

**NATURE AND SCALE OF CONVERSION
 FROM CONVENTIONAL BANKING TO ISLAMIC BANKING IN SELECTED
 ASEAN COUNTRIES:
 RECENT CONVERSION MODELS & MAJOR CHALLENGES¹**

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Abstract

Based on an extensive literature review and discussion with professionals and experts in the field of knowledge, this paper (a portion from the wider coverage thesis) will highlight some challenges faced by the industry players – approaching conversion – focusing on ASEAN countries namely Malaysia, Brunei, Indonesia, Thailand and Philippines, from Shari’ah, regulatory, and corporate perspectives. Conversion from conventional banking to Islamic operation is one of the approaches taken in financial industries in Middle East, South Asia and Asia Pacific since 1990s. Malaysia, Brunei, Indonesia, Thailand and Philippines are among ASEAN countries adopting the same approach. Financial institutions approach conversion in different ways based on their priorities, ecosystem and reasons. This article will cover conversion from regulatory perspectives, Fiqh perspectives and several reported conversion cases in ASEAN. Since there is no “absolute and correct” way of conversion, the industry players, the regulators and academicians will have to appreciate the uniqueness of each conversion exercise from conventional into Islamic operations. The demand for more Islamic financial institutions will provide better services and offer wider coverage based on technology advancement towards digital banking era. Conventional financial institutions focuses on Environmental Sustainable and Governance (ESG) products while Islamic financial institutions highlights the embedded Maqāsid al-Sharī’ah in Islamic Mu‘āmalāt long before United Nation declaration.

Keywords: Conversion models, challenges, ASEAN, conventional banks, and Islamic banks.

Introduction

Islamic banking needs to expand and continue competing with conventional banking for wider reaching. Islamic capital market needs to go face-to-face with Environmental Sustainable and

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Governance (ESG) products before the later takes the lead. Conversion from conventional to Islamic banking is one of the trend and path taken in some jurisdiction towards more *Sharī'ah* compliant services, meeting the regulatory requirement, and satisfying stakeholders' needs as well as commercial expansion. This paper will share a few conversion models taken by conventional banks to become Islamic banks or to provide Islamic banking services and products.

Findings expressed that conversions are acceptable models in ASEAN, but there is no fixed one model suitable for all institutions, jurisdiction and ecosystem. Conversion can be done in many forms including conversion via mergers and acquisition, absolute conversion, and staggered conversion. In addition to this, there are limited available guidelines for conversion which are still subjected to adoptions as well as criticism.

Conversion from Conventional to Islamic Banking Operation

Operationally, conversion from conventional to Islamic cut across (among others) from the original conventional institution corporate structure, the management, the human resource, the products & services offering, the workflow process, the risk and governance as well as the financial reporting, auditing and IT system. The behaviour will have to take into consideration *Sharī'ah* governance and risks on top of the normal financial institution prudential operational risk exposures.

New component in the organisational chart will include the *Sharī'ah* Advisory Board/ Committee, as an additional organ that will issue fatwa, endorsement and guideline for the converted institution. Another component of the *Sharī'ah* department or unit imbedded in the new organisation chart will ensure the implementation of their *Sharī'ah* Board/ committee decision. The units will also be observing the operation's ensuring compliance according to

Shariah ruling as stated in Islamic *Fiqh Mu'āmalāt* (Islamic Transaction) and the applicable laws and regulations in that particular jurisdiction.

There will be *Shari'ah* Audit and *Shari'ah* Review side-by-side with normal internal and external audit as previously conducted before the conversion. In Malaysia, Bank Negara Malaysia (BNM) provides the requirement under *Shari'ah* Governance Framework (SGF) 2013. The *Shari'ah* governance structure in Malaysia readjusted accordingly with the issuance of *Shari'ah* Governance Procedure 2019.

List of products offered will be tailor-made according to Islamic transaction in form and substances, not only eliminating the word “interest”, “loan” and other conventional components but also avoiding a Non-*Shari'ah* Complaint (NSC) provision adopted by each respective jurisdiction.

Board directors and management will have to consider all angles and chart a comprehensive plan to execute pre, on-going and post conversion impacts. Dedicated team are normally set-up with specific timeline and milestones to ensure smooth conversion success. Regulator will closely monitor the conversion progress and process based on the submitted schedule or planning. Impact on the cleansing mechanism, return to the shareholders, human capital readiness and resistance are among major internal challenges shared by some successful conversion team in Malaysia.

Sharing his experience during Session 2 Muzakarah KLIFF 2017, Ustaz Ahmad Suhaimi Yahya highlighted the importance for the converted entity, at least, to address issues related to:

- a) Conversion schedule.
- b) Transaction relationship between the converted entities with other institutions.

- c) The right of the converted entity shareholders in relation to liabilities or commitment (with their conventional clients, products or services) before the conversion.
- d) Treatment of liabilities, saving, current and investment account based on “conventional interest” before, during and after the conversion.
- e) Treatment for non-*Shari‘ah* compliant securities, collateral, debentures and charges.
- f) Cleansing mechanism on tainted income (especially during and after conversion).
- g) *At-Tadarruj* (stages) during conversion.
- h) *Zakāh* obligation before conversion decision, during conversion process (gradual conversion) and after conversion. Obligation in relation to conversion via mergers and acquisition (M&A) and internal conversion are different also.

