Conversion of conventional banking branches into Islamic banking: The Case of Pakistani Banks

***Dr. Muhammad Mushtaq Ahmed* [i] *Javed Khan* [ii]**

Abstract

Pakistan has vigorously resurrected Islamic banking in 2002 and State Bank of Pakistan has issued license to 1st full-fledged Islamic bank of the country. Within twelve years the Islamic Banking industry has crossed few millstones and today Islamic Banking industry is serving the people with more than fourteen hundred branches all over the country. After the success of Islamic banking and acceptability by the masses now every conventional bank showing interest to inter into Islamic banking market, there are different ways permitted by regulators for conventional counterpart of Islamic banks to inter into the market and one of them is conversion of Conventional Banking Branches ,(CBB's) into Islamic Banking Branches (IBB's).

In Pakistan, conversion of CBB's into IBBs has started in 2003-04 which has been increased since 2010 and it is expected that the regulator will allow more conventional banks to convert their CBB's into IBBs. While this growth is very encouraging sign for Islamic financial industry hence there are some Shariah rules and principle which must be followed strictly to make the practice Shariah compliant and within the parameters given by the Regulator.

This paper address present Practice, relevant Shariah principles and guide lines issued by the regulator regarding conversion of CBB's into IBBs along with recom - mendations regarding some practical issues facing by CBB's while conversion.

***Key words**: Islamic Bank; conversion; Riba; Islamic window; Shariah;*

History of Islamic Banking In Pakistan

Pakistan had made the bold attempt in 1980s to start Islamic banking by converting the whole banking and financial system into Islamic system. However, in first phase Pakistan's efforts had to face difficulties due to some reasons such as, lack of Shariah complaint mechanism in financial institutions, lack of public awareness about Islamic economic system and lack of socio-economic will etc.

After the historical supreme court's judgment (19th December, 1999), Commission for transformation of financial system was formed and the said commission evolved a new approach towards islamization of financial sector of Pakistan. This approach includes establishment of full-fledge Islamic Banks, Islamic Banking subsidiaries of existing banks and stand alone branches for Islamic Banking[1]. In order to promote Islamic Banking in Pakistan as a parallel banking system which is compatible to conventional banking system and the same is Shariah Compliant.

The new strategy worked very well for Islamic Financial industry in the country as total assets under the management of Islamic Banks in Pakistan reached Rs. 1.102 trillion by end September 2014 from Rs. 6.97 billion in December 2002. Total Islamic Banking deposits reached to Rs. 934 Billion in September 2014 from Rs. 5 billion in 2002. During this period the share of Islamic Banking assets and deposit in overall banking sector has reached to 10.7 percent. Branch network of Islamic Banking Industry has also expended and reached up to a total number of 1423 of Islamic Banking branches all over the country[2].

i ***Assistant Professor,Department of law and Sharia, University of swat***

ii ***Lecturer ,Department of law and Sharia, University of swat***

Conversion of Conventional Branches into Islamic Banking Branches

Islamic Banking industry has grown rapidly in the past decade, and this growth is expected to continue in near future. In banking industry, Islamic banking system has progressed from being a mere concept into being part of the mainstream financial services industry and that too in a very short span of time. The development and growth of Islamic financial industry increased interest of many conventional banks and financial institutions in Islamic finance[3].

They want to inter into Islamic finance market with their existing set-up State Bank of Pakistan, being a regulator introduced a strategy to ensure participation of key players of the industry in the evolution of Islamic finance and give them equal opportunity to start Islamic finance with their existing setup by establishing full-fledged Islamic bank(s) in the private sector or setting up a subsidiary for Islamic Banking by the existing commercial banks[4]. Even SBP allowed the Establishment of Islamic Banking Department in existing conventional banks with the strategy to open new Stand-alone Branches for Islamic Banking and to convert existing Conventional Branches into Islamic Banking Branches [5].

Keeping in view the advantages of conversion of present conventional Branches, some banks adopt the policy of conversion to utilize their present Branch network in Islamic Banking. Subsequently first ever branch conversion experience in Pakistan was witnessed in the year 2003, when Islamic Banking Group of the Bank of Khyber started its operations in 2003 by converting its Conventional banking Branch located at Peshawar into fully Shariah Compliant banking Branch[6].

After the success of this first ever experience other conventional banks have started establishing the Islamic Banking Departments and converting present CBB's into IBBs. The larger banks like National Bank of Pakistan, Allied Bank Limited, The Bank of Punjab and Askari Bank have converted more than 40 branches into IBBs. Moreover, the private banks like Summit Bank and Faysal Bank intends to convert their whole banking system into Shariah Compliant banking[7].

