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Conversion of conventional bank into an Islamic bank: risks and challenges

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CONVERSION OF CONVENTIONAL BANK INTO AN ISLAMIC BANK: RISKS AND CHALLENGES

This Research Project is submitted to the Department of Finance as partial fulfillment of Master of Science in Islamic Banking & Finance degree

by

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Abstract

Conversion of Conventional Bank into an Islamic Bank is a widely discussed topic in the world of Islamic Banking and Finance as none of the conversion on a larger scale has taken place except for the conversion of Faysal Bank Limited in Pakistan, which is a largest conversion taking place. This paper discusses different challenges which are associated with the Conversion process and qualitative approach has been used to assess those challenges. Interviews of the management of Faysal Bank Limited have been taken and literature has been reviewed to assess and discuss those challenges in this study. The findings show that there are multiple challenges associated with the conversion process including but not limited to Human resource, Reputational, Financial constraints, and operational challenges. Then the different Islamic products which have been offered to the Customers as an alternative to the conventional products, been briefly discussed.

Keywords: Conversion, Risks, Challenges, Faysal Bank

Chapter 1

Introduction

1.1 Background

During the last decade, we have seen the immense growth in the Islamic Banking around the globe. Muslims as well as non-Muslims are preferring the Islamic Banking over the traditional conventional banking. If we take the example of Pakistan, where there are 5 full fledge Islamic Banks and almost every conventional bank has its Islamic Banking subsidiary or window. Growth rate of Islamic banking in Pakistan is in double digits and its market share has been reached to 15.5%. Same is the case in other parts of the world especially in Muslim countries where people are now preferring Islamic Banks over Conventional Banks. Many conventional Banks are changing their operations into Islamic Banking, one of such case is in Pakistan where Faysal Bank Ltd is converting its operations into Islamic banking and by the time I are writing this report, more than half of its operations are being converted into Sharia-compliant mode.

There are many motives which are driving conventional banks to convert their operations from conventional to Islamic. These motives can be broadly categorized into following categories:

1. Customers need for Islamic Products
2. Performance of Islamic Banks
3. Financial Crisis of 2008
4. Sustainability of Islamic Banks

Above-mentioned motives or factors have played an important role in tempting conventional banks to convert their operations into Islamic Banking and we have seen the growth of Islamic Banking and Finance globally, especially after the financial crisis of 2008. As per IMF survey in 2010, it was reported that during the crisis of 2008, Islamic Banks on average showed more resilience than conventional Banks, but also incurred more losses than the Conventional peers when crisis hit the real economy.

AAOIFI has issued guidelines for the conversion process to make it in accordance with Sharia and to standardize the procedure and these guidelines act as a helping tool for the regulatory authorities and banks for the effective conversion of their operations. AAOIFI standard discusses in detail the Sharia requirements for the conventional bank to convert its operations into Sharia complaint. State Bank of Pakistan has also issued guidelines for the conversion process of

Conventional Bank into Islamic Bank and these guidelines must be followed to effectively carry on the conversion process. But there is still a need for a more comprehensive legislation and guidelines which must be followed for an effective and seamless conversion process.
Objective of this study is to identify the different challenges and risks that a Conventional Bank faces while converting its operations into an Islamic Bank.

1.2 Research Problem

(Hasan, 2016) in his study predicted that many Banks in the future might convert their operations to Islamic, fully, or partially given the performance of the converted Banks which is better than before conversion. So, there is a need to identify the issues and challenges that a conventional Bank may come across whilst converting its operations to Islamic. This study will focus on the potential issues, challenges and threats that can cause problem or hinder the conversion process.

Chapter 2

Literature Review

As explained above, this study aims to identify the challenges, issues or obstacles that a Bank faces while on its transformation journey from conventional to Islamic, so literature has been reviewed and it will be cited below to demonstrate the historical work being done on the conversion process. Also, as there are very examples of the conversion process around the globe, so there is a scarcity of the literature which is specifically related to the conversion process.

