



Paradigm Shift from Conventional to Islamic Banking System: A Case of the Conversion of Taqwa Islamic Banking in Pakistan

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Abstract *The paradigm shift in banking industry from conventional to Islamic system of banking has been evident in previous decade. Conventional institutions are also either setting-up Islamic subsidiaries or converting conventional set-up into Islamic. The bank of Punjab started Taqwa Islamic Banking-(TIB) by converting its 1st branch into Islamic banking in 2012. In 2014, the bank completed one of the largest conversion project by converting 24 conventional into Islamic banking. In this paper, the regulatory guidelines of SBP in respect to conversion is discussed and procedure adopted by the bank of Punjab-TIB- is studied and analyzed. Practical complications and key problems faced by BOP-TIB and its possible solution is also presented. The study will provide a clear view of the conversion and the method adopted by BOP-TIB. The study will further guide institutions intends to adopt conversion of its business from conventional model into Islamic model.*

Introduction

The Islamic Banking industry has developed swiftly in Pakistan reflecting the positive response of masses towards Islamic banking system. This system has been evolved rapidly and had got the momentum resultantly it has got a prestigious position in mainstream financial services industry. In Pakistan, apart from other reasons, the religious attachment of people as well as profitably of Islamic banks are considered behind the prompt development of the Islamic banking sector (State Bank of Pakistan, & Department of International Development, 2014). Keeping in view the tremendous success of Islamic banking, the conventional banking sector

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has also initiated to launch the Islamic nature banking through their pre-existing setup of banking throughout the country (Islamic Banking Department (SBP), 2014).

In continuation, the State Bank of Pakistan (SBP), has also showed interest in Islamic banking system. The SBP has provided opportunities to the key stakeholders to ensure their contribution into this new system through their prevailing structure, which was further converted to full-fledged Islamic bank(s) (Shehzad, 2003). SBP has established a separate Islamic Banking Department in conventional banks to open new branches for Islamic Banking and to convert existing Conventional branches into Islamic (Ullah, 2010).

Furthermore, this paradigm shift of State bank of Pakistan was welcomed overwhelmingly by the majority of conventional banks and first conventional branch of the bank of Khyber was converted into Islamic banking in 2003 (Farooq, 2011). Similarly, in 2012, the bank of Punjab also started conversion procedure for its conventional branches, Faysal bank also applied for whole system to be converted into Islamic banking system (Summit Bank, 2017).

Regulatory Instructions for Conversion

A short and comprehensive criteria for conversion of Conventional Bank into Islamic Bank vide IBD Circular No. 2 of 2010 dated 25 June 2010 was launched by SBP (Ullah, 2010), in which SBP restricted banks to convert branches unless they have already obtained approval of establishment of Islamic Banking department from SBP and have a fair financial reports. Although new license fee is waived-off by SBP for converted branches, however it is advised that the bank shall submit branch conversion plan along with in its annual branch expansion plan to SBP, the conversion plan shall be very comprehensive in nature which shall comprise of the start and completion date of the conversion process, duly approved by the sharia committee of the bank. The conversion plan shall have clear identification of the selected branches along with business plan for the branch. The plan shall also cover the procedure of transfer of conventional liabilities and deposits of customers who are not willing to opt the new system of Islamic banking system. The SBP may give in-principle approval to launch the process of conversion if satisfied by the quality of the submitted plan. After completion of the conversion process the branch shall apply for the Islamic banking license. The bank shall accept deposits on the basis of Islamic sharia after obtaining Islamic Banking License from SBP (Ullah, 2010).

In 2017, SBP further refined the already issued instructions for conversion and issued circular #1 of 2017 regarding conversion of conventional bank into an Islamic bank, these guidelines are very comprehensive in nature. The guideline covers conversion of conventional bank into full-fledge Islamic bank. Similarly, these guidelines covers in detail the process through which the conversion of

conventional banking into Islamic Banking do occurs. These guidelines were also considered as great initiative for the promotion and development of Islamic Banking culture in Pakistan. The annual report of the State Bank of Pakistan has also termed it as a step forward in the existing policy framework (State Bank of Pakistan, 2018).

Introduction of the Bank of Punjab and its Islamic banking:

In 1989 after the approval of the Bank of Punjab Act from the Punjab Assembly, the Bank of Punjab was established and within a short span of five year this bank was given the status of retail bank, presently the bank has 576 branches across the country with 74 Islamic banking offering sharia complaint products and services (BoK, 2018). The Bank of Punjab has formed Islamic banking division in 2012-13 by obtaining Islamic banking license from state bank of Pakistan with the brand name “*Taqwa*” Islamic banking and launched its first Islamic banking branch by converting new garden town Lahore, conventional Banking branch into Islamic banking branch. The bank has submitted its conversion plan of 2013 to SBP and the state bank of Pakistan has granted approval of conversion of 24 conventional Banking into Islamic banking, The bank has started its procedure for conversion and in the same year the conversion of all 24 branches is completed (BOK, n.d).

