CHAPTER 2

Islamic retail banking operations

2.1 Introduction

This chapter focuses on operational aspects of Islamic retail banking. Although retail banking practices cover a host of areas such as payment services/remittances, e-banking and fee based products, our concern will be on products offered to the consumer and small and medium enterprises (SME) i.e. businesses which have not yet reached the status of a limited public listed company (PLC). There are other criteria to consider when defining an SME such as assets under management (AUM) and labour force; but this differs from country to country.

Islamic banking distinguishes itself from its conventional counterpart in the following way:

i. Islamic banks play multiple roles in assisting individuals and enterprises such as acting as partner, agent, guarantor, etc.

ii. Under a partnership contract such as mudaraba and musharaka, Islamic banks jointly share any risk with their clients. However, the risks in musharaka differ from the risks in mudaraba. In a musharaka contract, the bank and entrepreneur both contribute capital and they jointly share the risk on their capital & effort. However, in mudaraba, the bank may lose its capital and the entrepreneur faces the risk of wasting his efforts.

iii. In a few jurisdictions, Islamic banks participate in true trading activities (asset backed transactions).

In explaining detailed relationships between banks and customers in conventional banking, F.E. Perry (1989) listed down the following relationships:

i. debtor and creditor
ii. bailor and bailee
iii. principal and agent
iv. mortgagor and mortgagee

Conventional banks earn profit through interest and fee based incomes. According to Shelagh Heffernan (1998), all modern banks act as intermediaries between borrowers and lenders, but they may do so in a variety of ways: from the traditional function of taking deposits and lending a percentage of these deposits to fee-based financial services. In contrast, Islamic retail banking activity capitalises on profit rate differentials.

2.2 Accounts

Islamic retail banks offer various products to individuals in order to mobilize deposits. Specifically, there are three main underlying contracts that have been applied by Islamic banks to collect deposits from their customers. Those concepts are wadia, mudaraba and qard.

2.2.1 Current accounts

In general, any Islamic bank which obtains its license under commercial banking law has a right to offer current accounts allowing the customer to withdraw his/her money. The withdrawals can be made either in person or by a third party designated by the customer through, for example, cheque payment.

2.2.1.1 Wadia based saving account

In classical Islamic law, wadia was a voluntary contract in which an individual deposits their valuable property with another person for the purpose of security and safekeeping. As it was considered to be a voluntary act, the custodian or safekeeper is not entitled to any fees. Furthermore, the custodian is not obliged to provide a guarantee for the items placed with him. If the property perishes whilst in the hands of the custodian due to no fault of his own, he is not required to replace the item. However, if on the other hand the item perishes due to his own negligence, he then becomes liable. The majority of the scholars stated that it is not permissible for the custodian to utilize the item placed with him without permission from the depositor, and even if permission is given, he is then liable to return the item. Further, restrictions include restrictions on travelling with the item and also mixing of it with other items in the custodian's safekeeping. If the restrictions are violated, the custodian automatically becomes liable for the items placed in his care. Considering these restrictions, wadia, in its classical sense, is not a suitable contract for contemporary Islamic banking deposit mobilization.

In order to solve this problem, the industry began offering a variation of the classical wadia contract. As the banks are interested in utilizing the funds placed with them, they request the permission of the depositors to utilize the funds and also agree to return the deposit no matter what happens to the bank. This incorporates the element of guarantee into the classical wadia contract and has been named wadia yad dhamana (wadia with guarantee). In essence, the permission to utilize funds and agreement to return the funds has turned the contract into more of a qard (loan) contract, and scholars in the Middle East prefer to view it as such.

2.2.1.2 Qard based savings account

Only a few banks accept customer funds under the principle of qard where deposits are treated as loans from the customers to the bank; it is entitled to use the fund and, simultaneously, the bank is fully responsible for returning the full amount of the fund upon demand.

2.2.2 Investment accounts

As the development in introducing Islamic banking products is a continuous process, most banks are offering a variety of Islamic banking products using various underlying contracts. The mudaraba based investment account is normally open to customers who are ready to face a slightly higher risk in order to gain higher profit. In contrast, there are customers who are inclined towards a fixed rate of return. Then the tawarruq concept looks more preferable to them. In this section, some of the existing investment products will be introduced:

2.2.2.1 Mudaraba based investment account

Some banks offer deposit products under the principle of mudaraba. This is a partnership contract where the customer who is the capital provider and the bank who is the mudarib (entrepreneur) agree on the profit sharing ratio. The mudarib then invests the funds in Shari'a-compliant activities. Under normal practices, a bank would state the ratio it requires in managing the customer's fund.

