

**Authored By:** Moinuddin Malim, Managing Partner  
Alternative International Management Services

### **Looking for Perfect Islamic Window Model?**

Islamic banking and finance assets have crossed US\$1.8 trillion and are growing at an average annual rate of 17%. The industry's growth story will remain positive, growing 50% faster than the overall banking sector and is expected to cross US\$3.4 trillion by 2018. The competitive pressures have coerced existing conventional banks in such territories where Islamic banking is gaining popularity. Consequently, they have resorted to formulating the "Islamic Windows" models within their existing infrastructure. Markets with higher demand for Islamic banking present better opportunity set; however, each market player intending to start up an Islamic Window will need to carve out their own unique market penetration strategy based on the breathing space allowed by their regulators in this segment.

#### **The evolution of Islamic Windows**

An Islamic Window by definition can be a department or a division or even a separate finance company set-up by a conventional financial institution which offers Islamic products and services to customers who prefer Islamic finance over conventional finance. There are two key reasons for a conventional entity to set-up an Islamic Window:

- (1) To keep the existing customers who are now opting to switch to Islamic finance; and
- (2) To attack new customers from existing banks including Islamic based on superior products and services extended by the conventional financial institution.

The primary rationale for any regulator to allow Islamic Window model is the cost efficiency and profitability in a sector where conventional banks are still enjoying better industry average ROE at 15% compared to 12% of Islamic banks. This is where the Islamic Windows can step-up and delivers.

While every Muslim dominated jurisdiction has witnessed Islamic banking and Islamic Windows, there is no uniformity of thinking on their operational model. This has even led one jurisdiction (Qatar) to disallow conventional banks to offer Islamic products and services through Islamic Window operations. This purpose of this paper is to put forward what could be possibly "a perfect model" of Islamic Window with pros and cons for the conventional banks to consider prior to their jumping into the bandwagon to set-up Islamic Window.

The concept of Islamic Window within a conventional bank goes back some 20 years; however, there is relatively little written on this concept and the fundamentals, which should be considered carefully by conventional institution. There is also absence of core guidelines issued by the State regulator on this subject matter. Perhaps the most advance and evolved model of Islamic Window is found in Malaysia where both lawmakers and regulators have proactively supported the Islamic banking and finance (IBF) industry. The Malaysian model has also evolved with time and has gone through changes over the years. While there are few variations of models for Islamic Windows operating in conventional financial institutions with sizes and focus as narrow as a few handful of resources and small segmental approach to a larger set-up with fuller coverage. There is no one model, which can be branded as the most

efficient and correct one. If one examines these Islamic Windows in domestic banks, one would realize that each has evolved based on the internal buy-in and even political maneuvering within the conventional bank which does not necessarily mean that they have opted for the perfect model.

When it comes to international banks seeking to tap into domestic markets, many have sought to capitalize on the demand for Shariah compliant products and the perceived vast pool of deposits, especially in the Middle East. Their commitment was not to advance Islamic finance but to try and take advantage of the situation. When the situation was not in their favor, they simply folded or minimized operations thereby adversely affecting the IBF industry.

### **What is the Shariah acceptability of Islamic Window?**

Generally, Shariah Scholars have approved Islamic Window subject to the bank complying with the guidelines set-up by the Shariah Scholars. Some Shariah Scholars have expressed their concerns with conventional banks operating Islamic Windows as their main mission statements omit any reference to supporting or advancing Islamic banking. Additionally, concerns arise about the income of conventional banks coming from “interest based” dealings or a common funding pool of “non-Halal” sources. However, most Shariah Scholars agree that any income source can be purified and cleansed and they subsequently directed to Shariah permissible channels through the Islamic Window.

So what are the generally accepted guidelines under which an Islamic Window can function? The following are some basic guidelines:

- Establish a working Shariah Supervisory Board (SSB) and strictly comply with its guidance.
- Shareholders, board of directors and the management of the bank to accept the concept.
- Shariah coordination, research and training across the bank.
- Develop Shariah focused policies and support infrastructure.
- Islamic banking code of ethics to be abided across the bank.
- Establish Shariah compliance and governance including review, audit and remedial policies.
- Develop products and services, which fully follow the Shariah guidelines.
- Transparency, disclosure, reporting and adapting standards

Experimentation by various regulators has led to two distinct formulas for setting up Islamic Windows.

- A. Independent Branches - The most evolved Islamic banking model requires fully independent Islamic branches to be separated from conventional operations. Wholesale banking products could be a combination of business originators or product specialists or both. This model is prominent in Malaysia and is gaining popularity in other jurisdictions.
- B. Centralized Divisions - The second model is where a centralized Shariah cum Islamic Business Division is set-up by the bank. It uses combination of delivery channels mixed with conventional distribution channels to sell Islamic products and services. Under this model, banks are not even forced to a separate auditable balance sheet or even segregating the Funding Center and booking the deals in conventional books directly.