After reviewing the literature, it has been found that there are many incentives or factors that play an important role in the conversion of Conventional Bank into an Islamic Bank. As the conversion of over-all operations of the Bank is not an over-night decision but an organizational strategy backed by strong qualitative and quantitative evidence. One of many factors behind the motivation for conversion is the immense growth of Islamic Banking in developed and developing economies. (Lee and Ullah, 2011) stated in their study that most of the customers start banking with the Islamic bansk mainly because of the Shariah compliance, but they also expect the Islamic banks to offer products and services as an alternative to conventional products, and there is a possibility that in the future the Customers will go for Isalmic banks not only because of their Shariah compliance but also because of their competitive products and services and social responsible activities. (Furqani and Mulyany, 2009) did a study in which they concluded that Malaysia's economic growth and capital accumulation is positively corelated with the financing extended by the Islamic Banks in the country. (Abduh and Omar, 2012) did a study on Islamic Banking and Economic growth and concluded that Islamic financial development is positively and significantly corelated with the economic growth and capital accumulation and also the financing extended by Islamic Banks has been found playing a major contribution to the Indonesian economy. (Asif, Ahmed, Zahid and Khan, 2017) did a study on the motives behind the conversion of Conventional Bank into Islamic and concluded that Performance of Islamic Banks and Customer need for the Islamic Products are important factors in the conversion of Conventional Bank into an Islamic Bank. (Hasan, 2016) conducted a study in which he concluded that after Conversion of conventional Banks to Islamic, their over-all performance was better than before conversion, their study also recommended that in the future some banks might also convert their operations to Islamic, fully or partially. (Alani and Yaacob, 2012) in their study on traditional banks conversion motivation into Islamic Banks narrated that increasing knowledge of Islamic Banking and Finance among the masses has created a huge demand for Shariah compliant products & services and Banks are trying to tap this huge growing market through either opening an Islamic banking window or converting into a full fledge Islamic Bank. They also stated that the success of international experiences is one of the reasons to push banks toward opting Islamic model but with limitation.

Many studies have also been conducted to identify the challenges that a Bank face whilst converting its operations from conventional to Islamic. (Bello, El-Brassi and Alhabshi, 2018) conducted a study on Issues and Challenges in the Conversion of Conventional Banks into Islamic Banks in Libya, and they concluded that lack of comprehensive guidelines for the Conversion Process is one of the major problems in the Conversion Process. (Saaid and Shafii, 2013) did a study on the obstacles facing conversion process from conventional to Islamic Banking, and in their study, they identified many obstacles in the conversion process i.e., Administrative, Human Resource, Technical, Product development and legitimate controls. They also argue that there is a significant relationship between forms of finance, risk, and traditional banks conversion to Islamic form. (Noor Khan, 2015) did a study on Gaps of Human Resource in Islamic Banks and reported that since the development of Islamic Banks, negative concerns arise because of lack of qualified staff and lack of planning and training to boost up the Islamic Bank's business growth and it was concluded in the study that Human Resource Departments should refine their practices regarding Islamic Banking hiring, recruitment and training process. (Ahmad and Arif, 2019) did a study on Employees' attitude toward Islamic Banking, and they addressed in their paper that not all who are working within Islamic Banking system are fully convinced of its objectives underlying philosophy. A handsome number of employees have the conventional background with very little Islamic Banking knowledge and their ambivalent attitude may affect their work commitment. (Abdalla, Ridhwan, Aziz and Johari, 2015) in their study concluded that the human resources who are qualified and trained to work in Islamic Banks can be considered as the most important affecting the success of transformation into Islamic bank. (Fesharaki and Sehhat, 2018) in their study concluded that is applicants in Islamic Banks are recruited in Islamic way, trained and developed properly then they will tend to stay in their job much longer. (Ahmed, Khan and Haq, 2018) remarked in their study that the branches converted to Islamic had to let go the major portion of their credit portfolio because they had very few Islamic financing product options available to offer to the Customers as an alternative to the conventional products, and they also concluded that without proper training and development of the staff of the converted branches, the conversion process may not produce the expected results. They also stated that the before opening or conversion of conventional branches into Islamic, it is recommended to invite the local elders, businessmen, Imam of Masjid and local Muftis and they may be given a briefing about the products and services of Islamic banking and how it is distinguished from conventional banking. (Islam, Uddin and Suzuki, 2020) concluded in their study that less reserve requirement for Islamic banks provides an economic incentive for the conversion, however, the conversion supported by the less reserve requirement does not always promise the sustainable positive impact on the converted Islamic banks. Studies have also been done to assess the effect the conversion on operational areas of Bank e.g., (Zulfiqar, 2018) in his study concluded that after the conversion Banks introduced new committee and new heads of expenses like Zakat and allowance for the members of Shariah Committee. Study also concluded that overall effects of the conversion are positive. Many scholars have done the research to identify the pre-requisites that a Bank need to formally start and seamless execution of the conversion drive. (Sole, 2007) wrote a paper named “Introducing Islamic Banks into Conventional Banking System” for IMF and stated that the financial institution wishing to offer Islamic products must first appoint a Shariah Board, or a Shariah Counselor at a very least, as it will help minimize the Shariah Risk. He also stated that the funds intended for Shariah compatible investments must not be comingled with those of non-Shariah compliant funds.