In the event of loss, the capital providers i.e. the depositors have to bear the loss unless the bank is negligent at which point the bank is not compensated for its effort and in addition may also be penalized for this negligence.

2.2.2.2 Commodity murabaha based account

Many Islamic banks opt to use the tawarruq concept as an alternative to bay al-ina to cater to the demand of investors who are familiar and inclined towards a fixed rate of return on investments. Bay al-inah is a sale and buy back product, in which the bank would purchase an asset from the client on a cash basis and then immediately resell the asset to the customer at a marked up price on a deferred payment basis. The two contracts must be executed separately from each other and be independent of each other. Tawarruq on the other hand is more acceptable to the scholars as it involves a third party so it does not indicate a clear ruse to the prohibition of riba. In tawarruq, the person seeking liquidity would buy an asset from a person for a higher price than its cash value on deferred payment terms. The individual would then go and sell the asset in the market to a third party for its cash market price in order to achieve the desired liquidity. Islamic banks prefer to use the tawarruq concept with minor modifications to ensure compliance with contract requirements of the Shari'a and avoid any controversial matters in the concept. The commodity murabaha trade via a commodity murabaha platform has become the enabler for the organized tawarruq.

2.3 Financing

Retail banking operations especially that of consumer banking is highly voluminous and transactional in nature and it is mass market focused. Depending on the volume involved, a great deal of effort is required in building up the overall business and operational infrastructure. The key established and basic products for the retail consumer market are:

1. Home financing
2. Car/vehicle financing
3. Personal financing

There are differences in the operational infrastructure and the Shari'a governance procedures to support these products. The manner that the Shari'a concepts are being used to facilitate product offerings is something that is most interesting and intriguing at times, as one bank may market and package the same home financing products differently from that of another bank.

2.3.1 Home financing

In the Malaysian Islamic retail market, home financing is being packaged mainly via the following structures; the commonality being that the products are structured to enable clients in purchasing a house via deferred instalment payments.

i. Bai bithaman ajil (BBA)
ii. Tawarruq (commodity murabaha)
iii. Musharakah mutanaqisa (diminishing partnership)
iv. Ijara

2.3.1.1 Bai bithaman ajil or deferred payment sale

Bai bithaman ajil or BBA is a deferred payment sale which requires the bank and customer to undertake a number of contracts between themselves, each independent of one another. The customer approaches the Islamic bank specifying a property that he wants the bank to purchase, and subsequently gives a binding promise to repurchase the same house from the bank at a pre-agreed mark-up price consisting of cost plus profit, in instalments or a lump sum payment in the future.

BBA, as defined operationally above, is accepted by almost all Islamic banks worldwide; however, the practices of BBA in South East Asia differ from the above definition.

Under the Malaysian practice of BBA, the customer will normally purchase the property directly from the developer by paying, for instance, ten percent of the price and paying the balance after securing finance from the bank. To secure the finance, the customer will sell the property to the bank at example 90% of its original price in cash to be paid directly to the developer. Subsequently, the bank will resell the property to the customer at cost plus profit to be paid in instalments.

2.3.1.2 Tawarruq concept

The concept of tawarruq is an extension of the BBA concept but involves a third party to the transaction. The original BBA concept (ie murabaha) applied when the bank purchased the asset from the supplier at cost price and sold the asset to the customer at credit.

However in tawarruq, the customer sells the asset again to a third party, which can be the original supplier or another person. Hence, the customer can get cash through the sale that he made to the third party and use the cash to pay for the property in house financing. In a normal tawarruq transaction, the commodity, such as iron and crude palm oil, has been used as an enabler for the transaction as it can be traded easily and is highly demanded.

As discussed previously, the issue of pre-arrangement exists in tawarruq which made the concept somewhat similar to the al-ina structure. In addition, the legal documentation must sufficiently cover the transfer of ownership of commodity between the bank, commodity trader and the customer as the end user.

Under the Malaysian context, Bursa Malaysia has initiated a Shari'a-compliant tawarruq commodity market platform named Bursa Suq al-sila'. Crude palm oil has been chosen as the underlying commodity in commodity murabaha transactions through registered participants as an enabler for the tawarruq concept.

