

Requirements to Be Fulfilled When Conventional Banks Set Up Islamic Banks, Windows, or Funds

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ABSTRACT

Many conventional banks and financial institutions are increasingly becoming interested in Islamic finance and investment. How can these conventional banks and institutions enter this market? Is it possible or not? This paper is an initial attempt to lay down the conditions necessary for conventional institutions to comply with and implement when doing so. The most important of these required conditions are: complete segregation of funds; the existence of a *sharīʿa* supervisory board; management committed to Islamic financial concepts; safeguarding Muslim investors' funds from negligence, trespass, and fraud; and compliance with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

I. INTRODUCTION

This is a modest contributory note that sets out the most important conditions to be fulfilled when conventional banks and financial institutions, the Articles of Association of which do not comply with the tenets of Islamic law (the *sharīʿa*), set up any Islamic bank, window, or fund. The importance of this issue cannot be overstated, particularly in view of the wide spread of this trend, over the past few years, and the oft-repeated claims by many parties that their transactions and dealings fully comply with the provisions of the *sharīʿa*. When subjected to scrutiny and examination, this proves otherwise. Little or no research appears to have been conducted on this matter, and therefore this note is a beginning toward this end. It is hoped that specialist research and studies by scholars and academics will follow, for this author is no more than a parasite eating at their banquets.

II. FORMS OF COLLABORATION AND THEIR PERMISSIBILITY

Before delving into the details of these requirements, we have to note that cooperation and overlap between Islamic and conventional financial institutions in managing investments has taken several forms. These include the following:

1. An Islamic financial institution (IFI) offers an investment portfolio, backed by its *sharīʿa* expertise, but vests management of this portfolio in an external investment manager who undertakes to comply with the IFI's conditions and applies the criteria and standards laid down by the IFI when managing investment. This is permissible under the *sharīʿa* if the investment manager complies with the Islamic conditions and his or her success has been proven in more than one instance.
2. A conventional financial institution or bank sells and markets an Islamic product, introduced and planned by an IFI through its *sharīʿa* expertise. This is also sanctioned by the *sharīʿa* if it has been proved successful in more than one practical example.
3. Alternatively, a conventional financial institution or bank opens an "Islamic window" on its premises, introduces an investment product marketed as "Islamic," such as a fund, or sets up a private Islamic bank or company. This is the subject of the present discussion.

Some scholars believe that this is not permissible, because conventional financial institutions do not comply, in the first place, with the *sharīʿa* in terms of their incorporation and statutes. If they do not comply with Islamic law in their basic charters, how can they claim to comply with it in their funds, branches, or windows?

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In addition, the funds of these conventional financial institutions are drawn from prohibited earnings, so how can they invest unlawful funds in Islamic products? The rationale cited by scholars is that these financial institutions or banks are only intent on exploiting practicing Muslim investors and on unfairly competing with Islamic financial institutions.

On the other hand, there is a group of contemporary scholars who permit this type of investment product as long as the *sharīʿa* conditions laid down for them are satisfied. They argue that dealing, in compliance with the teachings of the *sharīʿa*, in transactions and their Islamically sound contracts is not confined to a certain group of people. In this view, it is permissible—indeed incumbent—upon whomver can conduct dealings in accordance with the provisions of the *sharīʿa* to do so. If it is impossible to do so in all contracts, at least one should start with those that are possible. In response to the argument that the source of these funds is unlawful earnings, one may reply that there is nothing to prevent such funds from being purified, cleansed, and subsequently directed to lawful and permissible channels. Jurists say that it is permissible to deal with commingled (mixed) funds—funds that are not purely lawful funds, but rather are mixed, containing both lawful and unlawful money. This is as stated by Ibn Taymiyyah, in his *Collection of Fatāwā*, and by other eminent scholars.

Moreover, the claim that traditional financial institutions desire to unfairly compete with Islamic financial institutions can be refuted by saying that competition is always in favor of the most suitable, efficient, and fittest. This kind of competition may prompt Islamic financial institutions to exercise more diligence and care to introduce better quality products and conduct their activities more efficiently. This is in fact evident in many nations in which competition exists.

On the other hand, conventional financial institutions may gradually convert into full-fledged IFIs if they find this viable and if they have acquired adequate practical experience and *sharīʿa* practices in this field. There are practical examples to substantiate this argument.