Presently the Bank of Punjab –TIB- offers wide range of products for on liability side for instance, Basic Banking Accounts, Current Accounts, Profit and Loss Sharing Accounts, Taqwa Rahat Corporate Account, Taqwa Rahat Account and Taqwa Certificate. Current account is offered on the basis of *Qarz-e-Hasana* while all other remunerative accounts are offered on the basis of *Mudaraba*.

On financing side, the bank offers *Murabha*, *Ijara*, Running *Musharaka* and Diminishing *Musharaka* Products. the income earned from the financing is distributed with the *Mudarba* based depositors on pre agreed ratio announced on the website of the bank in the start of each month under the supervision of its esteemed sharia board comprises of prominent sharia scholars namely, Mufti Muammad Zahid being chairman of the board along with Mufti Ijaz samadani and Mufti Rafay Usmani as members of the board respectively (BoK, 2018).

The Conversion Procedures of the Bank of Punjab (Taqwa Banking):

Presently three models are being practiced for the process of conversion from conventional into Sharia compliant Banking in the banking industry of Pakistan:

1st Model

Some of the financial institutions adopted the conversion by parking all the investment in the nearest conventional branch and offer sharia compliant banking

operations in the newly established Islamic Banking Branch. In these scenarios no practical conversion takes place in the branch and the account holders have to open new accounts in the branch. The license of the branch is converted into Islamic (Shehzad, 2003). This model has been successfully implemented by Silk and Summit Banks Limited Pakistan for the conversion of conventional branches (Silk Bank Limited, 2012).

2nd Model

The second model reflects procedures for the conversion of liabilities where the bank authorities are responsible to take consent from the depositor four weeks before the process as per SBP's guidelines (Ullah, 2010). The Bank of Punjab, Taqwa Islamic Banking adopted this model for the process of conversion (BoK, 2013). In case if, the depositor is not willing to switch from conventional to Islamic his deposited will shift to the nearest conventional bank accounts or he may also withdraw his deposit.

3rd Model

In this model, the bank has to convert all its operations from conventional into Islamic banking. The remunerative deposits shall be converted into Mudarba Based deposits, the current account shall be considered Qarz in the Islamic Banking System. The advance or interest based financing shall be converted into Ijara - sale and lease back financing. However, non-performing loans of the branches shall not be converted as per directives of SBP, instead it shall be transferred to the conventional Branch designated by the Bank (Ullah, 2010). Bank of Punjab-Taqwa Islamic Banking adopted the second model of the conversion by converting the deposit system only.

Advantage of conversion and the model adopted by BOP-Taqwa

Retaining Deposits/Account holders:

In conversion, the bank avail the opportunity to retain the deposit of the branch intact with the bank while converting the conventional branch into Islamic banking branch. In case of opening of fresh branch, the bank will have to take fresh start by building a relationship with the local community (Shafi, Shahimi, & Saaid, 2016).

Minimum Hindrance and Complications:

Due to conversion, the bank also avail the opportunity to utilize its already available purposefully build premises, experienced and already hired staff familiar

with the internal environment of the bank for starting its Islamic operations, which make it easier for the management as compare to the launch of fresh branch (Shafi, Shahimi, & Saaid, 2016).

Acceptability under Sharia

The model adopted by the Bank of Punjab-Taqwa- is more acceptable to the sharia guidelines, in this case the previous interest based non sharia compliant relationship of the depositors with the bank is culminated on the conversion date, and a new sharia complaint relationship is started with new agreement of Mudarba without any other agreement. The customer is given his due share in profit or loss in the month end (Fatima, & Khalid, 2015). In the earlier model, in which bank convert interest based advances to sharia compliant modes of financing, the issues of permissibility arise.

Even though sharia scholars are of the opinion that sale and lease back transaction is allowed in case of conversion (Fatima, & Khalid, 2015). However, in that scenario the issue of reputational risk still exist.

Restricted Monitoring:

The conversion model adopted by BOP-Taqwa has advantage of insignificant sharia monitoring with lessor expenses as compare to the other models which requires extensive monitoring, in this model the sharia department have to check the premises, advertisements, stationary, Branch income expenses, consent of depositors and training of Staff. In the other model, the sharia department has to monitor all the assets cases as well as letters of guarantee and letters of credit and all agreements of advances (Fatima, & Khalid, 2015). The suitable conversion product for all the cases shall also be developed. Furthermore, execution of the agreements approved for each product designed for particular customer shall also be monitored. Which make the conversion more difficult.