2.3.1.3 Musharaka mutanaqisa

Operationally, musharaka mutanaqisa or diminishing musharaka financing is a partnership between the customer and bank to jointly purchase a property. For instance, the customer pays ten percent of the property price and the bank pays ninety percent. The customer undertakes to purchase the bank's share on a monthly basis at a specific duration at a pre-determined price. Thus the ownership of the bank will reduce from month to month.

Most scholars agree that the price can be pre determined if the musharaka contract falls under the shirkat al-milk concept (jointly owning an asset, but not for commercial purposes). Here, a criticism of the practice is that the bank definitely enters the contract for commercial purposes; hence it is not permissible to determine the price of the bank's portion as it will constitute a guarantee.

Beside this point, Islamic banking needs an exception from the prohibition of pre-determined price for the property in this product as it is among matters which may be volatile in terms of price and may burden the customer if the property price increases continuously.

2.3.1.4 Ijara

Ijara is a contract enabling the user to benefit from usufruct or benefits of a tangible item, or services provided by individuals in return for compensation. In order to ensure the validity of contract, the type of benefit, duration and price must be pre determined and the subject matter which is related to the benefits must be in existence. The human services and the fee or ujr must also be pre-determined to avoid gharar (uncertainty) in the contract.

Generally, Islamic banks do not practice the plain ijara as mentioned above. They enter into a number of contracts and agreements (all independent of each other), such as for example sale-purchase and then ijara. Here, the bank purchases the property from the developer and subsequently leases the asset to the customer. Under a separate agreement, the bank undertakes to sell the asset to the customer at the end of the tenure for a token price.

In practice, this is not normally the case as the bank purchases the house from the customer and then leases it back to the customer under a sale and lease back structure. Due to the nature of an ijara transaction, banks normally offer the product for completed property whereas for a property under construction, it is structured under an istisna (contract to build) during the construction phase and ends with an ijara structure. Thus, several contracts will have to be devised to operationalise the transaction. Another alternative structure is via an ijara mawsufa fi zimma structure (forward lease) between the client and the bank with an embedded istisna contract. Due to the long term nature of house financing, the ijara structure is highly suitable as it can be structured as a variable rate financing product.

Another version of ijara is the ijara thumma al bai (AITAB), which is a popular product in Malaysia, to cater for car/vehicle financing. This contract is similar to the conventional hire purchase product supported by a standard set of legal documents in place to support the operations of the product, thus ensuring mass appeal to clients. Under this structure, the bank will purchase the vehicle and thereon lease it back to the client. At maturity, the bank will sell the car to the client at a nominal fee.

2.4 Islamic banking for the SME

A lot is being said about sukuk and less is said about financing the SME market even though it is the backbone of the business sector in most countries. The requirements of SMEs in the Malaysian context are as follows:

1. Working capital
2. Term financing
3. Trade financing
4. Guarantee facility

In financing the SME, there is a need to set up an effective Shari'a screening methodology so as to ensure that the core business and the business set up is generally Shari'a-compliant and in most cases greater care must be put in to ensure that the SMEs with mixed businesses are being screened and evaluated accordingly. The process should be ongoing specifically when the facilities are of the working capital/trade financing type and to a certain degree when ijara structures are being used.

The most common requirement is working capital. Some banks offer products such as murabaha or commodity murabaha working capital financing facilities. Such facilities are vital for an SME to procure raw materials as working capital for production and sales purposes. To a certain extent, some banks do offer products such as al-ina based overdraft/cashline, but the more globally focused banks have started to offer an alternative overdraft product via mudaraba contracts.

For an SME, term financing products are crucial as it enables them to purchase office space, factories and fixed assets. Similar to consumer financing the more popular contracts are murabaha, BBA and the ijara contracts with deferred instalments payments.

Islamic trade finance products are a popular option in view of the standardized nature of the products. Islamic banks normally offer a Letter of Credit facility and it is normally structured using the wakala structure or murabaha structure for the purchase/import of raw materials or intermediate goods. To finance purchases, clients can opt for murabaha working capital financing, more popularly known as Islamic Trust Receipts (TR-i), or alternatively in Malaysia there is the standard Islamic bankers' acceptance (a combination of al-inah/murabaha and bai al dayn (debt discounting)).