The above components are good to be observed as references and to be adopted on a case by case basis in each conversion exercise. The listing may varies depending on the reasons and the initiators (internal or external etc.) of the conversion. Top bottom approaches are much faster comparing to the request from the staffs. Some steps maybe shortened due to initial measures taken way before the final decision to convert announced to the public. Few conventional financial institutions stop offering conventional products two (2) or three (3) years before they announced their final deadline for conversion to Islamic. Some even prioritised Islamic products over conventional to cleanup their financial statement. Staggered conversion is good so that the organisation especially the staffs can start to adopt Islamic products and the Syaraih requirements. The IT sytem will start be aligned with *Shari‘ah* compliant processes and reporting. Furthermore, direct conversion (in a shorter timeline) mat require external consultant to support the project management catching up with the targeted time given.

Conversion from Regulatory Perspective

Regulators will have to look at the conversion from their perspective. Gradual (stage-by-stage) conversion may not be applicable in jurisdiction that only issues either conventional or Islamic banking license like Brunei (in ASEAN). Converting entity will have to stop their conventional operation (maybe surrender their licence) and start fresh with Islamic banking license in a fresh operation. Some country⁴ insists on a fresh *Shari'ah* comply capital.

Gradual conversion will take time and the converting entity may have to offer conventional products and services while undergoing their conversion exercise. If conversion is acceptable in that particular jurisdiction, there will be changes from the laws and regulations that the conventional institutions were subjected to before the conversion and after the conversion has completed. The converted institution may carry different set of license and are subject to different compliant, risk and reporting rules.

Bank of Pakistan (BOP) and Bank Indonesia (BI) are the only central banks that has issued specific guidelines for conversion in 2017 and 2009, while other regulators either refer to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Standard Guideline No 6 or taking their own approaches on a case-by-case basis.

As regulators, ensuring smooth and successful conversion while addressing relevant risks should always be their top priorities. They need to avoid negative impact to all relevant stakeholders of the institution and their respective financial industry. Based on the trend in Malaysia, Indonesia and Brunei, the regulators, among others, will be looking at the conversion purposes, reasons, timeline, execution plan, interval checkpoint and post conversion compliant in order to satisfy their regulatory roles.

⁴ For example, Brunei.

Bank Negara Malaysia (BNM) has no specific guideline on conversion but have no objection as BNM *Shari'ah* Advisory Council's (SAC)⁵ general ruling in their meeting No. 107 addressed the issue of conversion (from conventional products into Shari'ah compliant products)⁶.

The regulators realised their important roles in promoting more Islamic banking within their financial industry. Encouraging new set up from new investors is not how a new financial institution is born today. Encouraging foreign Islamic bank to come to their jurisdiction will risk their local players. Promoting conversion is always a better option out of the three mentioned. In order to encourage the conversion, dedicated guidelines or at least available supports would encourage institutional efforts to convert their existing conventional operation to Islamic. Dealing with familiar industrial players and to provide more options to Muslim without depriving non-Muslims consumers is a good visibility for a regulator especially in Muslim dominated countries in ASEAN like Malaysia, Indonesia and Brunei. Similar encouragement of conversion will bring good image for the regulator in Muslim centric location like Southern Thailand and Muslim dominated island in Philipines.

Conversion from Fiqh Perspectives

This issue was discussed during the last *Muzākarah* (Scholars Dialogue) session at the 2017 Kuala Lumpur Islamic Finance Forum (KLIFF), held on October 5th in Kuala Lumpur. Apart from BOP and BI guidelines, the other dedicated *Shari'ah* guideline available from an Islamic perspective is the Standard No. 6 that was issued by AAOIFI. Several scholars including Dr

⁵ BNM SAC is a dedicated counsel appointed by the Malaysian King (Yang Di Pertuan Agong) to assist BNM in addressing, issuing guideline and monitoring the Islamic banking and takaful operation in Malaysia. Securities Commission (SC) SAC addressed similar issues for capital market products and services.

⁶ Presentation in Session 2 Muzakarah Kuala Lumpur Islamic Finance (KLIFF) 2017, Oct. 5, 2017 by Dr Suhaimy Yahya (Bank Negara Malaysia)

Sheikh Abu Sattar Abu Ghuddah and Sheikh Hussien Hamid Hassan elaborated on some considerations on conversion. Other Islamic finance scholars like Sheikh Nizam Yaquby, Dr Sheikh Ali Al Ghari had also shared their thoughts on the same topic. Due to the limited *fatwā* or guideline that is suitable for all conversion needs, *Shari'ah* boards, either at national level or institutional level including those in ASEAN, will have to make their own *ijtihād* approaching their own conversion exercise. Hence, several conversion models were taken place in the last few years.

Provision in AAOIFI Shari'ah Standard No.6

This is among the early Shari'ah standard issued by AAOIFI back in 2002 which is currently the under process of being reviewed⁷. The standard was issued based on the mode of Islamic banking products and services offered then. References were also made on on-going conversion exercises in various countries especially in the Middle East and Pakistan around early year 2000.