Present Practice of Conversion in Pakistan

The fund based banking operations are normally consists of three major activities. 01) collection of funds from the depositors of the bank, 02) investment of these funds in different business activates and 03) distribution of profit/ earning generated from business activities to depositors of the bank after deduction of banks portion.

Keeping in the view the above mentioned banking operations, different banks adopt different conversion model according to their convenient.

1st Model

Some of the institutions transfer all the liabilities and investment to other conventional branch and start Islamic banking activities in the designated branch. In this case no activity of conversion takes place in the branch and all the depositors have to open new accounts in converted branch. However branch license is converted into Islamic license and according to SBP instructions the converted branch will not involve in any conventional operation/activity[8]. This model has been adopted by Silk Bank Limited Pakistan and Summit Bank Limited Pakistan[9].

2nd Model

To take advantage of present deposit of conventional branch some conventional Banks Adopted model of conversion of Deposits only. In this case as per SBP instructions[10]. The depositors has informed about the conversion four weeks before conversion and process of taking consent and signing term and conditions of Islamic account opening form is started to retain maximum deposits in the branch as much as possible. This model has been adopted by The Bank of Punjab, Taqwa Islamic Banking for conversion[11]. If a depositor do not intend to convert his account into Islamic banking, he is informed to withdrawn his deposit or else his account will be transferred to designate conventional Branch. However this option is not given to TDRs holder as they have to encash their TDRs and if intended Islamic certificate may be issued.

3rd Model

Some of the banks convert all operations of the branch into Islamic banking from deposit to financing and it is called conversion of core branch operations into Islamic Banking. However, as per SBP instructions non performing loans of the branches are transferred into conventional Branches[12].

Shariah perspective of different models

Looking into first model of conversion there is actually no conversion of deposit or financing; however, in this case it shall be ensured that any interest bearing account of the branch with other conventional bank must be closed before starting operations of Islamic banking in the premises as it is against the Islamic guidelines to take interest[13].

Conversion of Deposit system only

Deposits accepted by Islamic Banks can be divided into two categories from Shariah (Islamic Law) point of view i.e. Qarḍ-e-ḥasana based (current accounts) and Mushārakah or Muḍārabah based accounts (Profit and loss sharing Savings)[14].

Treatment of Current Accounts

Current accounts in Islamic banking are based on Qarḍ-ḥasana. It is defined as providing money or goods to someone for his/her immediate benefit who returns an equal value at a later date[15]. There are some conditions associated with Qarḍ-e-ḥasana. Firstly, no extra benefit or excess money can be taken against qard as it is narrated**:**

> *"Every Qarḍ-e-ḥasana which attracts any type of benefit is Ribā[16]."*

Resolutions of the Islamic Fiqh Academy also consider it as qard e hasana. Resolution number 86/3/95 of the academy puts it in these words:

> *"Current accounts are considered as loan, from Shariah perspective, since the bank taking delivery of these deposits is answerable for their safety and is bound Shariah-wise to returning them on call[17]."*

In the light of above mentioned versus and jurist views it is understandable that current account holders shall not be given any portion in profit even free value added services if offered by the banks to current account holder before conversion shall be ceased after conversion as it is extra benefit on the basis of qard. However as per SBP instructions it is allowed only if given to all the account holders including Invstment account holders acrros the board [18].

A. Treatment of Normal Interest Bearing Account

All the interest on interest bearing accounts shall be paid to the account holders by the conventional bank up to date of conversion before conversion and no fixed return shall be given to these accounts holder after conversion. They will be considered investment account holders (IAH) and they will have their share in the Profit according to the defined wieghtages announced before start of investment period. Because, these interest bearing accounts may either be converted into *"Mudarbah"* or *"Musharaka"* based accounts after receiving consent of account holders. Because Profit and Loss Sharing (PLS) Accounts in Islamic Banking. Are accepted by Islamic banks on *Mushārakah* or *Muḍārabah* basis.

B. Mushārakah and Mudārabah

Mushārakah means a joint enterprise in which all the partners share the profit or loss of the joint venture[19]. *Mushārakah* deposits in Islamic banks are accepted on the basis of partnership between the banks and investment account holders.

Muḍārabah is form of business in which one person gives capital to another person for business and both of them share profits in mutually agreed proportions. The investor of capital is called the "Rabb-Ul-Mal" (Fund Provider) and the fund manager is called *Muḍārib*[20]. PLS account holders are either Partners (Shareek) of the bank or Fund Provider (Rabb-Ul-Māl) or the banks acts as partners or fund managers depending upon the deposit mechanism of the bank[21].