Analysis of Conversion of BOP-TIB

Methodology of the Study:

The practice of conversion and procedural documents along with the plan of the conversion is briefly studied by visiting the head office of the bank, The documents and process have been reviewed closely, The conventional banking converted into Islamic Banking have also been visited numerous times.

Submission of Conversion Plan to SBP by BOP Taqwa:

In 2013, the banking policy and regulations division of SBP received request from

Bank of Punjab –Taqwa Islamic Banking separately, along with a detailed and duly approved shari’ah advisory board for in-principle approval from SBP. This plan was comprised as per following details (Fatima & Khalid, 2015):

- i. The specification of the specific branch of conventional branch;
- ii. A strong justification for the conversion of a conventional branch to Islamic along with the identified reflective business potentials in the serving area of the bank;
- iii. A detailed business plan of at least three years revealing the projected assumptions;
- iv. A strong advertisement and information center to inform all the customers about the bank conversion to Islamic branch;
- v. An authentic process will be ensured through written consent form the customer;
- vi. The method of transferring existing assets and liabilities to nearest conventional setup;
- vii. Staff capacity building to ensure the effective implementation of the Islamic banking system;
- viii. Further to ensure the Shari’ah advisory board compliance of the respective banks;

Analysis of Steps taken by BOP Taqwa for conversion:

While reviewing the documents and visiting the Branches converted by the Bank of Punjab-Taqwa Islamic Bank-The following stepwise procedure was observed as adopted by the bank:

Surrendering License of Conational Banking to the SBP:

While looking into the correspondence with the SBP, is observed that original Conventional Banking License in original along with branch survey report was sent to IBD SBP by the Islamic banking department of the Bank of Punjab-Taqwa Islamic Banking-.

Information of general public

To adhere the advice of SBP IBD about conversion, the bank informed general public regarding conversion by displaying banners mentioning conversion of branch into Islamic Banking outside branch premises at prominent place. In

addition to this, bold notices were also displayed inside branch premises at the entrance door, cash counters and at notice board *taqwa* (Ahmed, & Khan, 2017).

Publication of conversion notice in newspaper

According to the provisions of SBP Circular No. 2 of 2010, bank management will ensure publication of conversion notice / information to customers and general public through newspapers at least 04 weeks before closure of conventional banking branch (conversion date). The News, daily Jang were selected for the publication of conversion notices to depositors and general public by BOP-TIB and notices were published in these daily newspapers (Ullah, 2010).

Consent Letters / Terms & conditions

To obtain customer consent, it is ensured by the bank that branch staff inform and brief branch customers about the conversion and obtain written consent from all existing customers for conversion to Islamic Banking Products and Services through ‘Consent Letter’ on bank’s prescribed format. Along with consent letters, Islamic terms and conditions for account opening forms is also obtained from the customer to be retained at branch including; sample of the same is available of the website of BOP-TIB (BoK, 2013).

The letters of consent were also sent through courier, specifically mentioning date of conversion, along with ‘Islamic Terms and Conditions’ to all branch customers. It is observed that record of this activity is maintained by adopting following method:

- a. Separate dispatch register is maintained to record the dispatch of consent letters.
- b. Courier receipt numbers is mentioned against the name of customer and courier receipts is attached on the relevant pages of the register accordingly.
- c. All returned mails are recorded on the dispatch register in a column against the customer name.

Specimen register maintained by BOP-Taqwa is as follows;

Customer Name	A/c No.	Date of Dispatch	Courier Receipt No.	Date of Receipt of signed letter & terms and conditions	Date of Return (If undelivered)	Date / Courier Receipt No. of Re-sent	Account to be retained / Trf to Conventional Branch	Remarks
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Treatment of Dormant and Foreign Currency Accounts

While analyzing the dormant (IDLE) accounts and foreign currency accounts of IBD-TIB, it is noted that dormant account were re-activated by contacting the account holders. Re-activation request with complete formalities were obtained from customer along with consent letter and acceptance of Islamic terms and conditions. It is witnessed that The profit and loss products of Islamic Banking for foreign currency was not available with the *Taqwa* Islamic Banking, these accounts were not shifted to Islamic banking, however current account holders of foreign currency account were offered conversion of their account and some account holders opted for Islamic banking current account .