Conversion exercises reportedly started back in 2002 in Sharjah (UAE), Bahrain, Kuwait and Kingdom of Saudi Arabia.

This AAOIFI standard can be divided into three (3) components ⁸, namely:

- i. Internal process within the banks involved. Few changes need to be made in order to comply with *Shari'ah* requirements.
- ii. Impact on the bank assets (including the receivables, liabilities, investments etc.).

⁷ AAOIFI to Re-Issue a New Shari'ah Standard on "Conversion of Conventional Banks and Financial Institutions to Islamic Banks and Financial Institutions". (n.d.). Retrieved January 16, 2018, from AAOIFI website:

<https://aaoifi.com/announcement/aaoifi-to-re-issue-a-new-shariah-standard-on-conversion-of-conventional-banks-and-financial-institutions-to-islamic-banks-and-financial-institutions/?lang=en>

⁸ Presentation in Session 2 Muzakarah Kuala Lumpur Islamic Finance (KLIFF) 2017, Oct. 5, 2017 by Prof. Dr. Engku Rabiah Adawiah (SC SAC member & Senior Lecturer IIUM)

- iii. External process in relation to external entities (including other banks, financial and non-financial institutions).

The coverage will include their dealing with their regulator, their central bank and other institutions that they are dealing with.

AAOIFI encourage total immediate conversion (*Fauriyyan*) and not conversion by stages⁹. This approach may be suitable in some conditions. In cases where the conversion is based on the request by the regulator, conversion will have to be executed as soon as possible. Available data and reports showed that the previous conversion from conventional to Islamic takes around one (1) to two (2) years, however three (3) to four (4) years is a very practical duration. The converting bank will have to prepare a solid timeline after robust fact findings and data collection. Continuous engagement with all stakeholders started way before the conversion announcement was made. Some institutions persevered at the last ten (10) to twenty (20) percent towards the end of their conversion journey due to operational and technical reasons.

The AAOIFI guideline is not suitable in all Islamic finance available jurisdictions including in ASEAN. Almost all conversion in ASEAN went through staggered, stage by stage conversion. That AAOIFI Standard (6) is under stages of review stages and would foresee major changes in the permissible methods and solution by taking into consideration the success conversion stories in ASEAN as well as countries of AAOIFI members.

SME Bank in Malaysia slowly increase their Islamic financing portfolio from RM2.3 billion in 2012 to RM4 billion in 2017 and announced their conversion attempt in 2017. They

⁹ Discussed during AAOIFI Al-Muktamar al-Khamis lil Haiat al-Syariyyah Iii Muassat al-Maliyah in 2005. Sheikh Dr Husin Hamid Hassan and Sheikh Dr. Abdul Sattar Abu Ghuddah presented Two (2) specific papers on conversion.

have not completed their 100% conversion as at today¹⁰. SME Bank was targeted to achieve 90% Islamic financing portfolio by December 2015, and they started with 15% when the bank was set up in 2005¹¹.

EXIM Bank Malaysia aims to be a full-fledged Islamic development financial institution by 2025. It was reported in their annual report that 45% of its business was *Shari'ah*-compliant in 2017¹².

Some stakeholders prefer to take staggered conversion due to operational readiness and sustainability. Starting from window and then into Islamic subsidiary and full-fledged Islamic banking are the normal routes taken in most of the conversion exercised. Information of around thirty (30) conversion cases are available but are not provided in detail for general public.

Provision in Nadwah Dallah al-Baraka No. 16¹³

Dallah al Baraka has been issuing various fatwa on Islamic finance and the pronouncement was widely referred to and used in Islamic finance industry. Unlike AAOFI's conversion guideline, Dallah al Baraka encouraged conversion by stages and to be flexible (*At-Tadarruj*). The decision also includes the requirement to collect amounts due from their customers before the conversion is subjected to appropriate *Shari'ah* compliant treatment. Different treatments were proposed for the principal and the "conventional interest" stipulated prior to the conversion as well as the manner for related cleansing process.

¹⁰ SME Bank set to become full-fledged Islamic Bank (2017, March 31), *The Malaysian Reserve*. Retrieved from www.themalaysianreserve.com

¹¹ SME Bank Target 90% Islamic financing portfolio by year-end (2015, June 18), *The Star*. Retrieved from www.thestar.com.my

¹² Malaysia's EXIM Bank appoint new CEO (2019, June 28), *Salaam Gateway*. Retrieved from www.salaamgateway.com

¹³ Fatwa Dalal al_Baraqah meeting no 16, 8 June 1999.

Between the different process of conversion, the option to convert by stages is the most ideal. Out of the 27 (twenty seven) conversion cases discovered, this format was widely adopted by the majority of the converted financial institutions. The human resources involved were better prepared, the consumers accepted the steps they have to follow and the market (in their respective jurisdiction) accepted the impacts of a new Islamic financial institutions in their ecosystem. The reputation of the respective converted financial institutions are almost intact among all their customers regardless Muslims or Non-Muslims.