Chapter 3

Research Methodology

This study is a qualitative study which is more appropriate to address the objectives of this study and, both the primary and secondary approach has been used to assess the challenges that the Banks come across or have faced during the conversion process. Most of the studies specifically related to the conversion process have used the qualitative approach to get the desired information or results. (Bello, El-Brassi and Alhabshi, 2018) conducted a qualitative study to assess the different challenges that a Conventional Bank faces whilst on a conversion journey. Researchers in this study conducted interviews from the management of five Libyan Banks who were part of the transformation and conversion process. (Saaid and Shafii, 2013) also did qualitative research to assess the different obstacles that will be faced by the conversion process.

The analysis in this study is based on the phenomenological approach i.e., it is based on the people's perception or views regarding an event. This approach tells us that how a certain phenomenon is experienced at the time it occurs. In this study, primary data has also been collected by interviewing FBL's higher management and the staff who are actively engaged in the conversion process were conducted to assess the different challenges or risks involved in the conversion process of a Conventional Bank into Islamic. Interviewees were asked the questions regarding their experience of the Conversion process and what challenges did they face and are facing during the conversion journey, so most of the issues and challenges elaborated in this study have been apprehended through the interviewees' personal experience of the conversion process. Names of the interviewees have not been disclosed for the sake of confidentiality. Further, author of this study is a part of the Shariah Compliance Department of Faysal Bank and has personally experienced the challenges that a Faysal Bank is facing on its conversion journey, so few risks / challenges have been assessed in this study out of the author's personal experience.

Alongside collecting primary data by interviewing FBL's management and staff, secondary data has also been collected through studying research papers / literature to get an insight about the different challenges that Banks around the world faced, who converted their operations from conventional to Islamic. Some of the risks and challenges that have been listed down in this study have been drawn through the secondary source.

3.1 Faysal Bank: A Case Study

We have few real-life examples where Banks converted their operations from Conventional to Islamic, e.g., Khadim Ali Shah Bukhari (KASB) Bank when it was acquired by Bank Islami. At present, we have an example of Faysal Bank Limited, who is converting its operations from Conventional to Islamic and it is by far the largest conversion by a conventional bank in the world. Faysal Bank started its operations in1994 and now it has more than 550 branches in more than 200 cities and is on track for its full fledge conversion to Islamic Bank. I, Haseeb Nasir, writer of this study, is a part of Faysal Bank Shariah Compliance Department and am directly involved in the conversion process and is a witness to the hurdles/hindrances that Faysal Bank is facing on its journey to conversion.

3.2 Risks and Challenges associated with Conversion Process:

As mentioned earlier, there are many risks and challenges associated with the conversion process which need to be identified and addressed, and, so, I have categorized the major risks involved in the conversion process which will be elaborated below:

3.2.1 Human Resource Risk

One of the major risks that is involved in conversion process is the human resource risk. Human Resource is the most important part of the organization and plays a vital role in the growth of any organization. Qualified human resources are the most influential factor in the decision making of conversion process. Human resource risk can be further categorized into following:

a. Trained Human Capital

Trained Human Capital is the major challenge that Banks come across to when they convert their operations form conventional to Islamic. Employees working in the conventional culture become use to that conventional set up and they face quite a challenge when they have to learn all the concepts from the scratch given that documentation, execution of Islamic Transaction is much different than that of Conventional. Role of management is also very important in the conversion process and Bank’s management should consider replacing its management by people who are capable to effectively execute the conversion process. Training of the Human Resources with regards to Islamic Banking is very important as this helps in achieving the conversion goals of the Bank in a much effective manner.

b. Employees' resistance to conversion

Some employees resist to change in their organization. The major reason behind the resistance is that certain group of employees is not convinced about the change that is being brought up in the organization. Talking in the perspective of conversion, some employees might not be convinced of the Islamic banking, and they deem Islamic Banking as just a mere change of name of Conventional Banking. There are many other factors which make employees to resist to any upcoming change in the organization, e.g., Employees are so used to the old (Conventional) practices that they do not want to learn or adapt new practice. There are many reasons behind the resistance from the employees, it could be the ethnic, religious, educational background and this resistance can lead up to many other operational challenges in the conversion process.

3.2.2 Reputational Risk

(Azrak, Saiti and Ali, 2016) analyzed the reputational risk in Islamic banks and they stated that the most critical intangible asset that a Bank has is its reputation, and establishing a good reputation is a key element of any organizational strategy. And any instance or issue with regards to the reputation of the Islamic Bank may cause a reputation risk to the whole Islamic Banking industry. Reputational Risk is also associated with the conversion of Conventional Bank into Islamic Bank, because if the bank fails to perform then its reputation is at stake and it is not good for that specific bank as well as Islamic Banking industry. It is one of the major hurdles for Bank to re-create its image as a full-fledge Islamic Bank in the Market. Faysal Bank is also going through this challenge as to re-brand its image as a full-fledge Islamic Bank and to do so Faysal Bank is paying immense importance to its marketing team to re-brand all its conventional products into Islamic.

