all together.

c) Government induced Vs Government-free conversion:

Another important aspect of conversion that is usually over sighted deals with the rule of government. What rule can the government play to make the conversion a success. The answer is very little. Successful cases of conversion happened with almost no government support what so ever. (we are tempted to say all failing

cases exhibit significant government involvement). This is not saying we don't need government regulation and supervision. On the contrary, it is very essential for the safety and soundness of the banking system. However, government rule should be confined to

that aspect, and especially when banks can't self regulate.

I have a lot of respect for central bankers. However, I start worrying whenever I see that they look at Islamic banking as a different animal, deserving a different system of regulation and special standards for accounting and audit.

3- Meaning of conversion:

Conversion simply means that the business of the financial institution becomes in compliance with Shari'ah requirements. This means significant changes in the structure and operation of a bank. On the one hand. It will no longer be a borrower of money. The liability side of the bank will basically be funds received on fiduciary basis to share in the profit generated from the uses of these funds. Should they be off balance sheet? This is a subject of debate. There is nothing against borrowing funds from bank customers, except for the fact that it has to be interest free. Therefore, Islamic banks do maintain the service of current

accounts which is effectively interest free loans. Operationally,

being in compliance with Shari'ah means more than just interest

free. Shari'ah injunctions in all bank activities should be followed.

On the asset side of the bank balance sheet, there will be debt. But

it is receivable created by sales of goods and services not lending

money. The distinction is not only legalistic. This debt will never

grow in size over time, because rescheduling is not permitted.

4-Shari'ah requirements for acceptable conversion:

Whether driven by the market force or by the religious motivation of

the shareholders, there are certain Shari'ah requirements that need to

be maintained if the process of conversion is to be Shari'ah complaint.

a- Shari'ah board.

It is essential to have a Shari'ah board. Although many Shari'ah based

modes of finance are now common knowledge. It is still important

that a Shari'ah board is established in any bank offering Islamic

banking products. Not only that a Shari'ah board will advise the bank

on permissibility or otherwise of new products and procedures, a

Shari'ah board bestows upon the process of conversion Shari'ah

validity and legitimacy that is essential in convincing the public of the

determination and resolve of the bank in this conversion project. Does

this mean a Shari'ah board is a marketing tool? Not necessarily. But it

sure is very helpful.

Some regulators and central bankers were baffled about the nature of

the job of Shari'ah boards in Islamic financial institution. They thought

Shari'ah scholars, with little or no training in banking, "call the shots"

in Islamic banks. Actually, Shari'ah boards have no executive power

and they don't interfere in the day to day management of the bank nor

take decisions on behalf of the management. They may express their

views about the Shari'ah permissibility of a transaction, but they will

never comment on the credit or risk aspects of it.

b- <u>Separation of Islamic from non-Islamic.</u>

Whether they are Islamic or non-Islamic, funds going through the

bank accounts can't be distinguished unless they are deliberately

separated. No conversion will succeed if doesn't give comfort to bank

customers that a Chinese wall has been erected between Islamic and

conventional. The prohibition of usury in Islamic is so cardinal that

Muslims are required to keep as much distance as possible from even

the suspicious of very. Hence separation is prerequisite for success.

This Chinese wall is in the form of management and accounting

documentation of what is Islamic and what is non-Islamic. In the

pioneering experiment of NCB, a separate division was established in

the bank with its own assets and liabilities managing dedicated

branches which only offer Shari'ah approved products and services.

That was an essential part of the success of NCB. It is no surprise that

it was followed by almost all banks in Saudi Arabia.

At its highest point separation means the break up of the balance sheet

of the bank to have a separate asset / liability structure for the Islamic

finance. This means that Islamic assets are actually financed by

Islamic liabilities. Islamic liabilities could simply be current accounts.

But this is a requirement for full conversion. This doesn't mean no

Islamic services are to be provided without this.

c- Shari'ah Compliance and Audit:

It is not sufficient that a bank has a Shari'ah board that meets every

few months and drafts forms of contracts and approve new products.

Just as important is Shari'ah compliance making sure that Shari'ah

requirements are adhered to by the functionaries. For this purpose,

many Islamic banks appoint an internal Shari'ah officer in-charge of

compliance. His job is mainly inspection, to ascertain the fact that set

procedures are followed by the employees of the bank and that

decision of the Shari'ah board are implemented.

Part of the function of Shari'ah board's is to carry out its Shari'ah

audit. Shari'ah audit is a duty in the process of formation. Shari'ah

audit has similarities to financial auditing in the fact that both take

place at the end of the financial year and result in the approval of these

financials by the auditor. The concern of the Shari'ah board is clearly

making sure that the sources of money and utilization of funds by the

bank are both in line with Shari'ah. Some regulators are now

encouraging such practice in earnest.

The function of Shari'ah audit requires a close co-operation with

accounts auditors and in some Islamic banks auditors themselves are

involved directly in the process.

Shari'ah boards do this audit through the inspection of sample of files

in each product category i.e. Murabaha, Istisna'a, etc. The purpose is

to make sure that the set procedures have been followed and that

approved forms of contracts are used.