To offer a holistic product, banks will package the above facility together with a guarantee facility in the form of kafala guarantee and kafala shipping guarantee. The finalised product will be a fee based product. The main issue here is the acceptance of such products as some banks charge flat fees and some charge a percentage over the amount guaranteed. At the end of the day, banks will adopt the pricing structure sufficing the banks Shari'a requirements.

2.5 Wealth management

Wealth is measured in many countries by accessibility to essential services such as health care, or the possession of crops and livestock. In economics, wealth refers to the value of assets owned minus the value of liabilities owed at a point in time (See: INCEIF, 2006).

In order to accumulate wealth and to maintain it, wealth management should be an essential part of achieving his or her financial goals. Therefore, for many individuals, wealth planning is the map that lays out the road to reach their financial goals.

In Islamic retail banking practices, it is an effort to provide professional services to individuals, their families and their businesses; to offer impartial assistance in analyzing and organizing financial affairs in order to achieve the desired financial and lifestyle goals, as long as the lifestyle is not prohibited in Islam (INCEIF, 2006).

2.6 Retail wealth management products

The wealth management products in the Islamic space are still in their infancy. They appeal to medium to high net worth individuals who wish to expand their investment horizon. Historically, the simplest form of an Islamic wealth management product is the Islamic unit trust, followed by the more complex structured products and banca assurance.

One of the main challenges in offering products is the clients' risk appetite: a balance between a high return and risk of loss. Capital guarantee in conventional products seems to be a requirement, but there is still business risk prevalent with the products.

On the Islamic side, the offering of such products is a challenging one where the Shari'a scholar may have to look at the issue of "capital protection". Structures such as commodity murabaha/tawarruq are being used to create this effect and linkages to Islamic indices endeavour to ensure extra returns for the clients. There is a need to be competitive with conventional products, thus research and development has to be continuously undertaken to come out with hedging mechanisms to reduce risk as well as account for foreign exchange differentials in some of these products.

2.7 Bancatakaful

Bancatakaful refers to the marketing of takaful products through a bank's established distribution channel. Normally, takaful companies leverage an existing bank's distribution channels under one group to market its products. In Malaysia, takaful operators are required to observe the regulatory requirements relating to bancatakaful as set out in the Bank Negara Guidelines on bancatakaful, so as to ensure that the consumers benefit from the efficient cost structures of bancatakaful arrangements.

According to Bank Negara Malaysia, bancatakaful has made noticeable headway albeit from a very low base, to account for 7% of the general takaful distribution share in 2005. The trend of increasing bancatakaful penetration is set to continue, owing to the ability of takaful operators to leverage on existing group structures and closer strategic affiliations with other financial institutions.

As bancatakaful in Malaysia is a new subsection of Islamic banking and finance, there are at this juncture only a few products such as will writing, structured products with takaful protection, deposit accounts with takaful protection and family takaful linked plans.

Table 1 below summarizes the operational aspects of Islamic retail banking.

2.8 Challenges for Islamic retail banking

Notwithstanding the salutary developments in Islamic retail banking, there are few challenges that Islamic banks have to overcome:

2.8.1 Marketing of Islamic retail financing products

There real challenges in the marketing of Islamic products are that Islamic banks need to first identify their target market. There is still a misconception that these products are only for Muslims. Islamic banks have to dispel this myth and gear its marketing approach towards the universal appeal of Islamic banking products. With respect to Islamic home financing products, the most common approach is to align the similarities with that of a conventional home loan and identify some

Description on the roles and products	Roles and products
Islamic banks role is as intermediaries between banks and clients to collect deposits for safe keeping and investment funds for the purpose of investing it in Shari'a-compliant products.	A. Intermediation role by Islamic bank • Mobilization i. Deposit ii. Investment • Financing i. Home financing ii. Car financing iii. Personal financing iv. SME Financing v. Trade Finance
Islamic banks mobilize deposits through offering various deposit products consisting of various underlying contracts such as wadia, qard, mudharaba and tawarruq. Islamic banks offer investment opportunities by offering various investment products using mainly mudaraba and wakala contracts and tawarruq concepts.	
Underlying contracts are murabaha or BBA, musharaka mutanaqisa or ijara Underlying concepts are BBA and ijara Tawarruq and al-ina BBA, Murabaha, Ijara, Ina Murabaha, Ad Dayn, Wakala, Kafala	
Wealth planning and management is a service by Islamic retail banks to individuals, their families and their businesses, in analyzing and organizing financial affairs in order to achieve the desired financial goals as long as it does not contradict with the teaching of Islam. Normal structured products have been structured under the tawarruq concept. However, few have been structured under mudaraba, musharaka and wakala contracts.	B. Wealth Management i. Unit trust-i ii. Structured products
Bancatakaful is a marketing of takaful products through a bank's established distribution channel.	C. Bancatakaful i. Will writing ii. Family takaful/General takaful