Islamic Finance Scholars views on conversion

Sheikh Hussein Hamid Hassan¹⁴ encouraged flexibility because the impact on conversion is equally important apart from the rigid process and guideline. *Maṣlaḥah is better than Mafsadah*. The rigid rule may discourage and delay conversion; that will expose Muslims to less option of Islamic finance products and services. Sheikh Dr Abu Sattar Abu Ghuddah shared his thoughts in his paper, “*Taḥawwul al-Bank al-Taqlīdī Ilā al-Maṣraf al-Islāmī*”¹⁵. Sheikh Nizam Yaquby and Sheikh Dr Ali Elgari, in their papers, reminded on the importance of proper preparation for conversion to avoiding post conversion impact.

The above mentioned four (4) reputable Islamic finance scholars who has contributed a lot in the development of Islamic finance in Middle East as well as globally. They were among the pioneer scholars who has provide guidance to new establishment, conversion and expansion of Islamic banking in Middle east from late 1980s to early 1990s. These scholars possess wide

¹⁴ Attached below is Attachment 1, it was a section taken from his case study on conversion of Sharjah Islamic Bank in “*Khuttah Tahawwul al-Bank Islami, Mutatollubat Hazihi Al-Khuttah wa Hulul Musykiltiha, Tajdid Masraf Al-Syariqah al-Watani*”.

¹⁵ The paper was used as a guideline by AAOFI in discussion and issuance of AAOIFI Standard no 6 and it was produced inside a book titled “*Dirasat al-Ma’ayir al-Syariah*”

view on what will work and what is difficult to be executed in modern financial system. They also supported conversion by stages in their articles, lectures and opinions.

Ustaz Ahmad Suhaimi Yahya (Chief *Shari'ah* Officer, Hong Leong Islamic Bank, Malaysia) had also shared a wider perspective of the *Fiqh* approach also during KLIFF 2017. He highlighted the conversion as part of “*Aslamat al-Mu'āmalāt*” which includes avoiding *ribā* based on *Sūrah al-Baqarah: 275*.

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَاَ فَمَنْ جَاءَهُ مَوْعِظَةٌ مِنْ رَبِّهِ فَانْتَهَى فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّهِ ط

He also shared his valuable experience on the conversion of Sharjah Islamic Bank when the *Shari'ah* Committee of Kuwait Finance House (one of Sharjah Islamic Bank shareholders (20%)) allowed the conversion process to be completed in over 3 years¹⁶.

Among Islamic finance practitioners, KFH is well known for being very strict in the *Fiqh Mu'āmalāt* applications. They are well aware that any decision or stand they make will be referred too or be adopted by Islamic finance industry. KFH's decision to allow three (3) years conversion for Sharjah Islamic Bank is a solid precedent after considering all angle.

From a *Fiqh* perspective, either the conversion is by stages or total conversion (at once), several criterions will differentiate one from another, namely:

- i. The timing of the conversion.
- ii. The products conversion process.
- iii. Management and operational re-structuring.
- iv. Establishment of *Shari'ah* Advisory committee.
- v. Human capital transformation and readiness.

¹⁶ Kuwait Finance House (KFH) Shariah Committee Resolution no 1078, 1079, 583 & 612 presented by Ustaz Ahmad Suhaimi Yahya – Session 2, Muzakarah KLIFF 2017.

- vi. *Shari'ah* compliant operation and governance component.
- vii. Cleansing mechanism for tainted income.

The conversion project team must be prepared to adopt their own calibration in the adopted suitable components and preparation in addressing each conversion hurdles.

Reported Conversion Cases in ASEAN

Malaysia

In Malaysia, the first full-fledged Islamic banking started with Bank Islam Malaysia in 1983. The Malaysian financial authority, Bank Negara Malaysia (BNM), also allowed Islamic window operation (a unit under conventional bank) until 2004 when BNM issued a policy¹⁷ for the establishment of Islamic bank subsidiary under conventional banking operators.

Malaysia has colourful conversion experiences. There are window operations, which upgraded into subsidiary while the conversion was also executed via mergers and acquisition of entities. BNM has appropriate guideline for window operators as well as criteria for *Shari'ah* compliant operation. There are eight (8) criteria¹⁸ for consideration including the aim to comply with *Shari'ah* requirements.

Among the examples of successful conversion stories in Malaysia are:

a. Bank Kerjasama Rakyat, Malaysia.

This bank was established back in 1954 under Cooperative Ordinance 1948 until it was governed under the BNM Development Financial Institution Act (DFIA) in 2002. The

¹⁷ BNM policy 2004.

¹⁸ BNM Guideline for Shariah Compliant operation.

bank was founded as a result of a merger with 11 union banks and it was based in Penang before moving to Kuala Lumpur in 1964¹⁹. In May 1993, Bank Rakyat started its *Shari'ah* compliant/conversion by introducing Islamic banking products at four (4) of its branches. The process completed in 2002 and became a full-fledged Islamic cooperative bank. To date, 147 branches offer Islamic banking facilities to its customers.²⁰

b. Bank Pertanian or Agrobank, Malaysia.