Islamic bank cannot pay fix amount on Musharakah and Mudarbah investment but they are bound to pay profit to every Shareek/ Rabb-ul-Maal according to the pre-agreed ratio in the *Mushārakah/ Muḍārabah* pool[22]. Hence after conversion of interest bearing account into *Mudarbah* or *Musharakah* based accounts, banks cannot pay fix profit on the same but they will get profit according to the pre-agreed ratio announced by the bank.

In the process of conversion it is important to announce weightages and profit sharing ratio before the commencment of busines in the branch[23].

This ratio shall be determined before interring into the contract and cannot be changed without mutual consent until liquidation of the Pool. Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners[24].

C. Treatment of Term Deposit Certificates

Term deposit certificates are long term deposits which are normally accepted on a higher rate than normal deposits. In Islamic banks these deposits are also accepted on the concept of "*Mudarbah*" or "*Musharakah*"[25]. However in the course of conversion these deposits cannot be converted into Islamic certificate merely on the basis of consent letter. They should be advised to encash conventional certificates as per conventional bank policy. Preferably no penalty shall be charged on early encashment. Islamic Certificates shall be issued then to customer from the date of conversion but no fix return shall be paid after conversion as it is not allowed under Mudarabah and Musharakah principle. Incase; consents of TDR;s holder is not received TDRs shall be shifted to Designated Conventional Branch and shall not be kept in Islamic banking branch as it is interest bearing cirtificate.

Conversion of Deposit as well as Financing (3rd Model)

The most important phase of conversion which needs more attention from Sharia perspective is the conversion of conventional advances. Following contracts may be used for the conversion of different advances.

Sale and Lease Back (if leasable assets are available with the client)

Sale & Lease back is such a transaction in which a customer sells his already possessed asset to a financier and then enters into a separate lease agreement to get the right of use over a certain period. Ideally SLB transactions should be avoided. It should be used in exceptional cases and care should be taken to ensure that the transaction is genuine and not merely a source of liquidity /overdraft facility or a substitute of personal financing. Accounting and Auditing Organization of Islamic Financial Institution's (AAOIFI) allowed the transaction that:

> *"An asset may be acquired from a party and then leased to that party. In this case, the Ijarah transaction should not be stipulated as a condition of the purchase contract by which the institution acquires the asset[26]."*

However, SBP has restricted the same with special cases and also subject it with prior approval of Sharia Advisor27.

In this case it is important that ownership of the subject matter of Ijara shall not be transferred to the lessee before completion of one year[28].

Third Party Murabaha

Some scholars suggested at the early stage of conversion that third party *Murabaha* may be adopted for conversion, they suggested that if the client has no leasable asset his existing stock/ asset may not be converted into *Murabaha*, however, if he sells those stocks to a third party and subsequently the bank opts purchasing those goods from a third party and sells it to the client on the basis of *Murabaha*, this is allowed only for the purpose of conversion on one time basis to facilitate easy and quick conversion to Islamic Modes[29]. However, latter on this practice has been reviewed and due to some reservation by Sharia Scholars it is recommended that only Ijara model shall be used for conversion[30].

Conclusions and Recommendation

Keeping in view the present practice of conversion of CBB's into IBBs following areas may be given more attention.

A. Training and Development of Human Resource

Branch officials, being the front line staff had to face all types of queries, concerns, and comments of customers and general public. Without proper training and development of all staff members of selected branches, the conversion process may not produce required results; even in some cases it may create misunderstanding among the masses. Moreover, converted branch will be integrated with various other departments such as Risk Management, Credit Administration, Information Technology, Administration,Compliance and Audit departments of conventional bank. Without proper training of the key officials of these departments, the smooth sailing of operations of the Islamic branch cannot be possible.

B. Conversion of Financing Portfolio

Limited number of products of financings is available for converted branches. Owing to the reason, converted branches had to forgo the major portion of credit portfolio. It is recommended that product development peers of the industry along with Sharia scholars may design some more Sharia complaint products for the conversion.

C. IT Developments

IT system is a key factor in the present banking practice, without sound IT system for (a) deposits, (b) financing, investments and placements, (c) income and expenses and (d) pool management the conversion process may not be able to produce expected results.

D. Audit & Compliance Issues

Without proper plan/ strategy resolution of adverse finding of internal, external and regulators audits cannot be ascertained, which may lead to penalty from regulator or reputational loss.

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