There can be any minor changes in the above two models to differentiate between what the regulator will allow in any jurisdiction or what the customers will accept eventually. Obviously everything must be

ultimately approved the Shariah Supervisory Board (SSB). The key point of consideration is that whatever model is being adapted by the stakeholder or pushed by the regulators; the model must not compete internally with existing conventional franchise. The Islamic Window must be seen as supplementing the existing business of the conventional bank through servicing existing customers who may elect to choose Islamic banking and targeting new customers, without cannibalization.

### **Why should conventional banks be allowed to operate Islamic Windows?**

Should the regulator forbid conventional banks to compete with full-fledged Islamic banks? Perhaps the shareholders of fully-fledged Islamic banks will agree and claim that since they do not offer conventional products & services; similarly, conventional banks should not be allowed to offer Islamic products and services through their Islamic Window. This is a very narrow, naïve and negative approach. Competition is healthy and in long run weaker institutions are weaned out. Additionally, competition is good for the end users as it provides them a choice between different product providers. The pressures exerted due to positive competition from bank's Islamic Windows should prompt Islamic banks to exercise more diligence and care to introduce better quality products that have at par service standards, if not better. It is only competition by Islamic Windows that full-fledged Islamic bank have been forced to take a hard look at the inefficiencies in their operating structure and risk assessment models. Prior to full advent of Islamic Windows, the customers were at the mercy of fully-fledged Islamic banks in which there were little consideration of service standards, quality check, price efficiency, transparency, etc.

Recent studies by leading consultancy firms highlight the inherent weakness of the pure Islamic banks which suffer operational inefficiencies, lack of product and services diversification, poor quality, higher cost to income ratios, weaker risk assessment systems, concentration on few sectors, etc. In the wake of recent financial crises, Islamic banks were shielded due prohibition of partaking in highly speculative products such as derivatives and multiple securitization. Conversely, this limitation resulted in lack of diversity in asset classes (with major concentration on real estate industry), which has, arguably an effect on the growth Islamic banks. It can be postulated that without the involvement of conventional banks in IBF the industry would not have grown to the enviable size and attention it has attained today. A look into the Sukuk industry support for this theory. With international Sukuks it is notable that at times the majority (up to 70% or even higher) allocation has been taken by conventional banks. It goes to show that to support the argument that Islamic finance is not simply for only full-fledged Islamic banks. The challenge to becoming more efficient operator in a challenging circumstance could not have been taken that seriously by fully-fledged Islamic banks if there were no competition from the Islamic Windows of conventional bank.

### **Framework for a “Real” Islamic Window**

A fully functional and cost effective Islamic window requires following:

#### **1. *Strategy, Key Initiative and Objectives:***

Being an integral part of the conventional bank, the Islamic Window initiative should have a very clear strategy. There are only two possible strategies which the Islamic Window should adapt as all else are bound to create confusion, confrontation and ultimate failure. The stakeholders of the conventional bank should have the complete clarity on the strategy they are adapting when they set-up the Islamic Window as well. Rather than toying with one model versus another year-on-year, the focus should be based on the ultimate target. Is the purpose of starting the

Islamic Window to simply stop the existing customers shifting to fully-fledged Islamic bank or to build-up a model that can be converted into a standalone Islamic bank as and when the opportunity presents itself through regulatory changes or acquisition targets? Islamic Windows should not be set-up simply because of market trends or due to pressures of stakeholders as this initiative requires a concerted effort by everyone in the conventional bank not just the Islamic banking personnel to set-up the operations. Hence, when the stakeholders of the bank have decided to establish Islamic Window, the senior management across the bank needs to take the ownership to deliver the model successfully. This means that the approved strategy for the Islamic Window must be layered with key initiatives that should have its well-defined objectives, which should be ultimately modeled to target certain market share in the segments it would like to penetrate against measurable revenues/expenses expectations. The success of Islamic Window is in buying in of the initiative by the management of the conventional bank and each one of them taking ownership for its successful launch and continuing support. The objectives must be converted into measurable targets both qualitative and quantitative. Each target need to have well defined processes duly supported by all the functionalities under a service level agreements and turnaround time.

## **2. Head of Islamic Banking Window:**

Success of any initiative is based on the front-end leadership. The Islamic Window should have a leader who should be responsible for overall Islamic window initiative and who should be the focal point to drive the Islamic Window strategy and objective across the bank. Ideally, the person should have numbers of years of Islamic banking experience and above all should have the passion to do the right thing without sacrificing Shariah governance and compliance. The head of Islamic window should be the key spokesperson for the Islamic Window and should lead all Islamic initiatives within the bank directly reporting to the chief executive of the bank. In an ideal situation, the bank should embed Islamic business & enablers managers in areas such as retail, corporate, treasury, trade finance, investments, operations, audit, etc. who have dual reporting lines – one to the head of Islamic banking window and the other to the group head. The role of Islamic business manager is to assure that annual targets are assigned to team, reporting & monitoring of the performance and essentially liaison between the centralized Shariah governance unit and the product managers. The head of Islamic Window should have clear and measurable targets to their teams with cross selling across all business groups. Lastly, it is critical that the Head of Islamic Banking should directly report to the CEO of the bank and should be part of the executive committees. The Islamic Window should get the same respect and attention as other businesses within the bank. The critical success factors are the empowerment of the head of Islamic Window to have a strong voice in the executive committee, the acceptance of the business model by the other business heads and the dual matrix reporting structure for Islamic managers who are embedded in various areas of banking.