3.2.3 Sharia Non-Compliance Risk

Shariah Compliance is of utmost importance to any Islamic Bank and it makes sure that every transaction of Islamic bank is in conformity with shariah rulings and principles. There is a major shariah noncompliance risk involve in the conversion of conventional bank into Islamic, because ultimate motive is to convert the entire conventional portfolio into Islamic in a shariah compliant manner. There are many primary factors or the factors that trigger the shariah non-compliance risk during the conversion process. We can take the example of untrained human capital who do not have expertise in Islamic banking and when they switch from conventional to Islamic, there is a major risk of potential shariah non-compliance in the transactions executed by untrained staff.

3.2.3 Loss of Business Risk

This is the one of the major risks that banks in their conversion process come across to. We can sub divide this risk into three parts which elaborate how this risk is a major hindrance in the conversion process and banks could face major financial hit as a repercussion of loss of business. Banks on their conversion journey to being Islamic are also exposed to a risk of lesser investment avenues i.e. There are less investment avenues for Islamic Banks as compared to the conventional Banks because Islamic Banks can only park their investment in shariah compliant avenues and so the Islamic Banks generally have the excess liquidity. Loss of business risk can be well explained by following three points.

a. Resistance from Customers

Banks face risk resistance from the conversion who are not convince of the Islamic banking or they are not comfortable in working with Islamic banks given the intensive documentation in Islamic banks as compared to conventional banks. Also, Islamic banks offer more structured products, and the customers who are used to the conventional banking are reluctant to work with the Islamic banking and thus such customer choose to exit the bank and work with some other conventional bank. Especially the SME sector, where the volume of the clients is much bigger than that of the Corporate and Commercial clients, it is difficult to convince the SME clients to make them agree to convert their conventional portfolio into Islamic. As most of the SME sector is very unorganized and unstructured and also the variety of product isn't as diverse as in the conventional, also they do not want to do documented transactions (Murabaha documentation etc.) with the Banks, so they resist. This is a major hit that is faced by the bank as it loses some of its valued clients due to conversion strategy.

b. Non-shariah compliant Portfolio

Another major hindrance that banks face on their conversion journey is the shariah non-compliant portfolio of the bank. For example we can take the example of credit card, conventional banks give much importance to its credit card department and they earn major chunk from their re revenue from the credit card operations, and as most of the Islamic banks do not deal in the credit card, then banks who is converting its operations will gave to let go its major business in the form of credit card which will most likely be swapped with other competitor bank or banks can decide to retain their customers by offering their customers and alternative in the form of Islamic credit card. Besides credit cards, there are many other consumer financing products which are difficult to convert to Islamic e.g., Personal Loans. Most of the customers avail personal loan product from conventional banks to meet their personal requirements and is mostly disbursed in cash to the Customers, so it is difficult to convert this into Islamic due to tangibility issues i.e., there is no Asset involved which can be used as a medium to convert the exposure to Islamic books.

c. Limited Investment Avenues

Islamic banks have very limited options or avenues as compared to the conventional banks when it comes to the investment. We take the example of a Treasury function in the Banks. Treasury is a major income-generating segment of the Banks. Treasury deals in the Forex operations, Capital Market and Money market etc. As in the Conventional Banks, the Treasury makes money through investment in the T-Bills, PIBs or by entering into other derivatives transactions and earn handsome amount of money. So, for a Bank on the conversion journey, the options of investment are quite limited, as there are very few Sukuks, REITs available in the market where Banks can invest as an alternate to the T-Bills, PIBs etc. So, generally Islamic Banks have higher liquidity as compared to the Conventional Banks because of the limited investment avenues.

d. Agricultural Portfolio

Agriculture sector in Pakistan is very un-organized and un-structured, and most of the farmers do not maintain any banking relationship. Banks are instructed from State Bank of Pakistan to open branches in the Rural areas and to bring maximum number of the rural population under Banking umbrella. Most of the farmers avail the financing facilities from the banks to finance their personal needs, or to buy equipment/machinery for their crops e.g., Tractors, Solar Panels or to install the Tube-well etc. And to convert the Conventional Agri portfolio to Islamic is a difficult task because there are many operational hurdles in offering Salam, Murabaha etc. to the farmers given they are operating in very un-organized market segment, also there are many issues from the risk perspective e.g., default rate of the farmers.

e. Short Product-Menu

This is the challenge that is faced by the Islamic industry as well but banks who convert their operations are majorly affected by the short product menu of Islamic banks as they must provide their customer an Islamic alternative of conventional products and short product menu is major hindrance in catering the requirements of their customers. I will discuss in detail about the products that are being offered to the Islamic Banking Customers in Faysal Bank as an alternative to the Conventional portfolio, but still Islamic Banking division is lagging in terms of product menu if we compare it with the conventional. Faysal Bank is doing intensive research and development to cater the customer's requirements and overall Islamic Banking Industry. The prime example of Faysal Bank's research is the recently launched Islamic Credit Card which is based on the Tawarruq principles, and this product will help Faysal Bank to convert its existing conventional credit portfolio to Islamic.