Table 1: Islamic Retail Banking Operation

key differences thereby reducing the need to undertake massive customer education programs. The product concepts that fall within this category are BBA and tawarruq. This approach is not liked by some purists as it suggests a resemblance between Islamic and conventional products.

The other approach is differentiating the features of the underlying concepts of musharaka and ijara which create a form of partnership and usufruct respectively and a right of use as opposed to pure lending under a conventional home loan. As mentioned earlier, these products require a substantial amount of marketing expenditure, not to mention massive consumer education.

2.8.2 Legal documentation

The legal documentation for each of the retail products differs in relation to the concepts used. For example, both the BBA and tawarruq concepts have an underlying sale contract with a selling price that encapsulates the financing amount plus the profit. The underlying asset for a BBA is the house to be financed, which is eventually charged to the bank as collateral whereas under a tawarruq, the client has to undertake a separate commodity transaction via brokers/agents to extract the financing amount and the house is used as collateral. These differences need to be reflected clearly in the legal documentation.

Operationally, it is necessary to ensure that the said transaction documents flow are being carried out in proper sequence so as to comply with the Islamic tenet that someone cannot sell something that he does not own, therefore the bank or customers must ensure that they possess ownership of the asset/house prior to selling it.

When we compare musharaka mutanaqisa and ijara concepts, the legal documentation requirements differ considerably as much emphasis is undertaken to define musharaka and ijara. Moreover, there are supplementary contracts that need to be drafted to operationalise the whole transaction. For example, under a diminishing musharaka, the core underlying contract is the partnership agreement between the bank and the customer in joint ownership of the house with an underlying ijara contract for the rental of the house from the customer. Under ijara, the core contract contains information regarding the rental of the house from the lessor (bank) to lessee (customer), which is supplemented by an agency agreement between lessor and lessee for the maintenance of the property.

2.8.3 IT support infrastructure

Ideally to support the business operations of an Islamic bank, an Islamic core system must be in place. This scenario is only prevalent in the new greenfield Islamic bank setup and is not the case for Islamic windows or subsidiary based Islamic banks where the Islamic IT infrastructure is being outsourced to the parent bank.

IT support infrastructure is definitely a key enabler in the Islamic retail banking business. From the outset, the Islamic bank will have to decide and undertake a strategy as to whether to buy an expensive new system to support the distinct features of the Islamic products or upgrade the existing conventional system. At the end of the day, banks will need to assess the business viability in this area as the cost benefit analysis will have to be carried out extensively before deciding on which IT system infrastructure to embark upon.

2.8.4 Risk management aspect of retail financing products

Shari'a-compliance risk is a major category under operational risks. It needs to be managed effectively so as to mitigate the non Shari'a-compliance risk. The mass market nature of these products requires an integrated risk management approach which encapsulates Shari'a requirements as well as ensuring effective marketing strategies, comprehensive legal documentation, robust IT infrastructure and appropriate review mechanisms.

There is similarity with conventional retail banking when it comes to credit risk, whether the counterparty is able to service the financing or not. Furthermore, depending on how the product is structured, elements of market risk may be prevalent thus there is a need to mitigate those risks.

A good example is in the musharaka mutanaqisa home financing where the bank, as a partner, shares the risk of co-owning a house as opposed to just being a financier under a BBA/tawarruq home financing product. Thus the bank has to assess the market risk for each product.

2.9 Conclusion

In conclusion, it is crystal clear that Islamic retail banking is on the right path to providing a good alternative to conventional banking consumers. From its edifying philosophy right through to its holistic approach, Islamic retail banking has the ability to penetrate consumer and SME markets step by step. However, Islamic retail banks should not ignore the need to strengthen themselves and overcome the challenges that they currently face.

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