CHAPTER 6

Looking for the Perfect Islamic Window

Introduction

Islamic banking is growing at an exponential rate, and competitive pressures have coerced existing conventional banks to enter into such territories where Islamic banking is gaining popularity. Consequently, they have resorted to formulating the "Islamic windows" model within their existing infrastructure. Markets with higher demand for Islamic banking present better opportunities; 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 existing customers who are opting to switch to Islamic finance; and

(2) To attract new customers from existing banks, including Islamic banks, with superior products and services extended by the conventional financial parent.

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

While every Muslim dominated jurisdiction has witnessed Islamic banking and Islamic windows, there is no uniformity of thinking on their operational model. This purpose of this chapter is to put forward what could possibly be "a perfect model" of the Islamic window with pros and cons for the conventional banks to consider prior to jumping onto the band wagon to set up an Islamic window.

The concept of an 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 institutions. There is also an absence of guidelines issued by the State regulator on this subject matter. Perhaps the most advanced and evolved model of the Islamic window is found in Malaysia where both law makers and regulators have proactively supported the Islamic banking and finance (IBF) industry.

When it comes to international banks seeking to tap into domestic markets, many have sought to capitalize on the demand for Shari'a 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 favour, they simply folded or minimized operations thereby adversely affecting the IBF industry.

What is the Shari'a Acceptability of the Islamic Window?

Generally, Shari'a scholars have approved Islamic windows subject to the bank complying with guidelines set by the Shari'a scholars. Some Shari'a scholars have expressed their concerns with conventional banks operating Islamic windows as their 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 Shari'a scholars agree that any income source can be purified and cleansed and then subsequently directed to Shari'a 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 Shari'a supervisory board (SSB) and strictly comply with its guidance.
- Shareholders, board of directors and the management of the bank to accept the concept.
- Shari'a coordination, research and training across the bank.
- Develop Shari'a focused policies and support infrastructure.
- Islamic banking code of ethics to be abided across the bank.
- Establish Shari'a compliance and governance including review, audit and remedial policies.
- Develop products and services which fully follow the Shari'a guidelines.
- Transparency, discloser, reporting and adapting standards.

Experimentation by various regulators has led to two distinct models for setting up Islamic windows.

A) Independent Branches The most evolved Islamic window 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 Shari'a cum Islamic business division is set up by the bank. It uses a combination of delivery channels mixed with conventional distribution channels to sell Islamic products and services. Under this model, banks do not require a separate auditable balance sheet or even have to segregate the funding centre and book the deals in conventional books directly.

There can be minor variations in the two models to differentiate between what the regulator will allow and what the customers will accept eventually. Obviously everything must be ultimately approved by the 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 the 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, or it can target new customers without cannibalization.

Why should Conventional Banks be allowed to operate Islamic Windows?

Should the regulator forbid conventional banks to compete with fully-fledgedIslamic banks? Perhaps the shareholders of fully-fledged Islamic banks will agree and claim that since they do not offer conventional products and services, 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 the 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 Islamic windows should prompt Islamic banks to exercise more diligence and care in introducing better quality products that have at par service standards, if not better. It is only competition by Islamic windows that pure IFIs have been forced to take a hard look at the inefficiencies in their operating structure and risk assessment models. Prior to the full advent of Islamic windows, customers were at the mercy of pure Islamic banks in which there was little consideration of service standards, quality checks, price efficiency, transparency, etc.

Recent studies by leading consultancy firms all highlight the inherent weakness of the pure Islamic bank, 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 the recent global financial crisis, Islamic banks were shielded due to the prohibition of partaking in highly speculative products such as derivatives and multiple securitizations. Conversely, this limitation resulted in a lack of diversity in asset classes (with major concentration on real estate industry), which has , arguably, an effect on the growth of 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 it has reached today. A look into the sukuk industry provides support for this theory. With international sukuk 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 IBF is not simply for only fully-fledged Islamic banks. The challenge to becoming a more efficient operator in challenging circumstances could not have been taken that seriously by fully-fledged Islamic banks if there was no competition from the Islamic windows of a conventional bank.