3.2.4 Lack of Comprehensive Legislation and Guidelines

Legislations and Guidelines is very important when it comes to conversion of conventional Bank into Islamic. Because Bank needs a certain framework which they can use to effectively execute the conversion process. Presence of a legislation at a central level is very important because it helps Banks to move in a certain direction with ease. State Bank of Pakistan issued minimum Shariah regulatory standards being necessary to establish a full-fledge Islamic Bank Islamic Banking subsidiary or setting up of standalone Islamic branches by a conventional bank, then it issued a detailed set of instructions in 2010 to convert the existing conventional branches into Islamic Banking branches, and then in 2017 the SBP issued guidelines to convert the conventional banks into full fledge Islamic Banks, and State Bank of Pakistan is also in continuous liaison with the Faysal Bank about the progress in the conversion of conventional portfolio, development of new products and how to cater the problem that Banks is coming across on its journey to conversion. Faysal Bank submits its annual Branch Review Plan to the Central Bank as per SBP requirement and SBP also issues certain guidelines to how to effectively convert the branches from conventional to Islamic and same goes for the Asset side portfolio.

3.2.5 Financial constraints

Financial constraint is also a major hindrance in the conversion process, because the conversion process requires major overhauling of all the systems that were already in place and being in use in the conventional domain, so whilst shifting the operations to Islamic, system need to be revamped as per Islamic requirements, also there is a major cost on training of human resources about Islamic banking. Bank has to come up with the complete transformation plan which acts as a guide in the conversion process and this conversion process also requires a separate team which is specially designated for the conversion tasks and briefs the banks management about the conversion progress. These are some major cost heads associated with the conversion.

3.2.6 Operational Challenges

Conversion of Conventional portfolio to Islamic also involves many operational challenges e.g. Conversion of Conventional Liability-side portfolio to Islamic is a lengthier, time taking and a costlier process, as there are thousands of the Current and saving account holders and to convert a single account requires many regulatory requirements to be fulfilled. So, it takes quite a long time to reach out to such large number of the customers and to seek their consent to convert their account into Islamic. There are many other issues involved as well, for example contacting the account holders whose accounts have been dormant and the customers whose address or contact information have been changed but they haven't updated the Bank, and also to convince the Customers about the conversion of their conventional account into Islamic and all of this process need a well-equipped, vigilant and learned staff as well who are being properly trained and they also need the support of all the stake holders e.g. the account opening department, the CPU department and other operations team that is being involved in the conversion process and also the legal, compliance which help the Branch staff to stay abreast with the legal, regulatory updates being issued by the regulators for the smooth, seamless and shariah complaint conversion of the conventional portfolio into Islamic.

3.2.7 Natural Calamities

There are many natural calamities that could happen and may slow down the transformation process. Covid-19 is the prime example that has slowed down the economic activity and it has also impacted the conversion process of the Faysal Bank Limited. Many businesses have been adversely impacted, and it has become difficult for the Bank's front-end staff to reach out and conduct meetings with the clients to convert their portfolio, and it has also become difficult to convert the accounts of the depositors, because of the hindrance in reaching out to the customers because of the on-going pandemic, and so the conversion process has been affected by this natural calamity. This pandemic also led to many other constraints, e.g., resource constraint i.e., 50% of the Bank's staff started operating from home, which also affected the pace of the conversion process, and all the reasons including but not limited to, hindered the conversion process one way or another.

1. Profit before and during the Conversion process

Faysal Bank Limited (FBL) formally started converting its portfolio in the year 2017, and the below graph shows the performance of FBL in terms of profit after tax over the course of past years i.e., 2002 – 2020, which also includes the period during which FBL is converting its entire operations into a full fledge Islamic Bank. The graph shows the upward trend of profit after tax over the course of past years, and for the year 2020, FBL's profit after tax stood at 6.5 billion PKR, and Islamic Banking assets contributed 40% of the profit.

