

Appendices

Appendix 1

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Appendix 2

Case Study: Conversion of a Commercial Bank to Islamic Banking

Roderick Millar

Kuwait International Bank (KIB) was established in 1973 and ran a successful network of retail and commercial banking operations across Kuwait. In 2004, it took the decision to convert its operations from conventional to Shari'a based offering.

This conversion to a full Islamic finance banking operation was bold, but also timely. Islamic banking was still a small part of the banking sector, even in the Gulf region in the early years of the 21st century, but it was developing fast and the indications were that it would become a vital growth sector in the years ahead. Clearly to convert to a fully approved Islamic banking structure posed a large number of challenges. From the marketing side, there was the task of informing the customer base of the change and educating them as to its implications; on the organizational side, KIB needed to fully appraise its processes to assess what areas were no longer necessary and what new operational structures needed to be created; on the regulatory side the new Islamic banking system would have to be approved by the Central Bank of Kuwait; but the largest challenge was on the technical side – not only would an entirely new suite of Islamic banking software be needed to run the new Shari'a products, but all the existing customer data needed to be cleansed and transferred across to this software in a seamless operation.

KIB needed to find somebody that could implement this complex transition, who had experience at this level of Islamic banking technical implementation and who could do so in a short period of time. This problem was made more difficult because in 2004, few banks had made the conversion from conventional to Islamic banking operations, so the pool of potential expertise was limited.

KIB formed an executive committee to search for a supplier to lead the conversion project. The committee, assisted by a core of primary users from critical departments within the bank, drew up a schedule of requirements they wanted addressed by the candidate companies. KPMG was also engaged

to identify the lead global suppliers and to help build the short-list of “must have” product requirements. They sent out requests for proposals in April 2004 to leading technology companies in the sector, and soon short-listed this to three potential candidate companies.

International Turnkey Systems (ITS) was selected for a number of reasons. As Lamy Al-Tabtebai, (the executive manager of the IT Department) notes:

“Primarily, ITS were one of the very few companies in 2004 that had a proven solution available and their people already had sophisticated knowledge of Islamic banking products and the technology structures required to service them. In addition, ITS was locally based and local expertise was going to be of critical importance as the project developed and evolved.”

At this stage, KIB’s own knowledge of the intricacies of Islamic banking was at a preliminary stage, and having a partner already familiar with the its complexities and implementation was of enormous value. KIB had not identified all their Islamic banking products by the time ITS was engaged in July 2004, so their new lead technology partner was able to input its knowledge and expertise to help close some of these gaps at an early stage.

While any project of this level of complexity needs to have some room to evolve as it goes forward, KIB had stipulated that the first phase of creating and installing the Core Banking System, that is the plain vanilla hardware and software frameworks, must be completed in six months. ITS was happy to take on the challenge and KIB accepted their recommendation of types of servers and other technical hardware issues.

The process was assisted by KIB deciding that their hardware should be upgraded at this time as well. This enabled the new system to be installed in parallel with the existing conventional system. However, new challenges were present; despite ITS’s expertise in the sector and their being located in Kuwait, they had not actually done such a project in the country before, so they needed to develop systems to meet the local regulatory requirements. This, while not unduly complicated, required working with and understanding the specific Kuwait regulatory regime and adapting it to their products and obviously was an additional job to complete within the target six-month schedule.

Although ITS had accepted the six-month implementation challenge on the understanding that only a “plain vanilla” version of the IT would be installed, clearly customization was required to fulfil the local regulations.

By April 2005, the first phase was fully installed and a parallel Islamic banking system was running at KIB. The Central Bank of Kuwait does not allow a bank to operate both a conventional and Islamic system simultaneously, and were to take several months to approve the new Islamic banking framework at KIB. This gave KIB and ITS some time to test the system and train the employees to use it and familiarise themselves with it. Crucially it also enabled them to identify gaps and bugs in the system.