Framework for a "Real" Islamic window

A fully functional and cost effective Islamic Window requires the following:

1. Strategy, Key Initiative and Objectives

Being an integral part of the conventional bank, the Islamic window should have a very clear strategy. There are only two possible strategies which the Islamic window should adopt as all else is bound to create confusion, confrontation and ultimate failure. Stakeholders of the conventional bank should have clarity on the strategy they are adopting when they set up the Islamic window. Rather than toying with one model versus another, the focus should be based on an ultimate target. Is the purpose of starting the Islamic window to simply stop existing customers shifting to fully-fledged Islamic banks, or to build-up a model which 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 the model requires a concerted effort by everyone in the conventional bank, not just the Islamic banking personnel to set up the operations. Hence, when stakeholders of the bank have decided to establish an Islamic window, senior management across the bank needs to take ownership to deliver the model successfully. This means that the approved strategy for the Islamic window must be layered with key initiatives underpinned by well defined objectives which should be modeled to target a certain market share in the segments it would like to penetrate against measurable revenues/expenses expectations. The success of the 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 needs to have well defined processes duly supported by all the functionalities under 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 will be responsible for the overall Islamic window initiative and who should be the focal point to drive the Islamic window strategy and objectives across the bank. Ideally, the person should have a number of years of Islamic banking experience, and above all should have the passion to do the right thing without sacrificing Shari'a governance and compliance principles and practices. The head of the Islamic window should be the key spokesperson for the 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 managers in areas such as retail, corporate, treasury, trade finance, investments, operations, audit, etc., who have dual reporting lines – one to the head of the Islamic banking window and the other to the group head. The role of the business manager is to ensure that annual targets are assigned to the team, reporting and monitoring performance, and essentially act as a liaison between the centralized Shari'a governance unit and the product managers. The head of the Islamic window should have clear and measurable targets. Lastly, it is critical that the head of Islamic banking directly reports to the CEO of the bank and should be part of the executive committee. The Islamic window needs to get the same respect as other businesses within the bank. The critical success factors are the empowerment of the head of the 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. Shari'a Supervisory Board

Fully functional SSBs consisting of reputable and experienced Shari'a scholars is an integral part of any Islamic financial intermediary including the Islamic window. There needs to be a minimum of three Shari'a scholars with one being the Chairman. The SSB should be independent and act as a consultative advisory body which approves all products and services, issue fatwas, approve financial statements of the Islamic window, etc. It is preferred that at least one if not all of the Shari'a scholars are locally based. The SSB function is to support the Islamic window and provide Shari'a guidelines. An independent SSB generates greater popular respect. A bank should consider using them beyond simply as a conduit for products and documents approval or for issuance of 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 Islamic banking activities, training and certification, etc.

4. Secretary to SSB

This critical function 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, relay SSB guidelines to the bank, etc. The Secretary should preferably be a relatively young Shari'a 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 Shari'a related and all other standardized Islamic banking documentation, in-charge of Shari'a compliance across the bank, assisting the various units on any Shari'a related issues of transactions, etc. There have been criticisms that most innovation in products services in Islamic banking has 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 interacts 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. Shari'a Governance, Compliance and Audit

The basic Islamic window model hinges strongly upon the level of Shari'a governance, Shari'a compliance and Shari'a audit. Once the Islamic window establishes the SSB with a clear charter, contractual arrangement and ultimate authority, Shari'a governance, compliance and audit functions need to be established. As most of the time, the SSB may not be easily accessible, or located in a different place, the Secretary to the SSB should also double-up and head the Shari'a governance and 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 ensure proper implementation of Shari'a approvals and the fatwa, Shari'a compliance and Shari'a audit play a critical role. Non-compliance on any approval or fatwa may make the underlying transaction non-compliant and in the worst case scenario, any resultant income derived from the non-compliant activity will have to be given away to charity. Shari'a compliance and Shari'a audit are two independent functions. Shari'a compliance related to independent spot checking of business, operations, staff's familiarity of Shari'a requirements on different products and services processes, etc. Shari'a compliance is the control structure necessary to ensure that nothing slips between audits which may be more time related and cyclical. The Shari'a compliance role is to ensure that while the products and services, as well as the underlying documents, are approved by SSB, there should not be any Shari'a repugnant activities and businesses included in the Islamic banking fabric due to ignorance, the chance of which is greater in a Islamic window than a standalone Islamic bank. Shari'a audit needs to reflect the standards issued by AAOIFI and IFSB. Ideally, the Islamic window should establish an independent Shari'a audit red flags manual and train the existing internal audit department of the bank. Any Shari'a related matters and red flags should be disclosed to the Shari'a auditor who should be able to seek a solution or action as deemed fit and can further refer the matter to the Shari'a governance unit.