## **3. Shariah Supervisory Board:**

Fully functional SSB consisting of reputable and experience Islamic Shariah Scholars is an integral part of any Islamic financial intermediary including Islamic Window. There need to be a minimum 3 Shariah Scholars with one being the Chairman. The SSB Board should be independent and acts as a consultative advisory body, which will approve all product, services, issue Fatwas, approve financial statement of the Islamic Window, etc. It is preferred that at least one if not all of the Shariah Scholars are locally based and have executive authority provide

interim approvals on behalf of the SSB to be ratified by the SSB, so as to not to hold back any critical transaction. The SSB function is to support the Islamic window and Shariah guidance. An independent SSB generates greater popular request and customer acceptability. The role of SSB so far has been kept very limited where it has been seen that Islamic Financial Institutions (IFI) and Islamic Windows outsource this activities to few selected Shariah Advisory companies. While value these entities add is definitely positive but the whole concept is highly debatable as they operate on pure profitable basis as they usually charge a fee on a annual basis or a monthly retainer as well as at times on transaction-by-transaction basis. Whereas the concept of SSB being more advisory / consultative needs be on a pure non-executive and non-commercial advisory where the Shariah Scholars are engaged and generally should receive a token amount for their contribution. An independent SSB bring more respect to IFIs where one should consider using them beyond simply as a conduit for products and documents approval or for issuance of Shariah Fatwas. The SSB could be potentially and practically engaged in meetings with bank's personnel, direct customer interaction, visiting banks various premises to engage and review the Islamic banking activities, training and certification, etc.

#### **4. Secretary to SSB:**

This critical role requires a qualified person who will act as a liaison between the Islamic Window and the SSB. The basic role of the Secretary to the SSB is to organize the SSB meetings, prepare the agenda, take minutes, prepare Fatwas, rely SSB guidelines to the bank etc. The Secretary should be preferably a relatively young Shariah Scholar with some banking experience who can also perform other roles for the Islamic Window which include training and basic Islamic banking certification for the sales/relationship teams, visiting the various units/branches of the bank to guide them, reviewing Islamic structures and documentation, custodian for all Shariah related and all other standardized Islamic banking documentation, in-charge of Shariah compliance role across the bank, assisting the various units on any Shariah related issues of transactions, etc. There have been criticisms that most innovation in products and services in Islamic banking have failed when there has been a lack of understanding between the SSB and the bank itself. This creates bigger gaps between conventional and Islamic products and services, and does not bode well for the Islamic Window. The SSB usually interact with the Islamic Window's management through a Secretary to the SSB who needs to have direct access to the Board of Directors (BoD) of the bank so as to liaise, if required, between the SSB and the BoD.

#### **5. Shariah Governance, Compliance & Audit:**

The basic Islamic Window model hinges strongly upon the level of Shariah governance, Shariah compliance and Shariah audit. Once the Islamic Window establishes the SSB with a clear charter, contractual arrangement and ultimate authority, Shariah governance, compliance and audit functions need to be established. As most of the time, the SSB may not be easily accessible or even not based on the same physical location / jurisdiction; the Secretary to SSB should also double-up and head the Shariah governance & compliance unit. The approvals on products and services by way of minutes of the meetings or issuance of Fatwas must be carefully implemented by the product or task manager within the Islamic Window regardless of wherever they are embedded or not. To overlook and assure proper implementation of the Shariah approvals and the Fatwa, Shariah Compliance and Shariah Audit play a critical role. Non-compliant and in the worst-case scenario, the resultant income derived from the non-compliant

activity will have to be given away to charity. Shariah compliance and Shariah audit are two independent functions. Shariah Compliance related to independent spot-checking of business, operations, staff's familiarity of Shariah requirements on different products and services processes, etc. Shariah compliance is the control structure necessary to assure that nothing slips between audits, which may be more time related and cyclical. Shariah compliance role is to assure that while the products and services, as well underlying documents, are approved by SSB, there should be not be any Shariah repugnant activities and businesses included in the Islamic banking fabric by share ignorance, the chance of which is greater in a Islamic Window operating than a standalone Islamic Bank. Shariah audit needs to reflect in light of the standards issued by AAOIFI and IFBS. Ideally, the Islamic Window should establish an independent Shariah audit red flags manual and train the existing internal audit department of the bank. Any Shariah related matters and red flags should be raised to Shariah auditor who should be able to seek a solution or action planning as deemed fit and can further escalate the matter to Shariah governance unit.