This second phase saw ITS working very closely with KIB as they prioritized the enhancements and improvements needed, and implemented the critical “showstoppers” and regulatory issues first. These modifications were followed by further enhancements that were implemented in batches, again according to their priority level, customer service functions first, then internal “must haves”. This process of core functional service being installed first and then additional layers of enhancement and development being added in phases afterwards worked effectively.

The final regulatory approval procedure was delayed, which pushed back the actual change-over day to July 2007. This provided further opportunities to introduce new Islamic banking products that had not existed when the project first began (such as deposits with profits, which were enabled in early 2007) and allowed monthly rehearsals, increasingly involving real customers as they neared change-over day, to be run before the system went live.

Sunday 1 July, 2007, the conversion day, was unsurprisingly extremely successful with no difficulties experienced. The relationship between ITS and KIB continues with new products and service improvements being implemented on an on-going basis in the main areas of retail, commercial and trade finance.

Appendix 3

Glossary of Islamic Finance Terms

Al-ajr

A commission, fees or wages levied for services.

Al-rahn al

An arrangement where an asset is used as collateral for a debt, similar to pawn broking. In default, the asset can be sold to repay the debt.

Al-wadia

Resale of goods at a discount to the original cost.

Al-wakala

Absolute power of attorney.

Amana

Reliability or trustworthiness, an important value of Islamic society in mutual dealings. It also refers to deposits in trust. A person may hold property in trust for another, sometimes by implication of a contract.

Aql

Intellectual reasoning, one of the sources of Shari'a rulings (see also: *ijtihad*)

Arboon

See *bai al-arboon*.

Awqaf

See *waqf*.

Bai al-arboon

A form of sales contract similar to an option, where only a small portion of the price is paid. The buyer will then hold an option for a specific length of time (days or months, but not more than one year) to either go through with the purchase or cancel the contract. If the buyer decides to go through with

the purchase, he will then have to pay the rest of the price. If the buyer decides to walk out, then the portion of the price that has been paid is retained by the seller.

Bai al-dayn

Debt financing – the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. *Bai al-dayn* is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from *bona fide* commercial transactions can be traded.

Bai al-inah

A sale by one party at a higher price on deferred payment, and they then buy back at a lower price to realize immediate cash for the other party. This structure is normally practiced in Malaysia, but is questionable in some other Islamic finance markets, such as the Gulf Cooperation Council and South East Asia, as they consider it contrary to the Shari'a rulings.

Bai al-muajjal

Deferred payment contract, where the bank /lender buys the assets on behalf of the business owner. The bank then sells the assets to the client at an agreed price, which will include a mark-up as the bank needs to make a profit. The business owner can pay the total balance at an agreed future date or pay by instalments over a pre-agreed period. This is similar to a *murabaha* contract since it is also a credit sale.

Bai al-muzayadah

Sale by auction. Other names for this principle used by past Islamic jurists include *bai al-fuqara*, *bai al-man kasadat bidha'atuhu*, *bai al-mahawij*, and *bai al-mafalis*.

Bai al-salam

This term refers to advance payment for goods which are to be delivered later. Normally, no sale can be affected unless the goods are in existence at the time of the bargain. But this type of sale forms an exception to the general rule, provided the goods are defined and the date of delivery is fixed. One of the conditions of this type of contract is advance payment; the parties cannot reserve their option of rescinding it but the option of revoking it on account of a defect in the subject matter is allowed. It is usually applied in the agricultural sector where the bank advances money for various inputs to receive a share in the crop, which the bank sells in the market.

Bai bithaman ajil

This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the client are bought by the bank, which subsequently sells the goods to the client an agreed price that includes the

bank's mark-up (profit). The client may be allowed to settle payment by instalments within a pre-agreed period, or in a lump sum. Similar to a *murabaha* contract, but with payment on a deferred basis.

Baitul mal

Treasury

Fatwa

A religious opinion or decree, which can be either positive or negative.

Fiqh

Islamic jurisprudence, the science of the Shari'a. It is an important source of Islamic economics.

Fiqh al-muamalat

Rulings on transactions specific to commerce and finance.