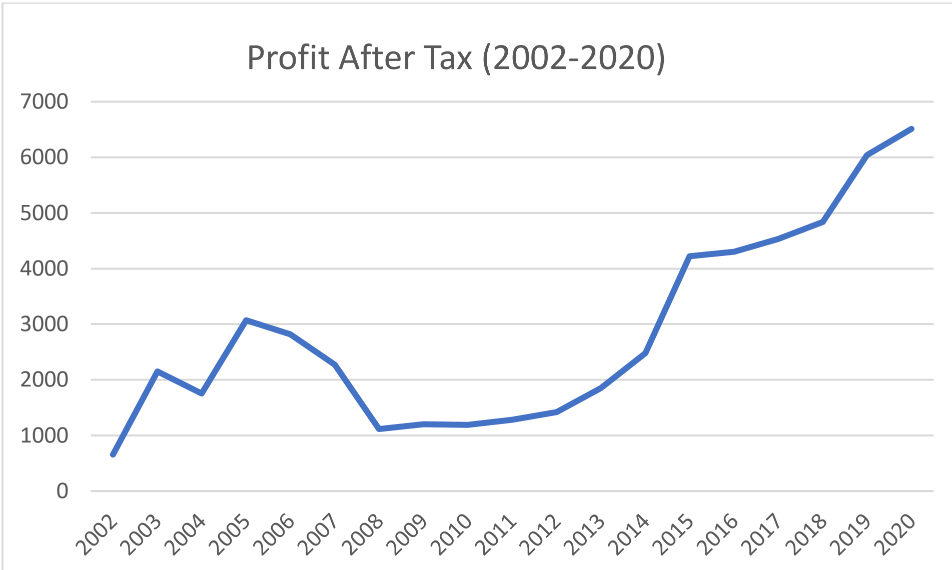

Figure 1: Profit After Tax (2002-2020)

2. Conversion of Bank's Conventional Portfolio into Islamic

Bank on it journey to conversion faces many challenges while converting its conventional portfolio into Islamic. Taking Faysal Bank example, it is converting its entire liabilities and asset side conventional corporate, commercial and SME portfolio into Islamic by offering a suitable Islamic product to its customers as an alternative of conventional. There is specifically a department created in the Faysal Bank which is working specifically on the Business Transformation plan. They develop annual conversion plan for both liabilities and asset side portfolio and then this is disseminated to all the concerned stakeholders to effectively execute the conversion. Below, I will explain in detail about the conventional products of Faysal Bank and the Islamic Products that are being offered to the conventional customers. I have categorized the product-wise conventional and Islamic portfolio of Faysal Bank as follow:

3.3 Conventional Portfolio

Faysal Bank's conventional portfolio is comprised of the following segments:

3.3.1 Liabilities Portfolio:

Faysal Bank Liabilities side portfolio comprises of many current, saving and term deposit products. Current Account is an account where the Customers deposit money and Banks generally do not offer any interest over the deposit, and Banks usually make the highest profit over the current accounts. Saving account is an account where the Customer is being offered a specific rate of interest over the deposit. And, in the fixed deposit, the deposit of the Customer is fixed for a specific tenure and the customer is offered a comparatively higher rate of interest as compared to the saving account. The aforementioned types are the three main types of the account being offered by the Conventional account and the Banks offer many liability products which may fall under any of the aforementioned types.

3.3.2 Treasury Products:

To support the Bank's treasury related requirements, Faysal Bank conventional treasury uses the conventional products e.g., Repo/Reverse-Repo, Call limits, Bill Purchase, FX limits etc.to manage its liquidity requirements. There are different segments in the Treasury which deals in Foreign Exchange Operations, Money Market Operations or Equity Market Operations etc. Few of the treasury products are explained below:

a) Forward Covers

Forward cover is a type of hedging in which a party buys something at a future rate at a fixed price to protect itself from the increase in price. In the context of treasury, importers enter into a forward cover with the Treasury to buy a dollar at a fixed rate in the future at specified date to make payment to their supplier/exporter. Treasury dealers sell the dollars at a higher price; premium for hedging the risk.

b) Repo

Repo or a Repurchase Agreement is a Treasury product and it's mostly used to raise a short-term capital. In a Repo transaction, the treasury dealer sells government securities to the investors and then buys then back the following day on a relatively higher price, the difference in the price is the interest rate. This helps to meet the short-term liquidity requirement. Central Banks also use this tool for the open market operations.

c) Reverse Repo

Reverse Repo or a Reverse Repurchase Agreement is opposite the Repo transaction. For a part, that is buying the government security with an agreement to sell it in the future, it is a reverse repo transaction.

Running Finance

Running finance, also known as overdraft facility, is a short-term conventional banking product wherein a certain financing limit is allowed to the Customer and the Customer can withdraw funds as per his need and then pays back to the Bank within stipulated time with the interest.