#### **6. *Human Resource Planning & Training:***

The most critical resource in Islamic finance today is the human capital. While it is difficult to find experienced Islamic bankers for various functionalities, there are basic Islamic banking courses available, which provide certifications and have been approved by the various Shariah Scholars around the world. It is, however, critical that key Islamic Window staff must have relevant Islamic banking experience. Based on the strategy adopted by the stakeholders of the bank, regardless of howsoever the Islamic Window model is set-up; the bank needs to impart basic Islamic Banking training to its existing enabler groups as well as business groups and administrator groups who will be the touch points for Islamic products and services. As the Islamic Window is not a fully-fledged standalone operation and will depend on the conventional banking personnel to assist in successfully delivery of the Islamic products and services with similar service quality and turnaround time. Developing in-house training modules, which consist of basic training on Islamic banking, related Shariah topics and specific product training would be necessary. The basic training on Islamic principles and contracts should be ideally set-up on e-learning platform and must be mandatory for everyone in the bank including all personnel whether business, enabler or administrator group across the bank without limitation. The specialized and focused product and services training courses should be targeted to the sales, operational, accounting, risk, technology teams who are responsible to sell, assess, process, manage and monitor the respective product and/or services. Additionally, each area of specialization need to make sure that their staff are specifically trained for competently delivering the outcome required from them, for example, product manager for liabilities in retail should know how Murabaha, Murabaha and Wakala structures works and how Profit Management System, Profit Equalization Reserves, etc. need to function with or without automated systems.

#### **7. *Products & Services:***

An ideal Islamic Window should have the capability to replicate all existing conventional products & services (subject to SSB approval) into the Islamic framework from retail to wholesale banking. Product managers on the conventional banking should work hand-in-hand with the Islamic structuring team to create the Islamic products and services. Otherwise, the Islamic Window should hire a core product development team to make all Islamic products &

services available to the bank. The key here is to make sure that while Islamic structures typically makes Islamic documentation slightly lengthier and cumbersome, the process, the delivery channel and serviceability should match the conventional products and services. It should be also possible to buy product off the shelf and adapt them to existing standards of the bank in those markets where Islamic banking is more developed than others. Needless to add that while adapting to offer Islamic product & services whether through a fully-fledged Islamic bank or through an Islamic window, the concept of risk remains the same. However, the way practice is prevailing globally, risk does not change between the conventional funding and Islamic Window funding. There are only structural differences and some product variation between the two types of institutions. The point being, Islamic Windows also operate under the same risk policy of the conventional bank with very few adjustments. While putting together Islamic products and services for customers, banks should remember that their best customers are their own employees and all Islamic products and services should also be made available to them at the same preferential rates and basis as it does on the conventional front.

#### **8. *Product Development:***

Islamic Product Development requires a team effort between the product development units, Shariah, legal, compliance, marketing, branding, accounting, auditing, risk management, processing, operations, technology and the business. The combination of the task force or team is determined by the product manager who may also include third party vendor. In an organized institution, product development itself is a disciplined approach that is systematic and the methodology is captured in a product development manual. The principle that Islamic window needs to follow is that all Islamic products & services are governed under the same risk guidelines as conventional products, follows same if not similar processing channels, has same level of quality, similar presale and post sales servicing in addition to price / cost to be the same if not better. In other words, Islamic products & services, despite being document heavy, should be fully aligned to its conventional counterpart. Each Islamic product should follow the same flow as that of conventional product and if such conventional product is parameterized under a product program then Islamic product should be identical with relevant Shariah compliant factors build-in. It is preferable to have a common product program, which clearly segregates the process or methodology for both while maintaining the common factors. Whatever the product & services offering may be, it is should be technology enabled for both retail and wholesale banking customers with viewing, transferring, investing, etc. Today, product and services should be technology enabled and everything should move to online, mobile, smart phone, etc. These should be secured with double back-up security firewalls.

#### **9. *Enabler / Back Office Support:***

The key strength of being part of a conventional bank where all back office functions are all standardized and manualized, is that the Islamic Window can adopt these functions seamlessly. If not correctly mapped, aligned, managed, transitioned and implemented with right maker – checker system, then it may cause issues with products performance and tarnish the reputation of the Islamic Window if confronted with frequent customer complaints. While the product manager creates Islamic concept papers, put together structuring guidelines, obtains product approval, develops legal documentation, working process mapping/charting and training; it is the bank's operations which will write the Standard Operating Procedures (SOP) for the Islamic Window. The financial affairs or accounting units of the bank, who will codify the entries, create

general and product specific ledgers as advised by the product managers including permissions and prohibitions under different Islamic structures consideration under different Islamic structures used to put together the product or service. Ultimately, everything boils down to the IT system that needs to be flexible to absorb the changes required to run Islamic products and services without reinvesting a new system. There are independent standalone Islamic banking software available in the market but the question remains “can the existing core-banking system interact with any new system or module”? This requires a much thought out framework and will at times need new procedures to ensure that Islamic transactions are properly processed. Additionally, new Islamic system may not be the most economical way for the Islamic Window model. Hence, back office activities includes very complex, interlinked and interdependent set of activities from one unit to another and Islamic products & services needs to follow the suit of the conventional alternative in terms of perfect alignment so as to have same turnaround time, delivery mechanism, service quality both pre and post sales. Every aspect of the enabler roles and function will need to be checked for acceptability under Shariah compliance mechanism. As highlighted above, basic Islamic banking training across the board will assist the bank in rolling out a balanced Islamic products and services.