6. Human Resource Planning and Training

The most critical resource in Islamic banking today is human capital. While it is difficult to find experienced Islamic bankers for the various functionalities, there are basic Islamic banking courses available which provide certifications and have been approved by various Shari'a 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 stand alone operation and will depend on conventional banking personnel to assist in successful delivery of 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 Shari'a topics and specific product training will be necessary. The basic training on Islamic principles and contracts should be ideally set upon an 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 needs to make sure that their staff are specifically trained to competently deliver; for example, a product manager in retail should know how murabaha and wakala structures works and how Profit Management System, Profit Equalization Reserves, etc. need to function with or without automated systems.

7. Products and Services

An ideal Islamic window should have the capability to replicate all existing conventional products and services (subject to SSB approval) into the Islamic framework from retail to wholesale banking. Product managers on the conventional side should work hand-in-hand with the Islamic structuring team to create Islamic products and services. Otherwise, the Islamic window should hire a core product development team to make all Islamic products and services available to the bank. The key here is to make sure that while Islamic structures typically makes legal and procedural documentation slightly lengthier and cumbersome, the process, the delivery channels and serviceability should match conventional products and services. It should also be possible to buy the 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 products and services whether through a pure 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 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 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 unit, Shari'a, 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 a third party vendor. In an organized institution, product development itself is a disciplined approach which is systematic and the methodology is captured in a product development manual. The principle that the Islamic window needs to follow is that all Islamic products and services are governed under the same risk guidelines as conventional products, follows same if not similar processing channels, has same levels of quality, similar presale and post sales servicing in addition to having price and cost the same if not better. In other words, Islamic products and 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 products, and if such conventional product is parameterized under a product program then the Islamic product should be identical with relevant Shari'a compliant factors built in. It is preferable to have a common product program which clearly segregates the process or methodology for both while maintaining common factors. Whatever the product and service offering may be, it 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 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, structuring guidelines, gets product approval, provides legal documentation, working process mapping and charting and training, it is the bank's operations department which will write the standard operating procedures (SOP) for the Islamic window. The financial affairs or accounting units of the bank will codify the entries, create general and product specific ledgers as advised by the product managers including the permissions and prohibitions under different Islamic structures used to put together the product or service. Ultimately, everything boils down to the IT system which needs to be flexible to absorb the changes required to run Islamic products and services. There are independent standalone Islamic banking software available in the market but the question remains: does the existing system interact with any new systems or modules? 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 systems may not be the most economical way for the Islamic window. Hence, back office activities includes very complex, interlinked and interdependent set of activities from one unit to another and Islamic products and services need to follow the conventional alternative in terms of perfect alignment so as to have the same turnaround time, delivery mechanisms, service quality both pre and post sales. Every aspect of the enabler roles and function will need to be checked for acceptability under Shari'a compliance mechanisms. As highlighted above, basic Islamic banking training across the board will assist the bank in rolling out a balanced portfolio of Islamic products and services.