It is a very unique transformation and conversion exercise²¹. It was established as Bank Pertanian Malaysia Berhad (BPMB) in 1969 becoming a 100% Malaysian government owned entity under Ministry of Finance (MOF) with purview of Ministry of Agriculture and Agro-Based Industry (MOA). BPMB provided financed agriculture activities driven by policies set forth by MOA. Starting with 2 branches in 1970, it went on to have 49 branches throughout Malaysia by 1985. It was corporatized in 2008 with a paid capital of RM1 billion and was allowed to operate as a commercial bank for agricultural sector under the new name Agrobank.

The entity started introducing Islamic financial products back in 1997 with 2 officers in their Islamic Banking Unit. Three (3) types of *Shari'ah* compliant products were offered, namely Savings (*Wadi'ah*), project financing (*Bay' Bithaman A'jil*) and fixed deposit (*Mud'arabah*). The unit was upgraded into a department and contributed

¹⁹ Bank Rakyat: Corporate Info Milestones. (n.d.). Retrieved January 18, 2018, from Bank Rakyat website: <https://www.bankrakyat.com.my/c/about/corporate/milestones-14>

²⁰ Bank Rakyat: Legacy. (n.d.). Retrieved January 18, 2018, from Bank Rakyat website: <https://www.bankrakyat.com.my/c/about/corporate/legacy-3>

²¹ Agrobank: Charting a New Path to Sustainable Growth. (n.d.). Retrieved January 18, 2018, from Cambridge IF Analytica website: www.cambridge-ifa.com

a lot to Agrobank profits and Islamic banking assets by 1991. *Al-Rahnu* (Islamic pawn broking) product was offered in 2002 through a strategic understanding with Bank Rakyat. Conversion was re-initiated in 2009 and accelerated in 2012 (targeting January 1, 2014) under the new President and CEO Dato Wan Mohd Fadzmi. By January 2015, the bank had successfully converted 96% of its existing non-*Shari'ah* loans. The other 4% was addressed accordingly. Some non-compliant facilities (pork livestock and agriculture products such as tobacco) went through transfer arrangement with Hap Seng Credit.

Agrobank received various international recognition awards and was recorded as the largest financier for Malaysia's primary agro food segment. They achieved the highest growth rate of 9.2% in 2015 with an average 5 years in growth of 6% per annum. The President and the CEO described the achievement as a "*barakah*" and decided to take another challenge in August 2017²².

c. Bank Muamalat Malaysia

This bank is the second full-fledged Islamic bank in Malaysia. Established in 1999 after a merger process of Islamic banking windows of Bank Bumiputera Malaysia Berhad, Bank of Commerce (M) Bhd and BBMB Kewangan. The first two (2) banks were conventional banks operating Islamic window. Their Islamic asset and liabilities were transferred into a newly set-up entity, Bank Muamalat Malaysia.

²² Dato Wan Mohd Fadzmi shared his experience during the panel discussion in Bank Negara Malaysia (BNM), Conversion Process towards becoming an Islamic Financial Institutions program, 18-20 September 2017, Sasana Kijang, Kuala Lumpur.

d. MBSB Bank

The most recent conversion in Malaysia, which completed in less than two (2) years. It was a mergers and acquisition between MBSB and Asian Finance Bank (AFB). The approval from MBSB Building Society Berhad shareholders was approved on January 23, 2018 to acquire the entire stake in AFB for RM644.95 million. The application for merger was submitted to Bank Negara Malaysia (BNM) on June 2017. BNM on December 2016 was given the green light for MBSB, which was 65.56%-owned by Malaysian Employee Provident Fund (EPF) to hold a merger talk with AFB. The merger exercised converted MBSB into MBSB Bank into a full-fledged Islamic bank on February 2018²³.

Unlike Bank Muamalat and MBSB who went on corporate conversion root, Bank Rakyat and Agrobank went through an organic conversion stages by stages.

Brunei

Brunei Darussalam had a very early inclusion in the Islamic finance fraternity with the establishment of Tabung Amanah Islam Brunei (TAIB) in 1990s. Two (2) Islamic banking entities were converted from the conventional in Bandar Seri Begawan before 2007.

Before the establishment of the Autoriti Monitory Brunei Darussalam (AMBD) in 2011, all financial activities in Brunei was regulated by their Ministry of Finance. Financial operation can be conducted either with conventional or Islamic compliance license, however Islamic window operation is still not allowed until today. There are (1) one Islamic, five (5)

²³ MMSB-Asian Finance Bank merger completed (2018, February 7), *The Sun Daily*. Retrieved from www.thesundaily.my

conventional bank and other related financial operations in Brunei. The setup of Brunei Stock Exchange has been announced back in 2015.

Bank Islam Brunei Darussalam (BIBD), Brunei Darussalam.

Bank Islamic Brunei Berhad's (BIBD) banking journey dated back over 32 years ago, from its humble beginnings as the conventional Island Development Bank in 1981, which was then renamed International Bank of Brunei. This was subsequently converted to the nation's first Islamic Bank, Islamic Bank of Brunei (IBB). IBB merged with the Islamic Development Bank of Brunei (IDBB) in 2005, to form BIBD²⁴ in 2007.

IBB started as Bank of Philippines Island Limited before it became International Bank of Brunei Berhad and then Islamic Bank of Brunei (IBB). IDBB was the Economic Planning Unit (EPU) under Ministry of Finance Brunei before it was transformed.