#### **10. Comingling of fund:**

What differentiates between a true Shariah Complaint Islamic Window and a “dressed-up” Islamic Window is the comingling of funds. Due to lack of expertise, most conventional banks start their Islamic windows by offering Shariah Compliant products and services, which are not truly segregated within the balance sheet and income statement of the conventional bank. As the concept of Islamic Window is catching on and more conventional banks are opting to take this route, SSBs as well as regulators are making some mandatory actions that include segregation of customer accounts between Islamic and conventional. Moreover, SSBs require that Islamic Window is treated as a virtual bank within bank which should have a separate, audited balance sheet, income statement where each and every asset, income, revenue, expense as well as provisions need to be captured. In other words, for an effective Islamic Window, there should be no comingling of Islamic funds with conventional funds. This requires much work including setting up different general ledgers where Islamic transactions are booked end-to-end, careful assessment of existing core banking capabilities and developing an IT infrastructure which captures and keep the segregation between the conventional and Islamic accounts, printing of different or common stationery, etc. The prohibition of comingling of funds also means establishing an Islamic funding center within the main funding center of the bank that looks at interbank liquidity management and deposit mobilization tools for effective asset and liability management.

#### **11. Cost Allocation Mechanism**

The bank needs to know the profitability of every product so as to decide what type marketing strategy whether “push” or “pull” will need to be deployed. All financial institutions have well defined costing methodology to basically split the cost associated with running any product or services. The ability to break-up the cost of delivering and servicing a product and service plays a more so critical role in Islamic Window depending upon the various functionalities within its conventional arm for effective delivery. The idea being that there should not be any difference between how a conventional institution allocates costs of its conventional product or service to its various functionalities as compared to Islamic. Additionally, in case the Islamic Window it is



using the same channels for distributing its Islamic products and services as that of conventional, one should be able to assess the incremental revenues generated by Islamic Window without matching incremental expenses. The idea is to scale-up productivity without scaling up same level of direct costs associated with selling. A robust cost allocation methodology tied with specific service level agreement with turnaround time will only have better operational efficiencies and enhance customer service. Fully-fledged Islamic banks are known to have higher operational cost which emanates from having no or lose control on cost allocation model which is one major benefit Islamic Windows can have over the Islamic banks.

## **12. Cost of Funds and Transfer Pricing**

The Islamic Window needs to develop various types of fund raising instruments from retail to corporate and bank-to-bank deposits schemes from overnight to longer maturities at market driven rates. While current accounts and saving accounts (CASA) are least costly, these are also least predictable. Historical analysis shows that there is a systematic risk of reduction in CASA levels when other investment opportunities are made available to depositors. Additionally, Islamic banks have always competed with conventional banks operating in the same economy for deposits hence rate sensitivity is always present. Cost of funding needs to be kept well checked if the Islamic Window has created a mismatch between the duration of assets with liabilities. Usually, assets are not easily re-priced and this could affect the bottom line drastically in case the liability re-price more frequently due to market pressures. There should be a disciplined way to transfer funding cost to asset acquisition through transfer pricing mechanism that takes into account liquidity premium and risk premium. Having an efficient transfer pricing mechanism means that the funding center that handles conventional funding should also be responsible for Islamic fund and should keep checks and control on overall cost of funding of the Islamic Window.

## **13. Deposit Mobilization**

Islamic Windows usually don't have any capital. Most of the SSBs across the Islamic world prefers the any Islamic lending to be funded by Islamic liabilities / capital. Segregation of Islamic books with the conventional books across assets, liabilities, revenues, expenses, etc., means that Islamic Window should also have its own distinct deposit mobilization strategy. For retail segment, Islamic Window have variety of instruments from current account, savings account, fixed deposits, etc. based on Qard Hasan, Mudaraba, non-discretionary Wakala, etc. where it can attract liquidity from the market. From corporate segment it can raise time deposits through commodity Murabaha or non-discretionary Wakala. To plug the liquidity gaps, Islamic Windows need to have their service level agreement with the conventional bank's treasury and funding center so that they can line-up from overnight to near term liquidity on Islamic contracts from other funding sources. If there was one most critical success factor for an Islamic Window then it is the ability to mobilize deposits to funds the Islamic assets. The emphasis being to maintain a healthy asset to deposit ratio (AD ratio) of less than 100% at all times. There are no correct mixes of what level of retail, corporate and near term liability should be maintained or what should be the mix of current account and non-current account deposit ratios. These things vary from one jurisdiction to another and on saving habits of the consumers. This directly links with asset liability management and duration mismatch, and should be a key consideration for the asset liability committee of the conventional bank, who should also be responsible for the Islamic Window.