10. Comingling of Funds

What differentiates a true Shari'a compliant 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 Shari'a compliant products and services which are not truly segregated within the balance sheet and income statement of the conventional bank. As the concept of the Islamic window is catching on and more conventional banks are opting to take this route, SSBs as well as regulators are imposing some mandatory actions which include segregation of customer accounts between Islamic and conventional. Moreover, SSBs require that the Islamic window is treated as a virtual bank within the 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 keeps 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 centre within the main funding centre of the bank which 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 of marketing strategy, whether "push" or "pull", will need to be deployed. All financial institutions have well defined costing methodologies 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 or service plays a more critical role in the 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 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 the Islamic window without matching incremental expenses. The idea is to scale-up productivity without scaling up the same level of direct costs associated with selling. A robust cost allocation methodology tied with specific service level agreements with adequate turnaround time will only have better operational efficiencies and enhance customer service. Islamic banks are known to have higher operational costs which emanates from having no or little control on the cost allocation model, which is one major benefit Islamic windows can have over fully-fledged 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 mechanisms that takes into account liquidity premium and risk premium. Having an efficient transfer pricing mechanism means that the funding centre which handles conventional funding should also be responsible for the Islamic fund and should keep checks and control on the 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 prefer any lending to be funded by Islamic liabilities and capital. Segregation of Islamic books with the conventional books across assets, liabilities, revenues, expenses, etc., means that the Islamic window should also have its own distinct deposit mobilization strategy. For the retail segment, the Islamic window has a variety of instruments from current accounts, savings accounts, fixed deposits, etc., based on qard hasan, mudaraba, non-discretionary wakala, etc., where it can attract liquidity from the market. From corporate segments 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 centre so that they can line-up overnight to near term liquidity on Islamic contracts from other funding sources. If there was one critical success factor for an Islamic window then it is the ability to mobilize deposits to fund Islamic assets. The emphasis being to maintain a healthy asset to deposit ratio of less than 100% at all times. There is no correct mix 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 also directly links with asset liability management and duration mismatch which should be also considered by the asset liability committee of the conventional bank.

14. Accounting and Financial Reporting

Shari'a requirements vary from one window to another. Commonly management reports are kept segregated for Shari'a purposes yet consolidated from filing and reporting perspectives. In case the SSB has been able to enforce strict compliance with its fatwas then the 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 systems for those customers who use both types of banking channels. This also means that 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 the mudaraba structure, which essentially requires Profit Management System ("PMS") and the creation of Profit Equalization Reserves ("PER"). PMS essentially assists the Islamic windows to pool its saving and time deposits mobilized under the mudaraba structure. It requires periodic closure of books, which is usually done on a quarterly 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 form a PER to create a reserve for equalizing any shortfall in profit in future periods. Charity processes 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 various types of Islamic structures bank uses for its products. For example, ready to live-in home financing is different compared to under development homes. Similarly, while home financing under ijara can be easily booked as a term loan, the delay payment, payment of insurance, major maintenance, etc., are treated differently under Shari'a as compared to say the home mortgage product under conventional banking.

15. Branding and Premises

The Islamic window needs to make sure that the level of service quality is either at par or better than the conventional bank to really make the difference. While branding, marketing and aesthetically pleasing premises may bring the customers in for the first time, poor quality of service will not produce any repeat business. One needs to develop a two pronged approach to these critical elements while maintaining a good balance between the effectiveness and efficiency paradigm. One does not need to go on a spending spree with roadside flags, billboards, banners, newspaper clips, radio and television coverage, 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, SSBs 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 lever 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 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: (1) they set up their own dedicated sales and relationship teams to market Islamic products and services eventually competing with the bigger bank hence the conflict; and/or (2) where the bank decides to use the existing conventional sales and relationship teams to sell Islamic products and services, they do not take this initiative seriously at all. Both strategies are incorrect. The better model is for the Islamic window to use a combination of dedicated experts and existing sales and 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 relationships. Otherwise, they should have "originators" or "hunters" where the target is to get new-to-bank customers.

17. Hunters and Harvesters

With the dual reporting matrix in place, targets and budgets jointly made between the head of Islamic banking and different business heads, the real test of the model will be in its execution. At the retail level, training needs to be imparted to the retail team through a system where they need to understand the differentiating factors between conventional and Islamic products. The key to this training is to make sure that the sales team 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 standards are the same even with slightly lengthier documentation processes. A preferred retail model should have totally segregated Islamic branches where no conventional products and services are offered. This means dedicated Islamic branches sell products and services of the Islamic window. It may be costly but will create better market perception and customer loyalty. At the wholesale banking level, the 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-fledged Islamic banks rather than an Islamic window unless they have become disenchanted with the fully-fledged Islamic bank for some reason and are looking for alternatives. It has been seen that at the 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 as SMEs 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 indicators (KPI) and management by objectives (MBO). For large ticket customers including corporate, financial institutions and sovereign entities, a team of specialist Islamic banking professionals needs to be available as product specialists within the Islamic window or embedded in the business group based on the level of sophistication and segregation by business type within the conventional bank.

