From Windows to Subsidiaries for Islamic Banking

Bank Negara Malaysia has issued more than 6 Islamic banking licenses to local and foreign banks since 2002 with about half awarded to the Islamic bank subsidiaries (IS) of conventional banks. To date 6 domestic banking groups have been approved to establish Islamic banking subsidiaries of which three have started operations. These are RHB Islamic bank, Hong Leong Islamic bank and CIMB-Tijari Islamic bank. Potential line-ups from Maybank, Public Bank, Affin Bank, Ambank and EON Bank group will make the competition even better. However, transformation of Islamic banking windows into Islamic banking subsidiaries, is not made mandatory by Bank Negara Malaysia.

Islamic banking subsidiaries shall come under the governance of the Islamic Banking Act 1983 instead of BAFIA 1992. It should remove most of the impediments that prevents Islamic windows to participate in non-traditional banking business such as wholesale and retail trading, purchase of assets and landed properties as well as purchases of equities via joint-venture and portfolio investments.

The rationalization for Islamic bank subsidiaries is mainly driven by Shariah requirement for greater compliance. For one thing, running interest-bearing and Islamic banking business under one roof may invite ambiguities (*gharar*) concerning the legitimacy of profits generated from the business. Some examples are given below:

- **Start-up capital**: As of 2004, total capitalization of Islamic banking divisions amounted to RM3.88 billion with Public Bank standing highest at RM1.09 billion and Maybank coming second at RM0.94 billion. Funded mainly by the interest-bearing mother bank, the capital injection remains an eye-sore to many people in view of the Islamic label it carries.

- **Management of reserves**: The conventional treasury department usually handles money-market operations. To secure income, daily surplus from Islamic banking division (IBD) is normally passed on to the treasury for overnight transactions. Sometimes, the treasury may not have enough surplus from Islamic reserves to cover its position. Instead it uses proceeds from the sale of conventional papers to meet their Islamic deposit obligations at maturity. Mixing reserves from both sides seems inevitable under the Islamic window system. The Islamic banking subsidiaries will have their own respective independent treasuries.

- **Financial reporting**: To take on Islamic banking another level, standardization of Islamic banking reporting can only be made with a critical mass of full-fledged Islamic banking companies. In this way, issues concerning capital adequacy with equity deposits and full disclosure of Islamic investment can be sought with more consistency. Setting up more Islamic bank subsidiaries should help achieve this goal.

- **Global trend**: Middle-East Islamic banks are predominantly "stand alone" banks (i.e. they are not attached to the interest-bearing mother banks). The same applies to Islamic banks in Pakistan, Indonesia and the Sudan. With Malaysia joining the club, performance of Islamic banks in Malaysia can be assessed on both purity and efficiency criteria. The former is a crucial factor to attract Islamic funds into Malaysian Islamic banks. The funds can come in to increase bank's capitalization as well deposits. In the pursuance of financial liberalization policy, all Islamic banking subsidiaries are open up to 49% foreign ownership.

With the reasons outlined above, the establishment of Islamic banking subsidiaries shall prove fruitful to all parties concerned. It allows an Islamic bank to offer alternative modes of financing as well as niche transactions peculiar to Islamic banks alone.

For example, an Islamic bank can enter into a true leasing business contract or conduct a joint-venture project or acquire land and properties – all under one roof. It should be able to underwrite Islamic bonds and stocks in addition to providing fee-based business such as brokerage and unit trusts. Unlike BAFIA 1989, the Islamic banking Act 1983 practically allows Islamic banks in Malaysia to adopt the universal banking model.

The Islamic windows system operates on the assumption that Islamic banking division (IBD) is in charge of product development alone. For example, a new product for entrepreneurial financing may require the bank to adopt the contract of *istisna'* (sale by order). The IBD personnel are expected to come up with this idea as it is part of their job to suggest new products. It shall consult the Shariah Committee for comments before taking it up to Bank Negara for final approval. In some cases, Shariah compliant status is obtained in-house without resorting to Bank Negara Shariah Supervisory Board.

Next is marketing and promotion over which the IBD has no direct control. The conventional marketing department usually handles promotion via the bank's branches throughout the country, with a bank personnel dealing with Islamic banking being stationed to oversee day to day operations. In general, the IBD has no marketing arm. Marketing at the branch level is undertaken by the conventional branch manager who reports to the conventional marketing department at the bank's headquarters. The branch manager is responsible to see that targeted monthly deposits and financing are dutifully met.

But how the targets are secured for Islamic products is unclear. For example, a customer may want to open a fixed deposit account or apply for a mortgage facility. Should the bank officer in charge recommend this customer a conventional or an Islamic product?

There are no straight answers to the above. Usually, the customer seeking home financing may ask which one is cheaper. With adequate information, one can choose what is best that suits one's tastes and values. But most customers are in the dark about the Islamic option. It is therefore critical at this juncture to see that bank at the branch level has adequate people to help customers understand more about the Islamic alternative available to them.

But this is always not the case. Training of bank officers at the branch level has been a stingy affair as most who attended Islamic banking seminars and conferences are officers serving the Islamic banking divisions (IBD). In fact, there is practically no specialized bank officer at the branch level who is solely stationed to entertain prospective customers interested in Islamic products.

By setting up an Islamic subsidiary, promotion of Islamic products can be conducted with more rigour since bank officers at the branch level should knew well enough the salient features of Islamic banking products and what is expected of them in the Islamic banking business. This would include knowledge about the contracts on which the product is built, legal documentations as well as implications over default and early settlement.

Finally, one may wonder whether the new subsidiary system will improve the bottomline. Although by setting up the subsidiaries some Shariah issues are now settled, there are more challenges ahead, namely:

- Under the window system, the conventional bank absorbs most of the costly overheads such as computer and security systems. In this way, profits for Islamic windows are usually overstated. But now the subsidiary bank must bear these overheads, which it does not carry otherwise. The relatively higher overheads may diminish profits and render the subsidiary a liability instead.

- Marketing network is now smaller since existing conventional branches can no longer offer Islamic products. This may adversely affect the growth of Islamic deposits and financing instantly.

But all is not lost. Islamic banking subsidiaries can reduce overheads by outsourcing some of the operations such as computer solutions. Cross-selling is also an effective mechanism, but this must acquire Shariah compliant status in so far as the sharing of premises and other logistics is concerned.

Most importantly, it must offer multiple products under one roof. By adopting the universal banking model, the Islamic banking subsidiary is set to offer non-traditional banking products such as *ijarah* (leasing), *salam* and *istisna'* (sale by order), *mudarabah* (partnership of skill and capital) and *musyarakah* (joint-venture). These products will prove potent for entrepreneurial development as they (i.e. products) are relatively collateral-free. By carrying an equity flavour and risk-sharing values, Islamic banking subsidiary can play a significant role in developing new entrepreneurial-friendly product not readily found in conventional banking.

Private sector growth is crucial for economic growth. Entrepreneurs constitute the backbone of innovation and real productive growth. In the absence of money-lending environment they (i.e. entrepreneurs) should stand a chance to flourish and perform even better under the new Islamic subsidiary system.

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