BIBD's source of capital issue was settled before the merger in 2007, as IBB and IDBB were already "Islamic banking entities" via their own conversion exercise.

Autoriti Monitori Brunei Darussalam may consider converting their other local financial players namely Tabung Amanah Islam Brunei (TAIB) and Baiduri Bank. TAIB is talking about converting into banking institution before 2009.

Indonesia

The development of Islamic finance in Indonesia started with the establishment of Bank Muamalat Indonesia in 1992. After the issuance of Banking Act No. 10/1998, some conventional banks run Islamic bank unit as part of their operations. Indonesian Bank regulation

²⁴ BIBD Press release on June 26, 2013 – a „Bruneian at Heart“ banking experience has been launched by BIBD today introducing a new brand.

no.8/3/PBI/2006 on 30th January 2006 permitted the Islamic unit under conventional banks to open counters in their branch. Their Act No. 21/2008 permitted conventional banks to have Islamic units before converting to a full-fledged Islamic banking system. Some units grew into a subsidiary with some conversion taking place after that²⁵.

Since setting up of new Shari'ah bank is very costly and requires at least 25% of Rp 1 trillion (as pay up), conversion via merger and acquisition was the vital option in Indonesia for certain shareholders. By the end of 2007, the Central bank requires a bank in Indonesia to hold a minimum capital of Rp 100 billion which forced some banks to add capital, merge or be sold by the owners.

a. Bank BUKOPIN, Indonesia

In November 2008, Bank Bukopin converted into a full-fledged Islamic bank. Their asset size in 2005 was about Rp 2 billion but made a substantial loss in 2009 due to bigger operational expenses. They made a significant recovery in 2011.

b. CIMB Niaga, Indonesia

In 2008-2009 LippoBank merged with CIMB Niaga (formerly known as Bank Niaga) which completed on May 18, 2009, 4 months ahead of the schedule. Upon merger, by June 2009, CIMB Niaga transformed into:

- 5th largest Indonesian bank by assets; 655 branch outlets & 1,261 ATMs throughout Indonesia.
- 3rd largest in terms of Shariah financing.

²⁵ Dodik Siswanto. (2012). The conversion effects of Islamic unit to full fledged system Islamic banks in Indonesia. *Australian Journal of Islamic Banking and Finance*, (2), 55-63.

- CIMB Niaga Indonesian consumers have direct linkages to CIMB. Group, Southeast Asia 5th largest bank.

CIMB (the shareholder of CIMB Niaga) is a unique Malaysian “Universal Bank” platform with international presence in Indonesia, Singapore and several other countries. The complex merger requires Malaysian and Indonesian stakeholders’ approval. The merger had also established a unique dual banking operator (conventional and Islamic banking) with “leverage model” operation.

The merger consolidated CIMB Niaga’s *Shari’ah* unit with ex-LippoBank Salam entity and created Indonesia’s 3rd largest Islamic financial institution in Indonesia in 2009. By the end of year 2009, 500 conventional CIMB Niaga branches had *Shari’ah* windows.

CIMB Niaga was also moving towards universal dual banking status by converting their branches into full *Shari’ah* services branch. The target was to have 14 *Shari’ah* branches by 2010, from the initial 9 in 2009.

The 15 months mergers exercises involved, among others, massive IT integration, entailing the reconciliation of more than 1.4 million customers or approximately 1.7 million accounts and training more than 8,000 staff within 10 months with 99.97% success rate²⁶. The 2008 conversion drive by market capitalization and establishment of a conventional bank also offers Islamic window services.

²⁶ CIMB Niaga, Merger Closing Report, November 2009.

c. Bank Rakyat Indonesia (BRI), Indonesia

BRI *Shari'ah* unit had almost Rp 8 billion assets in 2005. BRI chose to merge and went full-fledged in 2008. BRI acquired PT Bank Jasa Artha in October 2009 for Rp 61 billion and spin-off BRI *Shari'ah* Business Unit into BRI Shari'ah. Technically, the conversion (via merger and acquisition) was driven by the expensive fresh new bank and capital requirement imposed by the regulator in 2007.

d. PT Bank Aceh Syariah, Indonesia.

NV Bank Kesejahteraan Atjeh (BKA) was established back in November 1958. The name was changed for the fourth time into PT Bank Aceh until it was converted to PT Bank Aceh *Shari'ah* in September 2016 (PBI No. 11/15/PBI/2009).

Their first *Shari'ah* branch was established in November 2004. An Extraordinary General Meeting (EGM) which was held in May 2015 and the final conversion initiatives started with a dedicated team under the close supervision of the Central Bank Indonesia (OJK). The permission to convert was issued by OJK (OJK No. KEP-44/D.03/2016) on September 1, 2016 which was announced publicly on 19, September 2016.

Almost 230 million Muslims or around 87% of population in Indonesia would welcome more Islamic banking players to serve their needs. Converting some of their existing conventional bank is something that is encouraged by their regulators and government. Specific guidelines on conversion demonstrates their seriousness.

Thailand

Based on the key indicators of population and housing in Thailand from 1990-2010, about 4.9% of 66 million population in Thailand are Muslims. Islamic finance still remains developing after Islamic Bank of Thailand Act B.E.2545 was enacted in 2002 as well as the establishment of Islamic Bank of Thailand (majority owned by the government of Thailand).