Among scholars and jurists who hold this view are Yusuf Al Qaradawi, Abdul-Sattar Abu Ghuddah, M. Taqi Usmani, Nazih Hammad, Abdullah Al Muslih, and Abdullah bin Sulaiman Al Manea. Economists who also espouse this view include M. Ali Elgari and Monzer Kahf. They all concur that the required conditions, outlined below, necessitate strict compliance.

III. REQUIRED CONDITIONS

The most important of these required conditions are: complete segregation of funds; existence of a *sharīʿa* supervisory board; management that is committed to Islamic financial concepts; safeguarding of Muslim investors' funds from negligence, trespass, and fraud; and compliance with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

A. Complete Segregation of Funds

The funds of the Islamic investment product and those of the financial institution in which *sharīʿa* provisions are not observed must be completely segregated. The funds of investors who are very diligent and anxious to earn lawful income should not be commingled with those of conventional investors who are not observant of the *sharīʿa*. Therefore, there should be separate accounts, books, and computer programs evidencing this complete segregation of funds. This matter is not difficult or problematic in view of the availability of modern computer systems, assuming that intentions are sincere and the required expertise is available. This compliance should be enshrined and expressly stated in the statutes or the prospectus.

B. *Sharīʿa* Supervisory Board

There should be a *sharīʿa* supervisory board for any institutional Islamic investment body, and that Board should consist of trustworthy scholars who are highly qualified to issue *fatāwā* (religious rulings) on financial transactions. In addition, they ought to have considerable experience with knowledge of modern dealings and transactions. The Articles of Association, prospectuses, or statutes (depending on the type of activity) should provide for the existence of a *sharīʿa* board, whose *fatāwā* and resolutions should be binding upon the financial institution's management. It should be independent and free to give opinions on proposed contracts and transactions. The role of the *sharīʿa* supervisory board should be concurrent with that of the financial institution itself in the sense that it should be formed from the moment the financial institution is incorporated, and that it should provide continued supervision and permanent checking of contracts, transactions, and procedures. This should be expressly provided for in the Articles of Association or the prospectus.

C. Managerial Commitment

The financial institution's management, which is undertaking such business activities, should be fully convinced of the concept and fully committed and dedicated to it. It should be anxious to implement it and comply with the teachings governing it. Unless the entire management is committed and convinced, the business activities and the enterprise will not be foul free or will not escape irregularities and deviation. Regardless of how strict and stringent *fatāwā* and contracts are, this will not ensure sound practices if there is no one sufficiently sincere and committed to implement the principles. However, there is no harm in starting first with the executive senior management, which implement resolutions and subsequently trains the other members of the administrative team. The general manager himself should act as a springboard and set a good example for all in this respect.

D. Safeguarding Muslim Investors' Funds

It is an established principle in Islamic law that the *mudārib* does not guarantee the *mudāraba* capital for the capital provider. Hence, investment accounts in Islamic financial institutions are not guaranteed by the *mudārib*. However, this does not prevent the laying down of a stipulation requiring that the parent conventional financial institution (the original company) guarantee Muslim investors' funds against trespass, negligence, and fraud. Major financial institutions may sometimes shirk their responsibility in this connection by claiming that their Islamic windows, branches, or sections are privately incorporated, among other reasons and excuses. This is wholly unacceptable. Precautions should be taken to guard against this, and a similar policy should be expressly stated in the Articles of Association or the prospectus of the financial institution.

E. Compliance with AAOIFI Standards

The Accounting and Auditing Organization for Islamic Financial Institutions has issued and published a number of accounting and auditing standards that all Islamic financial institutions should comply with and implement. The AAOIFI's activities are considered a fundamental groundwork that underpins Islamic banking activities by keeping them away from individual, personal reasoning. The collective personal reasoning (*ijtihad*) of the AAOIFI is highly important in this vital aspect of Islamic economic life. Therefore, these standards deserve strict adherence. A number of government authorities and central banks in certain countries have circulated these standards and obliged other financial institutions to comply with them. That is why any party wishing to incorporate or set up an Islamic financial institution should be required to conform to these standards in order to avoid confusion, misunderstanding, and ambiguity, and to seek clarity and sound business activities.

IV. CONCLUSION

Islamic investment, with its governing *sharī'a* rulings and provisions, is an open area for all those wishing to give it a try, provided that they approach it from its front door. They ought to comply with its provisions and honestly deal with people in their communications and transactions. For those who are intent on fraud, cheating, and misleading, all that can be said is that "he who cheats us is not one from us."