18. Retail Offering

Islamic retail offerings 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 is no perfect way. Learning from the example of a few jurisdictions where IBF has taken root, it is evident that the ultimate way to offer retail services is to have independent Islamic retail branches which have no linkage to conventional branches other than perhaps common reporting lines. Offering conventional and Islamic products and services from the same platform has had a mixed record. In the long run, it dilutes the Islamic offering. Also, sales personnel may not be familiar with Islamic products, hindering their sales strategy. The view of the SSB and the regulator becomes 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 Shari'a 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 sell Islamic retail products. In the end, the bottom line is the impression of the customers on the purity of the offering.

19. Wholesale Offering

The Islamic window will also need a structured finance team, to work with clients in treasury, debt capital markets, syndication, etc. This is required especially when any of the existing clients of the banks opt for Islamic solutions. Unless the existing bank has this expertise and product range, the bank stands to lose its customer to fully-fledged Islamic banks or another competing Islamic window. Thus, Islamic windows should start with a dedicated team of originators, hunters and harvesters. With increasing interest in product suites by the wholesale customer, it is ideal to embed Islamic experts in key functionalities such as treasury, syndication, debt capital market, etc. However, a core Islamic structured finance team needs to be within the Islamic window to support everything else that requires attention, e.g., 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 reports 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 opportunities to bring in the Islamic experts as required. This will only work when Islamic targets are agreed to amongst 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 the Islamic window is based on how the business groups in the conventional bank treat the Islamic initiative itself. If it is perceived to be competing with an existing conventional bank then it is bound to fall flat merely because conventional practice has an established line of business with a strong customer base, performance track record and resources whereas the Islamic window will be very new with teething issues. The only way the Islamic window is bound to succeed is when the entire bank wholeheartedly accepts the window as (1) an added value tool (2) an alternate channel to deliver products and services (3) a mechanism to retain existing customers, 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 figure head with a core team that has full responsibility to ensure the initiatives succeeds 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 is a 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 businesses 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 existing customers are availing Islamic facilities from another institution, the Islamic window needs to formulate a strategy to target this segment.

22. Technology and System

Having a right IT platform, Shari'a 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, 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 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, approved by the SSB, and could also be presented to the regulatory examiner. One way of developing a Shari'a compliant system is to work with the 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 which can be fully integrated with the existing core banking system. A customer interface is 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 institution, and this is also valid for the Islamic window model. On-line banking systems should allow customers to enquire, transact, instruct and get reports of their activities at all levels in addition to 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 a customer profitability report. The idea being that all hard income from Islamic businesses should be booked in one consolidated book.

23. Credit Policies, Risk Management and Legal

There is no difference in credit risk between Islamic banks and conventional banks, at least in practice. The key differentiation is in the structuring of an Islamic transaction. Structuring is an added layer for the Islamic mode of financing using either the pass through or pay through structure and bifurcating the transaction as either asset backed or asset based. So long as the current practice continues, the Islamic window also needs to adopt best practices from its conventional parent bank to ensure that all its structures fall into the same credit risk policy whether retail or wholesale and are also approved by risk management department. With this in mind, standardization needs 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 are not embedded within the business segment there will always be infighting for risk allocation for the 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 segment, should 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 is no regulatory oversight or guidelines, it becomes quite critical that the 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. As it has been discussed in the previous sections, the Islamic window can take any shape, and for most conventional players 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 jurisdictions both the regulators as well as the financial institutions both have limited experience and the learning curve may be limited. Hence the expertise of a team in a conventional bank in setting up the Islamic window plays a critical role

25. Transparency and Disclosure

To gain market confidence, the Islamic window must be more transparent and have a better disclosure policy as compared to mainstream Islamic banks. In this regard, customer education is one of the key tools, and there is nothing better than clearly documented products and services with detailed yet simplified features explained in the website of the Islamic window. This also includes publicising the Shari'a fatwas in dual languages (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 for the users. In addition to fatwas, it is always helpful to list a glossary of terms the Islamic window uses as well as the FAQs for each and every product no matter how simple they may be.