Muang Thai Life Insurance started establishing *Takāful* products since 2011; general life *Takāful*, personal accident *Takāful* and in 2018 collaborated with Islamic Bank of Thailand to issue savings *Takāful*. These products allow long-term savings and life planning, similar to common savings insurance but adhere to Shari'ah principles. Other insurance operators, South East Group and Philips Life Assurance are also involved in offering *Takāful* products. Hopefully we can see conversion steps taken in conventional insurance Thailand towards becoming *Takāful* operators²⁷.

Islamic cooperative structure is more acceptable in Thailand since the first establishment of Islamic Co-operative of Pattani Limited (ISCOP) in 1987. As at 2012, there are 42 active Islamic cooperatives in Thailand²⁸.

In 2014, Thailand has three (3) Islamic banks, one (1) full-fledged (Islamic Bank of Thailand) and two (2) Islamic windows under conventional operators (the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives). A review on Thailand's double taxation laws, wider product offering (to capture non-Muslims customers) and human capacity readiness would render a conversion in Thailand catering to the 620 million populations potential demand.

²⁷ Chaiyasri, A. (2018, June 20). Islamic Finance in Thailand: Prospects and Challenges. *ZICO law*. Retrieved from www.zicolaw.com

²⁸ Access to finance: The case of Muslim Minority in Southernmost Provinces of Thailand. (n.d.). Retrieved January 19, 2018, from The World Bank website: <https://documents.worldbank.org>

Conversion may be possible if adjustment is also made on²⁹ the Islamic Bank of Thailand Act (2002) for more financial liberalisation. Thailand should allow investors (local and foreign) to open another full-fledged Islamic bank there.

Philippines

There has been positive updates from Manila after the first Islamic bank started operating in 1973 (Development Bank of the Philippines' subsidiary Al Amanah). On August 22, 2019, Republic Act No 11439 (Islamic Banking Act) was signed and provides for the regulation, organisation and power to established Islamic banks in Philippines. A well-defined law will boost confidence in domestic and foreign stakeholders to deal with Bangko Sentral ng Pilipinas ("BSP" ; the Central Bank of the Philippines). Apart from establishing a full-fledged Islamic bank, this new provision allows conventional banks to participate in offering Islamic banking products via Islamic banking units. This could create a path for future conversion like many other conversion roots taken globally as at today.

Another opportunity for conversion was also made available when the foreign banks allowed new banking entry under the Republic Act No.7721 (Liberalisation of Entry and Operations of Foreign Banks). Foreign bank could be owning up to 100% of voting stocks of an existing Islamic bank by establishing an Islamic bank subsidiary or a branch there. The requirement for setting up a dedicated *Sharī'ah* Advisory Councils shows that BSP is adopting the best market practice standard adopted in many Islamic jurisdiction³⁰.

²⁹ Sarntisart, S. (2014, September 10). Are Thailand's Islamic financial institutions ready for the AEC?. *The Nation Thailand*. Retrieved from www.nationthailand.com

³⁰ Sy, F. (2019, November 25). Islamic Banking Act passed in the Philippines. *ZICO law*. Retrieved from www.zicolaw.com

A series of legislation was approved subsequent to Act No. 11439, including BSP Circular No. 1069 (Guideline on the Establishment of Islamic Banks and Islamic Banking Units) and BSP Circular No. 1070 on Shari'ah Governance Frameworks³¹. The country has 45 universal banks with 10% Muslim population³².

Conversion Models

Information on conversion exercises and challenges are not openly shared with the public. Most of the academic papers shared their information based on surveys conducted. Based on the above success stories and available report on conversion in ASEAN, several methods prevail:

- a. Integral / full conversion.
 - i. Change of license.
 - ii. Mergers and acquisition.

- b. Partial / gradual conversion / staggered.
 - i. Gradual conversion by branches.
 - ii. Gradual conversion by scheduling (timing)

- c. Conversion via window and subsidiary.
 - i. Fresh set-up of new Islamic Subsidiary (s)
 - ii. Fresh set-up of new Islamic window (s).

³¹ Sy, F., & Santos, R. B. (2020, February 5). Philippine Central Bank passes Shari'ah Governance Framework. *ZICO law*. Retrieved from www.zicolaw.com

³² Alegado, S., & Lopez, D. B. (2019, October 28). Philippines plans to allow banks to set up Islamic Banking Units. *Bloomberg*. Retrieved from www.bloombergquint.com

Major Finding

Conversions (from conventional to Islamic operation) are acceptable models in several countries including ASEAN. There is no fixed one (1) model suitable for all institutions, jurisdiction and ecosystem. *Shari'ah* Scholars will have to make *ijtihad* (suggestion on solution) on acceptable model suitable for issues presented to them and the *fatwā* (resolution) may vary from one another. There are available guidelines for conversion but they are subjected to adoptions as well as criticism.

There is a specific need to focus on this topic in assisting the stakeholders to consider conversion as their vital option. Available data and literatures are limited in relation to this topic. Islamic finance components are facing stiff challenges in this 20th Century in order to survive the next financial industry era.