#### **14. Accounting & Financial Reporting:**

Shariah requirements vary from one window to another. Common management reports are kept segregated for Shariah purposes yet consolidated from filing and reporting perspective. In case the SSB has been able to enforce strict compliance with its Fatwas then Islamic Window may be required to prepare a separate audited financial statement, which can be consolidated at the conventional bank level for regulatory reporting purposes. This is easier said than done and means that the bank creates separate accounting ledgers at all levels and is able to segregate the customers' conventional accounts and Islamic accounts while keeping one common customer identification system for those customers who use both type of banking channels. This also means that the all Islamic assets and liabilities are accounted separately including all revenues and expenses. One must remember that each Islamic transaction mode has different requirements in terms of processing and booking. Additionally, the Islamic saving schemes are usually under Mudaraba structure, which essentially requires Profit Management System ("PMS") and creation of Profit Equalization Reserves ("PER"). PMS essentially assist the Islamic Windows to pool its saving and time deposits mobilized under Mudaraba structure. It requires periodic closure of books, which can be done on a quarterly or even monthly basis where all funds deposited in these types of accounts and the underlying investments made through deployment of these funds with income being produced from them, is declared and distributed to the depositors. Islamic banks create PER to create a reserve for equalizing any shortfall in profit in the future periods. Charity process and accounting is also one common aspect in Islamic banking which conventional banks are alien to. This definitely requires keeping the accounting record segregated including customer reporting as the regulator will most definitely require this to be the primary requirement. There is also a need to develop accounting codes and processes based on the various types of Islamic structures bank uses for its products. For example, ready to live-in home financing for end user is different compared to under development home. Similarly, while the home financing under Ijara can be easily booked as "term loan"; the delay payment, payment of insurance, major maintenance, etc. are treated differently under Shariah as compared to say the home mortgage product under conventional banking.

#### **15. Branding & Premises:**

The Islamic Window needs to make sure that the level of service quality is either at par or better than existing conventional bank to really make the difference. While branding, marketing and aesthetically pleasing premises may bring the customers in for the first time, poor level of service quality will not give any repeat business. One needs to develop a two-pronged approach to these critical elements while maintaining a good balance between effectiveness and efficiency paradigm. One does not need to go on a spending spree with roadside flags, billboards, banners, newspaper clips, radio & television converge etc. Remember the new brand representing the Islamic Window will also carry the legacy of its parent whether good or bad. One needs to use the strength of the parent brand to make its branding and marketing campaign a success. Again, SSB tend to allow dual branding of a product. Depending on the regulatory framework, dual branding can be a huge success and very cost effective. Hence, the recommendation that one should leverage the loyalty attached to its parent's brand and use synergy to enhance the Islamic offering.

## **16. Marketing an Islamic Window:**

As an Islamic window, the key challenge faced by the bank is how to facilitate the internal acceptance of the initiative while stopping the leakage and capturing the market share. The addition of an Islamic window by a bank in its system definitely does not allow the bank to increase its per party exposure allowed by its regulator, it certainly introduces complexities in terms of internal processes, risk allocation, product acceptance, etc. Generally, most Islamic windows fail for two reasons (a) they set-up their own dedicated sales and relationship teams to marketing Islamic products & services eventually competing with the bigger bank hence the conflict and/or (b) where the banks decides to use the existing conventional sales and relationship teams to sell Islamic products & services who do not take this initiative seriously at all. Both strategies are incorrect. The better model is when Islamic window uses a combination of dedicated experts and existing sales & relationship teams to penetrate this segment. The Islamic Window should be used as a “product specialist” where customers are sophisticated and have existing long-term relationship working side-by-side with conventional bank’s relationship teams. Otherwise they should have “originators” or “hunters” where the target is to get new-to-bank customers.

## **17. Hunters & Harvesters:**

With the dual reporting matrix in place, targets and budgets jointly made between the Head of Islamic Banking and different business head, the real test of the model will be in its execution. At retail level, training needs to be imparted to the retail team through a system where they need to understand the differentiating factors between the conventional and Islamic products. The key to this training is to make sure that the sales team understands and accepts the Islamic product wholeheartedly despite change in the structure principally due to the fact that pricing of both Islamic and conventional is the same, service standard are the same even with slightly lengthy documentation process. A preferred retail model should have totally segregated Islamic branches where no conventional products and services are offered. This means dedicated Islamic branches to sell products and services of Islamic Window. It may be a costly affair but will create better market perception and customer loyalty. At wholesale banking level, hunter team is more prevalent; however, existing conventional relationship managers and units may show their reservation. The main reason for this is the fact that most conservative Islamic customers would prefer to bank with fully-fledge Islamic bank rather than an Islamic Window unless they have become disenchanted with the fully-fledged Islamic bank for some reason and are looking alternatives. It has been seen that at wholesale banking level, customers are neutral and whosoever is able to get to the customer first and convince them to take Islamic products first will win the account. A small hunter team needs to be embedded within units such at SME or Commercial Banking whose purpose is to originate new Islamic customers to be booked by the bank’s existing relationship managers who should have Islamic targets in their key performance indicator (KPI) and management by objectives (MBO). For large ticket customers including corporate, financial institutions and sovereign entities, a team of specialist Islamic banking professional also need to be available as product specialist within the Islamic Window or embedded with the business group based on the level of sophistication and segregation by business type within the conventional bank.