Short Term Finance

Short term loans are facilities having maturity of less than one year and are used by the businesses to finance their working capital requirements. This is one of the major used products at the conventional counters of Faysal Bank as it helps businesses to finance their short-term liquidity requirements.

Pledge Financing

The pledge financing facility involves disbursement of funds to the customer against delivery of approved Muqaddam. Drawdown is allowed on receipt of goods for pledge. Drawing power is determined on the basis of value of the goods placed under pledge along with stipulated margin. Each drawdown is required to be adjusted within a stipulated period along with mark-up. There is also an option to the Customer to replace the pledge goods with prior approval from the Bank.

Commodity Finance

The Bank may also participate in commodity financing as directed by the SBP. Typically, the Government of Pakistan or a provincial government undertakes commodity operations to provide farmer level support as well as maintain minimum safety stocks of key commodities.

Finance against Imported Merchandise (FIM)

FIM is allowed against the pledge of imported goods. FIM is almost similar to pledge financing but with the addition that the Bill of Lading is directly endorsed in favor of the Muqaddam for clearance of goods from the port and storage is under Muqaddam's security arrangement. FIM is settled as and when the customer requests for release of goods after deposit of funds to its account to adjust the outstanding against FIM.

Financing Against Trust Receipt (FATR)

Another form of import related financing is FATR. In the case of FATR, the imported goods are released to the importer upon providing a trust receipt. Technically this facility is similar to STF finance for financing imported goods with the additional comfort that the Bank has proof of use of funds.

Export Refinance Schemes

As part of its strategy to support export-oriented companies, the SBP offers pre-shipment and post-shipment finance at subsidized rates. Through this facility, the SBP hopes to encourage development and export growth in various industry segments.

Letter of Credits

A Letter of Credit (LC), also known as “Credit Letter”, is a document which is used in the local/international trade. This document ensures that seller receives the due payment from the buyer on time. If the buyer is unable to make payment to the seller, then buyer’s bank makes the payment to the seller’s bank on buyer’s behalf.

Guarantees

Bank Guarantee is an instrument through which Bank (Guarantor) undertakes to make/honor a payment to the guarantee-holder (beneficiary), if the customer (applicant) doesn’t fulfill or meet the performance which was contractually agreed between Customer (applicant) and the guarantee-holder (beneficiary).

3.4 Islamic Products

Above, I have explained the conventional products of the Faysal Bank which is now been converted into Islamic modes after analyzing the customer’s modus operandi and detailed discussion with the clients, and then the appropriate Islamic product is structured and proposed to the Customer which caters the Customer’s requirements.

3.4.1 Murabaha

Murabaha is a product in which seller discloses cost plus profit of the goods to the buyer of the goods. Customers who are mainly involved in the trading and they need the money to finance their raw material or the commodities in which they trade. These customers are offered a Murabaha product.

3.4.2 Diminishing Musharakah

Diminishing Musharakah is a type of joint ownership wherein two or more parties share the ownership in an asset (physical) in the pre-agreed proportion. One party (A) gives an undertaking to purchase the share of the other party (B) over a certain period in the periodic instalments, until the share of the party (B) is completely transferred to the party (A). This product is usually offered to the customers to for fresh buying of asset e.g. land, machinery, building etc.

3.4.3 Diminishing Musharakah – Sale and Lease Back

Customers who belong to the Services sector and were availing RF/WCL from the conventional counters to cater their working capital requirements, were offered Diminishing Musharakah – SLB as a last resort because no other short-term product is available to cater the requirements of SME Services sector clients. Most of these customers have adopted an exit strategy as there is no short-term product available at Islamic counters and DM-SLB is a long-term product which is offered to these service sector clients to settle their conventional outstanding.

3.4.4 Salam

Salam is a kind of sale where the seller agrees to supply goods with certain specifications to a buyer at a future specific date for the price which is paid fully in advance at the time of execution of Salam contract. Specification of goods with the date of delivery of the goods is mentioned in the Salam contract to avoid any ambiguity. The buyer shall pay the full price in advance to the seller which is an essential part to validate the Salam sale as per Shariah. Salam is offered to the Customers who were availing conventional line from the conventional counter and these customers belong to the agriculture sector, such customers are offered a Salam Product to finance their working capital requirement.

3.4.5 Istisna

Istisna Product is offered to the customers who are a manufacturing entity and so the Istisna is proposed to them to cater their working capital requirements. Istisna is a mode of sale where the buyer places an order with the manufacturer to manufacture / assemble or construct anything (must be Shariah compliant) to be delivered at a future date for an agreed consideration/price. Price of the goods to be manufactured must be fixed to avoid any ambiguity or Gharar. Istisna allows customer to provide the delivery of the goods at a future date and then the customer as an agent of Bank sells the goods to its buyers on cash/credit and accordingly settles the Istisna financing facility. This enables customers to finance its working capital requirements.