Credit Accounts or Account of Advances

As mentioned earlier, *Taqwa* Islamic Bank has adopted conversion of deposits only, the advances and accounts attached with the interest-based advances are transferred to nearest conventional Branch (BoK, 2018). However, some cases of branch employees were not transferred to conventional Branch timely. Even though it was transferred at the later stage.

Promotional Material and Stationary of Islamic and Conventional Banking

State Bank of Pakistan focuses on separation of Islamic and conventional system for this purpose the Bank of Punjab *Taqwa* Islamic Banking also issued notification to the branches to be converted that IBD shall sent requisition for Islamic Banking Stationery for the branch to Stationery Department at least 30 days before the conversion date, mentioning the conversion date. However in some branches were observed that conventional Branch stationary was in use in some branches which is against the advice of the State Bank of Pakistan (BoK, 2018). The Bank intends to convert its branches shall focus on availability of the Islamic Banking stationary and promotional material before conversion. Branch stamps / visiting cards or advertisement material of conventional Banking shall also be discarded to give the Branch a whole new look. For this purpose, Islamic verses regarding Halal Business and against *Riba* may also be displayed on the walls of the branch to reflect Islamic business vision from the environment of the Branch. It is observed that the atmosphere and look of the branch were not so impressive to be considered by Islamic from its appearance. The bank intends to opt for conversion shall also look into this matter.

Staff Training

As per BOP-TIB Manual of Conversion, staff will be provided Islamic Banking Operations Manual for general familiarity with the system. Training Department will also ensure appropriate level training of branch staff well in time before conversion, so the staff may be ready before conversion to satisfy customer queries of both old and perspective customers. Training will comprise of at least 05 days. Credit staff will be educated about Islamic banking products and their mode of operations. The same is also conveyed by the SBP as well (Islamic Banking Department, SBP, 2017).

Key Problems and their Solutions

The conversion of BOP-Taqwa Branches from conventional banking into Islamic Banking is more suitable for the public especially in the environment of Islamic Republic of Pakistan, as it provides an opportunity to the locals to avail Islamic Banking facilities at their door steps. It is also an opportunity for the people who want to avoid interest based banking to have an alternative in banking sector. Similarly, the conversion model adopted by BOP-TIB is beneficial for the banks, as the bank utilizes the already existing staff and premises for new operations and attracts new customers who want to avail Islamic facilities. However, after analyzing the whole process of BOP-TIB it is recommended that the following are may be given more attention in this conversion model in future.

Training of Staff

Normally, in these branches, existing staff has been given the opportunity to serve, and only five days training on Islamic banking have been imparted to the staff of conventional Branch who are not familiar with the Islamic banking, they do not have knowledge about the product and services and the basis of products offered by Islamic banking. During our interaction with the branch employees, it is observed that they lack Islamic banking Training. It is strongly recommended that manager and manager operations of the branch must be given comprehensive training on Islamic Banking to be able to satisfy customers/people of the vicinity and can clear the misconception/doubts about Islamic Banking. Apart from these two office holders, five day training for other Branch staff is sufficient.

Awareness of local community and *Ulamas*

It is observed that the local community, were not aware about the opening of

Islamic banking branch in the vicinity, they do not have education about the products or the advantages of the Islamic banking. The bank also did not take any serious steps to involve the public of the area or the locally available sharia scholar into confidence to educate them about the product or services offered by the Taqwa Islamic Banking. It is recommended that before opening or conversion of conventional Branch, the local elders, businessman's, imam of Masajid and local Muftis shall be invited to the Branch and they may be given a briefing about the products and services of Islamic banking and how it is distinguished from the conventional banking system.

Conversion of Financing Portfolio

As the product of financing for conversion is limited in numbers and that too having some complication in execution, the product development department of the Islamic Banks, The Islamic Banking Department of The State Bank of Pakistan and the Sharia scholars of the industry may work together to design and recommend more Sharia complaint products for the conversion of advances portfolio.

IT Developments

Electronic data processing, and advance system of I.T is a key factor in the present banking practice, without sound IT system for each and every aspect of present day banking the conversion process will always be difficult to execute, it is recommended that advance I.T system with provision of conversion related issues may be developed by the Bank before executing the conversion process to avoid difficulties.

Proper Execution of Plan Submitted to SBP

The execution of proper plan is the key for conversion, the plan submitted to SBP may be very sound on paper however its execution is very important. All the department involves in conversion process, from I.T, Audit, Compliance, Sharia, Media, Treasury to Islamic Banking Department shall be fully prepared for conversion and role of each department shall be distinguished from each other to avoid any mishandling, which may lead to penalty from regulator or may attract reputational loss.

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