### **18. Retail Offering:**

Islamic retail offering can take any shape based on the interpretation of the SSB. While every jurisdiction where Islamic finance is practiced has carefully evaluated the pros and cons of what Islamic Windows should or shouldn't be allowed to market, there are no one perfect way. Learning from the example of few jurisdictions where IBF has taken roots, it is evident that the ultimate choice for retail offering is to have independent Islamic retail branches, which have no linkage with conventional branches other than perhaps common reporting lines. Offering conventional and Islamic products and services from the same platform had mixed record. In long run, it dilutes the Islamic offerings. Also, sales personnel may not be familiar with Islamic products, hindering their sales strategy. The view of SSB and the regulator become a key differentiating factor and these two must play a critical role in framing the guidelines of how a conventional bank should offer Islamic products through its branches. The orthodox view of few reputable Shariah Scholars has been to avoid mixing the conventional branches with Islamic. Whereas the moderate view is that so long as proper training has been imparted to conventional sales team with clear targets and a discipline of offering to "sell Islamic first", one can use its conventional branches to selling Islamic retail products. In the end, the bottom line is the impression of the customers on purity and acceptability of the offering.

### **19. Wholesale Offering:**

The Islamic Window will also need a structured finance team to with clients in treasury, debt capital market, Syndication, financial institutions, etc. This is required especially when any of the existing clients of the banks opt to prefer Islamic solution. Unless the existing bank has this expertise and product range, the bank stands to lose its customer to fully-fledged Islamic banks or competing Islamic Windows. Thus, Islamic Window should start with a dedicated team of originators, hunters and harvesters. With increasing interest in product suits by the wholesale customer, it is ideal to embed Islamic experts in key functionalities such as treasury, financial institution, syndication, debt capital market, etc. However, a core team needs to be within the Islamic Window to support everything else that requires attention i.e., product experts in structured finance.

### **20. Front End Cross Functional Support:**

To have an improved cost to income model, the Islamic Window will need to cut across all front end business groups and should have experienced people either embedded within who report to the Head of Islamic Window; else basic Islamic training needs to be provided to the front end business personnel and relationship managers who can identify any opportunity to bring in the Islamic experts as required. This will only work when Islamic targets are agreed with to all business groups and are disseminated to every relationship and sales team member. The success of the Islamic Window will depend purely on the acceptability of the Islamic initiative by the front-end function of the conventional bank and how they adapt the Islamic banking themselves. More often it is seen that the success or failure of Islamic Window is based on how the business groups in the conventional bank treat Islamic Initiative itself. If it is perceived to be competing with existing conventional bank then it is bound to fall flat merely because conventional practice has been a established line of business with customer base, performance track record and resources whereas Islamic Window will be very new with teething issues. The only way Islamic Window is bound to succeed in any environment is when the entire bank

wholeheartedly accept this as (1) added value tool (2) an alternate channel to deliver products & services (3) a mechanism to retain existing customer and (4) attract new customers who prefer Islamic finance. It must be emphasized again that while Islamic Window resources can and must be embedded into various business, administrator and enabler groups, there should be a central figurehead with a core team that has full responsibility to deliver the initiative for the bank.

### **21. Account Planning:**

For lean management of the Islamic Window, account planning at every level of the conventional bank for Islamic targets and aspiration is mandatory exercise where the conventional team plus Islamic Hunters embedded in various business segments evaluate each customer. The basic concept of account planning is to look at possible ways of increasing and/or decreasing the exposure with the customer in all areas with funded, unfunded as well as other ancillary business based on the risk rating, appetite and limit exposures. The Islamic Window should be able to define the possibility of selling more Islamic products and services to existing customers and identify new segments for further penetration. It has been commonly assumed that Islamic Windows have suffered because customers prefer conventional financial services. However, if the option is not present at the bank, then this makes it difficult to determine whether this assumption is correct. Additionally, if the existing customers are availing Islamic facilities from other institutions, the Islamic Window needs to formulate a strategy to target this segment.

### **22. Technology & System:**

Having a right IT platform, Shariah based Islamic banking architecture and experienced Islamic banking IT team is another critical success factor. The challenge is to create a parallel banking platform, which seamlessly interfaces, with the existing system of the conventional bank while maintaining a Chinese wall between the Islamic and conventional accounts. This includes creating the Islamic business objectives universe, general ledgers, accounting codes for overall Islamic business segments, products and services accounting codes and booking methodology, product profitability measurements, account maintenance, etc. and how all of this is reflected in the system and produced in the management reports and financial statements. The purpose of this is to make sure that Islamic funds, assets, liabilities and expenses are not comingled with the conventional books and could be separately audited by external auditors, to be approved by the SSB and could also be presented to the regulatory examiner. One way of developing Shariah compliant system is to work with existing legacy system and the core-banking platform, which the conventional bank has, and to modify this, which requires more time and resources. The other option is to look at a latch-on Islamic system that can be fully integrated with the existing core banking system. A customer interface is the on-line banking whether at retail or corporate banking level. A user friendly on-line banking system has become an essential tool for any banking institutions and this is also valid for the Islamic Window model. On-line banking system should allow customer to enquire, transact, instruct and get reports of their activities at all levels in additional cash management solutions for corporate customers. The better approach is to have the ability to segregate customer-by-customer levels into two – conventional and Islamic with both reporting separate statements yet being reflected with the account manager for customer profitability report. The idea being that all hard income from Islamic business

should be booked in one consolidated book with shadow reflection to the relationship manager so that their performance can be measured against targets.