3.4.6 Tijarah

Tijarah is a Sale & Agency based financing facility for customers who have a stock of the finished goods. The facility enables the Customers to sell their finished goods stock to FBL for a price, through which they can meet their short-term financing requirements and then the Customer as an agent of FBL, sells the goods to its buyers on cash/credit basis and settles the transaction.

3.4.7 Running Musharakah

Running Musharakah is offered mostly to the corporate clients to cater their working capital requirements. Running Musharakah means an agreement between two or more partners to form a joint business venture/enterprise for conducting business in which all partners make contributions/investments in the business and agree to share the profit as per specific ratios while the loss is distributed/shared amongst the parties according to the ratio of their contributions/investments in the business.

3.4.8 Islamic Export Refinance Schemes

Islamic Export Refinance Schemes (IERS) is offered to the clients who were availing the Export Refinance Line from the conventional counter. This is mainly offered to the customer who are involved in the manufacturing and export of goods. These Refinance Schemes are available to the customer on subsidized rates as announced by the SBP.

3.4.9 Pledge Financing

Faysal Bank also offers Islamic Pledge Financing facilities as an alternative to the conventional pledge facilities. Pledge financing is being offered to the customers under various Islamic modes e.g. Istisna, Tijarah, Murabaha etc., in which the Muccaddam keeps the possession of the goods and then releases the goods as per the terms decided with the customer.

3.4.10 Sukuk

Sukuk is an Islamic Product which is the alternative to Conventional Bond. Sukuk is an asset backed Islamic bond and it can be offered to the customer under various modes e.g. Ijarah Sukuk, Salam Sukuk etc. Faysal Bank has offered Sukuk to its corporate customers through its Corporate and Investment Banking window to finance their long-term financing requirements. Sukuk is also majorly used in the Islamic Capital Market Operations.

3.4.11 Al-Wa’ad

Al-Wa’ad can be explained as a promise made by one person to another to undertake a certain actual or verbal disposal which is beneficial to the second party. The transactions of sale/purchase of currency are initiated and executed in the bank on the basis of unilateral promise (Al-Wa'ad basis). A unilateral promise is an offer or promise by the person and the offeror is bound to abide by the promise/offer. Initially, the customer will make a unilateral promise to the bank to sell/buy the currency to/from the bank & then the sale/purchase of currency transaction will be executed on the relevant sale/purchase transaction date/s. This is merely the concept of Al-Wa'ad based currency transactions in the bank. All other rules and conditions will also apply as per the Shariah principles as directed by the Shariah Board of the bank. This product is mostly used in the treasury operations of the Islamic Banks in foreign exchange market.

3.4.12 Bai Muajjal

Bai Muajjal is a sale transaction in which parties agree that the payment of agreed contract price shall be deferred. For validity of Bai Muajjal, it is important to fix date of payment of contract price in an unambiguous manner. In FBL Islamic Treasury, Bai-Muajjal product is used for outright sale of Sukuk to any counterparty under which FBL Islamic Treasury sells the Sukuk at an agreed contract price payable at any fixed future date in lump sum under Deliver verses free mechanism.

Chapter 4

Conclusion

In the above discussion, many challenges, or risks that a Bank come across to whilst transforming its operation from conventional to Islamic, have been discussed. All the risks, challenges can put the Bank's reputation at stake or there can be monetary consequences. Bank, before formally starting off the conversion drive, should form a transformation plan and Research & Development wing which must brain-storm and list down all the risks/challenges that a Bank could come across during its conversion drive in the future and it should also make the contingency plan in order to effectively cater the risks. To cater the potential risks, capacity building of the human resources is very important through training, research & development. It is also important to establish a department and fully designate for the implementation of the transformation plan and which would act as a conduit amongst all the stakeholders involved in the conversion process and this department will be responsible to update the Senior management regarding the progress on the transformation journey and it can help disseminate the Management's decision to all the employees working under their jurisdiction. From the above decision, it is safe to remark that the Conversion could result into the loss of business to many business segments in the Bank e.g., Treasury, Commercial Banking, SMEs, Corporate Banking, Consumer Finance etc., so the Product Development and the Shariah Team of the Islamic Division must work on the development of new products/initiatives so the Bank can tap the maximum untapped segment of the economy and the conventional portfolio can be effectively converted to the Islamic. Also, role of Central Bank is very important, and it must issue the comprehensive guidelines under the supervision of its Shariah Board regarding the conversion process, as these guidelines can help and guide the other conventional financial institutions willing to convert their operations into Islamic.

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