Gharar

Uncertainty, hazard, chance or risk. Technically, the sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not. There are several types of *gharar*, all of which are *haram*. The word *gharar* denotes deception. *Bai al-gharar* is an exchange in which there is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods. *Bai al-gharar* is an exchange in which one or both parties stand to be deceived through ignorance of an essential element of exchange. Gambling is a form of *gharar* because the gambler is ignorant of the result of his gamble.

Halal

That which is permissible. In Islam, there are activities, professions, contracts and transactions which are explicitly prohibited (*haram*). Barring them, all other activities, professions, contracts, and transactions etc. are *halal*.

Haram

Unlawful.

Hawala

Bill of exchange, promissory note, cheque or draft.

Ijara

Leasing, where the bank or financier buys and leases equipment or other assets to the business owner for a fee. The duration of the lease as well as the fee are set in advance. The bank remains the owner of the assets. The

benefit and cost of the each party are to be clearly spelled out in the contract so that any ambiguity (*gharar*) may be avoided.

Ijara wa iqtina

Lease to purchase, where the lender finances an asset against an agreed rental together with an undertaking from the client to purchase the equipment or the facility. The rental as well as the purchase price is fixed in such a manner that the bank gets back its principal sum along with some profit which is usually determined in advance.

Ijma

Shari'a rulings derived from consensus.

Ijtihad

Shari'a rulings and concepts derived from critical thinking (see also: *aql*).

Ikhtilat

Combining of invested capital in a partnership into one single amount, so that individual contributions cannot be identified.

Istisna'a

Progressive financing – a contract where goods are purchased in part progressively in accordance with the progress of a job. This type of financing, along with *bai al-salam* are used as purchasing mechanisms, and *murabaha* and *bai al-muajjal* are for financing sales.

Ju'ala

Stipulated price for performing a service, technically applied in the model of Islamic banking by some. Bank charges and commission have been interpreted to be *ju'ala* by jurists and thus considered lawful.

Juzaf

Goods sold in bulk.

Mal

Wealth.

Maqasa

Clearance of mutual debts.

Maslaha

Public interest, social welfare – a condition of society that Shari'a is committed to protect and maintain.

Mu'amala(t)

Economic transaction(s).

Mudaraba

Trust financing, a business contract in which one party brings capital and the other effort. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour (see also: *rabb al-maal*).

Mudariib

The manager of the investment in a *mudaraba* contract – the entrepreneur rather than the investor.

Murabaha

Cost-plus financing – technically a contract of sale in which the seller declares his cost and profit, and the client asks the lender to purchase a specific asset for them. The lender does this for a defined amount over the cost of the asset, which is agreed in advance.

Musharaka

Similar to venture capital – *musharaka* is a technique of financing partnership, where two or more financiers provide finance for a project. Profits are shared in a mutually agreed ratio; however, the losses, if any, are to be shared exactly in the proportion of capital proportion.

Diminishing musharaka – permits equity participation and sharing of profit on a *pro rata* basis, but also allows a method through which the bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset on of the participants. *Musharaka* form of financing is being increasingly used by the Islamic banks to finance domestic trade, imports and to issue letters of credit.

Permanent musharaka – where an Islamic bank participates in the equity of a project and receives a share of profit on a *pro rata* basis. The period of contract is not specified. This technique is suitable for financing projects on a longer term, where funds are committed over a long period and gestation period of the project may also be protracted.

Muthman

Subject of a sale.

Qard

A loan. Shari'a practice is that loans should be made free of charge (ie with no interest payable).

Qard al-hasan

Interest free loans. Islamic banks normally provide interest free loans to their customers. If this practice is not possible on a significant scale, even then, it is adopted at least to cover some needy people.

Qimar

Similar to gambling, technically an agreement in which possession of a property is contingent upon the occurrence of an uncertain event. By implication, it applies to those agreements in which there is a definite loss for one party and definite gain for the other, without specifying which party will gain and which party will lose.

Qist

Fair dealing.