Contributions or Solutions

The findings highlight (among others):

- a) Islamic banking services are not offered only by full-fledged Islamic banking institutions. There are several models of Islamic banking service providers in a form of window and subsidiary.
- b) There should be positives moves to encourage conversion from pure conventional to window providers and from window or subsidiary to full-fledge Islamic banking.
- c) The conversion can come in many forms including conversion via mergers & acquisition, absolute conversion and staggered conversion.

- d) The findings will remind Islamic finance regulators and *Shari'ah* scholars to provide necessary guideline and references to assist the conversion, which will then increase Islamic finance presence.
- e) Converted entity must cover all angles in conversion process and timeline.
- f) Human Resources readiness is an important factor to avoid resistance in conversion exercise, hence, structured and targeted training and capacity building must be part of the conversion milestone.
- g) Product development and product replacement must be ready to offer new services to their clients.
- h) Appropriate policies and procedures (including accounting, system and workflow) must be prepared for smooth guidance to all levels of the entity stakeholders.

Conclusion

Conversion in any form is a vital option with available eco-system. Adoption for digital banking would be much easier due to operational strength, established ready products and wider customer range (Muslim and Non-Muslims).

Several converted financial institutions positioned themselves well in their respective jurisdiction post conversion exercise. Continuous efforts to convert will make Islamic finance in ASEAN more vibrant. All stakeholders will have to play their part in converting more Islamic financial institutions and reach out beyond ASEAN. More Muslim ummah globally are looking for options to participate in Islamic finance in ASEAN due to political and economic stability, unlike in Europe and Middle East in current economic situations. Superb internet connectivity and wide offering internet banking products will be an easy sales for more Islamic banking from ASEAN region.

NOTES

Attachment 1

- Part of Sheikh Hussien Hamid Hasan case study on conversion of Sharjah Islamic Bank in “ Khuttah Tahawwul al-Bank Islami, Mutatollubat Hazihi Al-Khuttah wa Hulul Musykiltiha, Tajdid Masraf Al-Syariqah al-Watani”.
- Fatwa Dalal al_Baraqah meeting no 16, 8 June 1999
- AAOIFI Shariah Standards No 6.

وقد أكدت خطة التحويل لبعض المصارف الحكم بالعمو عن الفوائد المقبوضة باعتبارها جزءاً من حقوق المساهمين بأصل اعتبار المال في الشريعة الإسلامية، ومقتضى هذا الأصل أن الأفعال يحكم عليها شرعاً بما تتول إليه من مصالح أو مفسد، فدخل الفوائد المقبوضة في ملك البنك، وإن كان ظاهره المنع لما يترتب عليه من مفسدة أخذ الربا، إلا أنه يحقق مصلحة أهم، هي تحول البنك الربوي إلى مصرف إسلامي، وتخليص المجتمع من التعامل بالربا، ويدفع مفسدة أشد، هي عدم تحول البنك واستمرار تعامله بالربا في حالة ما إذا رفض المساهمون التخلي عن حقوقهم التي تكونت من الربا

Sheikh Husein Hamid Hasan

1) Nadwah al-Barakah ke-16 :

16/7 : التدرج في تطبيق التحويل للالتزام بالشريعة
لا مانع من التدرج في تنفيذ المتطلبات الشرعية للتحويل للالتزام بالشريعة إذا اقتضت الظروف الواقعية للمؤسسة، لتجنب حالات التعثر أو خطر الانهيار. ولا بد في التدرج للتحويل من المحافظة على الصفة الشرعية (من تحريم أو كراهة أو بطلان أو فساد) للممارسات التي أوجب إلغاءها بسبب خطة التدرج.
ومستند ذلك أنه قد يكون وسيلة معينة لتحقيق هذا المقصد الشرعي، وأن نجاح التحويل يتطلب كثيراً من الإجراءات التي تحتاج إلى إعداد، فضلاً عن إيجاد البدائل لما يستبعد من تطبيقات متنوعة وتأهيل الطاقات البشرية للتنفيذ الصحيح.

2) AAOIFI – Piawaiian No.6

2- المدى الزمني للتحويل
2/1 يجب تنفيذ ما تتطلبه الشريعة لتحويل البنك التقليدي إلى مصرف والالتزام بأحكام ومبادئ الشريعة الإسلامية، في جميع العمليات الجديدة عقب التحويل. أما العمليات غير المشروعة المبرمة قبل قرار التحويل فالأصل التخلص منها فوراً ولا يجوز التأخير إلا فيما تقتضيه الضرورة أو الحاجة مراعاة للظروف الواقعية للبنك، لتجنب خطر الانهيار أو حالات التعثر على أن يتم التخلص من آثارها وفقاً لهذا المعيار.
2/2 إذا لم يقرر البنك التحويل الكلي الفوري طبقاً للبند 2/1 ولما قرر التحويل مرحلياً فإنه لا يعتبر بنكاً متحولاً، ولا يدرج بين المصارف الإسلامية إلا بعد إتمام التحويل، ويجب على مالكي البنك الإسراع في التحويل للتخلص من إثم الاستمرار في الأنشطة المحرمة. ويسترشد بهذا المعيار في خطوات التحويل.