### **23. Credit Policies, Risk Management & Legal:**

There is no difference in credit risk between Islamic banks and conventional banks, at least in practice. The key differentiation is in structuring of Islamic transaction. Structuring is added layer of Islamic mode of financing using either the pass through or pay through structure bifurcating the transaction as assets backed or asset based which at times is also commonly referred as Shariah back or Shariah compliant. So long as the current practice continues, the Islamic Window also need to adopt a best practice from its parent conventional bank to assure that all its structures fall into the same credit risk policy whether retail or wholesale and are also approved by risk management. With this in mind, standardization need to set-in when it comes to retail, treasury, SME and commercial banking practice where all documentation including but not limited to common terms agreements, application forms, master agreements for the Islamic modes and the respective operational supplements agreements, Agency Agreements, etc. need to be standardized with. Structured finance and complex deals including capital market issuances, club deals and syndications will always require third party legal assistance for banks as well as the customer. Another key and critical success factor is risk allocation for Islamic transactions. Unless, Islamic business originators/hunters are not embedded within the business segment there will always be infighting for risk allocation for common customer. The Islamic Window should not experiment by setting up independent Islamic business originators outside the business segment. As explained above, all conventional relationship managers especially in the wholesale banking should also have Islamic financial targets based on the overall aspiration of the bank and/or Islamic banking growth forecast by industry experts.

### **24. Regulatory Relations:**

In jurisdictions where there are no regulatory oversight or guidance, it becomes quite critical that conventional bank establishes a hands-on relationship with its regulator. The head of the Islamic Window, who is experienced in setting up such initiatives in the past, is the key as there will be multiple issues, which one needs the regulator to comprehend and support positively. It has been discussed in the previous sections that Islamic Window can take any shape and for most conventional players; however, it will be better if it is kept as a core product team where business is booked by trained and certified personnel in the conventional side under the Islamic book. As most of the time, in newer jurisdiction the regulators as well as the financial institutions both have limited experience and learning curve may be limited. Hence, the expertise with team in conventional bank setting up Islamic Window plays a critical party.

### **25. Transparency and Disclosure:**

To gain market confidence, the Islamic Window must be more transparent and have better disclosure policy as compared to the main stream Islamic banks. In this regards, customer education is one of the key tools and there is nothing better than clearly documented products and services with detail yet simplified features explained in the website of the Islamic Window. This also includes publishing the Shariah Fatwas in dual language (local language plus English or Arabic), which is duly signed by the SSB. It should disclose what the transaction is; what are the underlying documents; and when it was reviewed; discussed and approved. It is better if the

Islamic Window adapts a standard format so as to create ease of understanding by the users. In addition to Fatwas, it is always helpful to list glossary of terms the Islamic Window uses as well as the FAQs for each and every product no matter how simple they may be.

## **Concluding Remarks**

Islamic Windows have become an acceptable mode for accessing or placing Islamic funds by customers, SSB and regulators. However, this article should have demonstrated the complexities of setting up, managing and operating an Islamic Window in a conventional bank. In all probability, an Islamic Window has more competition internally than from external forces. Staff in conventional banks are used to their systematic way of processing, documenting and booking deals. To teach a new way of transacting is not always a task everyone accepts wholeheartedly. However, once they see the value proposition and understand that Islamic Window is there to not only retain their existing customers who may be opting for Islamic products and solutions but also to add new customer as well as an effective cross selling tool, they adopt and push it across all segment. If a conventional banks adopt a right model as discussed above, it should stop attrition and enjoy the better growth prospects which fully-fledged Islamic banks do.

### **About the Author:**

*Moinuddin Malim is an experienced Islamic banking professional with more than 25 years of experience that ranges across various functionalities and specialization. From setting up an award winning Islamic Window to receiving numerous local, regional as well as international awards for innovative Sukuks, Islamic Investment Fund, Project Finance and Structured Finance deals that ranked the institution top of lead tables, Moin has also being also recognized as one of the six most influential leaders who is influencing the Islamic banking in the region. He has been a Board Member of various key initiatives including International Islamic Financial Markets, National Bonds Corporation and Mashreq Al Islami. Moin was the first elected Chairman of Islamic Banking Committee that consisted of all Islamic banking and Islamic windows in the UAE. He submitted a researched proposal to set-up a Shariah Governance & Compliance Unit within the Central Bank of UAE in addition to maintaining a direct dialogue with it on various matters pertaining to growth and standardization of UAE's Islamic and finance sector. Moin's contribution toward Islamic finance has been also well documented in his published work from detailed researched chapters published in Euromoney publication to pinching topic that touch the core of Islamic banking and finance in Islamic Finance News. He has been part of the Islamic thought leadership and an active speaker, moderator and panelist is Islamic banking and finance conference around the world.*

*Moin has now set-up a boutique Islamic Advisory Partnership with leading Islamic banking, finance and takaful partners under the name of "Alternative International Management Services where the team is assisting variety of clientele from advisory on their Islamic initiatives, to Sukuks, Structured Finance, Shariah Governance, Shariah Audit, Training, etc. Moin can be reached on his email [moin.malim@aims-qcc.com](mailto:moin.malim@aims-qcc.com).*