Qiyas

Analogous reasoning – a source for Shari’a rulings, where an existing ruling is extrapolated to a connected (but not explicitly mentioned) action.

Rabb al-maal

In a *mudaraba* contract, the person who invests the capital.

Riba

Interest – one of the three fundamental prohibitions in Islamic finance (the other two being *gharar* and *maysir*). Literally meaning an “increase” or “addition”, technically it denotes any advantage obtained by the lender as a condition of the loan. Any risk-free or “guaranteed” rate of return on a loan or investment is *riba*. *Riba*, in all forms, is prohibited in Islam.

Rukn

Cornerstone of a contract, an essential requirement.

Sadaqa

Charitable giving.

Shari’a

Islamic law derived from three primary sources: the Quran; the *Hadith* (sayings of the Prophet Mohammed); and the *Sunnah* (practice and traditions of the Prophet Mohammed), and three secondary sources: *qiyas* (analogical deductions and reasoning), *ijma* (consensus of Islamic scholars) and *ijtihad* (legal reasoning).

Shari’a Supervisory Board

The committee of Islamic scholars available to an Islamic financial institution for guidance and supervision on religious interpretation and application in the development of Shari’a-compliant products.

Shirka

A contract between two or more persons who launch a business or financial enterprise to make profit. *Shirka* = *musharaka*.

Suftaja

A banking instrument used for the delegation of credit and was used to collect taxes, disburse government dues and transfer funds by merchants. In some cases, *suftajas* were payable at a future fixed date and in other cases they were payable on sight. *Suftaja* is distinct from the modern bill of exchange in some respects. Firstly, a sum of money transferred by *suftaja* had to keep its identity and payment had to be made in the same currency; exchange of currencies could not take place in this case. Secondly, *suftaja* usually involved three persons; A pays a certain sum of money to B for agreeing to give an order to C, to pay back to A. Thirdly, *suftajas* can be endorsed.

Sukuk

Equivalent to an asset-backed fixed income bond. A certificate entitling the holder to the benefits of the income stream of the assets backing the certificate. *Sukuks* can be listed and rated, though this is not necessary, depending on the target investor market. *Sukuks* are typically issued by corporate issuers, and some financial institutions, and also by governments.

Takaful

This is a form of Islamic insurance based on the Quranic principle of *ta'awun* or mutual assistance. It provides mutual protection of assets and property, and offers joint risk sharing in the event of a loss by one of its members. *Takaful* is similar to mutual insurance in that members are the insurers as well as the insured. Conventional insurance is prohibited in Islam because its dealings contain several *haram* elements, including *gharar* and *riba*, as mentioned above.

Tawarruq

Reversed *murabaha*.

Tawliyah

Sale at cost.

Wa'ad

Literally a "promise". In Islamic finance associated with "swaps", a promise agreement with which returns from one basket of assets are swapped with returns from another; controversially, this mechanism is being used to give Shari'a-compliant investors exposure to returns from *haram*, or non-Shari'a compliant, assets.

Wadiyah

Safekeeping, in which the bank is deemed as a keeper and trustee of funds.

Wakala

An agency contract.

Wakil

An agent or general representative.

Waqf

Similar to placing an asset, particularly property, in trust. Technically, appropriation or tying-up of a property in perpetuity, so that no proprietary rights can be exercised over the usufruct. The *waqf* property can neither be sold nor inherited or donated to anyone. The plural of *waqf* is *awqaf*.

Zakat

Zakat is the third pillar of Islam –a levy on wealth, which is defined by the Quran on all people having wealth above a prescribed level. The levy must be spent on any of eight categories of beneficiaries. The purpose is to redistribute wealth from the wealthy to the needy. The distribution of *zakat* funds has been laid down in the Quran, and is for the poor, the needy, *zakat* collectors, new converts to Islam, travellers in difficulty, captives and debtors, etc. It is payable if the owner is a Muslim and sane. It is an obligatory contribution that every well-off Muslim is required to pay to the Islamic state, in the absence of which individuals are required to distribute the *zakat* among the poor and the needy as prescribed by the Shari'a.