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FOREIGN EXPERIENCE IN IMPLEMENTING ISLAMIC BANKING SERVICES IN THE ACTIVITIES OF COMMERCIAL BANKS

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Abstract

This article examines international experience in integrating Islamic (Shariah-compliant) banking services into the operations of commercial banks. It reviews the main implementation models — Islamic windows, Islamic banking branches, full-fledged conversion, and dual-banking systems — and compares regulatory frameworks, operational practices, product adaptation, governance, and market outcomes across representative countries. Case studies include Malaysia, Turkey, Pakistan, and the United Kingdom. The article draws lessons for commercial banks considering introduction of Islamic services: legal clarity, strong Shariah governance, product innovation, staff and systems readiness, risk-management adaptation, and customer education. Key empirical findings indicate that hybrid approaches (Islamic windows and branches) allow rapid market entry but require robust segregated accounting and governance to avoid reputational and compliance risks. Policy recommendations are offered for banks and regulators pursuing Islamic banking inclusion.

Keywords: Islamic banking; Islamic windows; participation banks; dual banking; Shariah governance; commercial banks; Malaysia; Turkey; Pakistan; United Kingdom.

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Introduction

Islamic banking — finance conducted in accordance with Shariah principles, notably the prohibition of interest (riba), avoidance of excessive uncertainty (gharar), and investment in halal activities — has expanded rapidly in recent decades. Commercial banks worldwide have responded by offering Shariah-compliant services either through separate institutions or by adapting parts of their operations. Understanding foreign experience is essential for commercial banks contemplating the introduction of Islamic services, whether to capture new markets, broaden financial inclusion, or comply with legal/regulatory mandates. This article synthesizes the literature, regulatory guidance, and country experiences to present practical models, benefits, challenges, and concrete steps for implementation by commercial banks. It emphasizes evidence-based lessons from countries where Islamic services operate alongside conventional banking. Commercial banks typically adopt one of four main models to deliver Islamic services:

1. Islamic Windows — a set of Islamic products offered within a conventional bank through a segregated desk or "window." Customers transact under Shariah-compliant contracts while funds and accounts for Islamic activities are kept separate in accounting and governance. Islamic windows allow quick entry using existing branch networks and systems but require strict segregation to maintain Shariah integrity and depositor protection.

2. Islamic Banking Branches (IBBs) — dedicated branches of conventional banks operating exclusively with Shariah-compliant products. IBBs provide clearer separation than windows and can build distinct brand identity while leveraging the parent bank's infrastructure.

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3. Full Conversion (one-bank approach) — conversion of a conventional bank into a full-fledged Islamic bank. This is rare and typically occurs in markets with strong political/regulatory support for Islamic finance.

4. Dual Banking System — coexistence of conventional and Islamic banks in the same financial system. In many countries (e.g., Malaysia, Turkey, Pakistan), regulators permit both models, with legal and supervisory frameworks tailored to each.

Each model involves trade-offs across speed-to-market, regulatory complexity, operational cost, and reputational risk. The rest of the article explores how these models have worked in specific jurisdictions and what commercial banks can learn.

Successful implementation of Islamic banking services within the activities of commercial banks critically depends on regulatory clarity, institutional consistency, and supervisory capacity. Unlike conventional banking, Islamic finance is grounded in religious–ethical principles derived from Shariah, which require not only financial regulation but also specific legal, governance, tax, and accounting frameworks. International experience demonstrates that without a comprehensive and coherent regulatory environment, Islamic banking initiatives often face operational inefficiencies, compliance risks, and limited market credibility.

One of the most fundamental regulatory prerequisites is the formal legal recognition of Islamic financial contracts and instruments. Islamic banking operates through contracts such as murabaha (cost-plus sale), mudarabah (profit-sharing), musharakah (partnership), ijara (leasing), wakala (agency), and sukuk (Islamic securities). These contracts differ significantly from interest-based loan agreements used in conventional banking.

In jurisdictions with successful Islamic banking integration, legislation explicitly: recognizes Shariah-compliant contracts as legally enforceable; clarifies

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ownership transfer, risk-sharing mechanisms, and profit distribution rules; provides dispute resolution mechanisms (often through specialized courts or arbitration frameworks).

Without such legal recognition, commercial banks face uncertainty in contract enforcement, which discourages product innovation and increases legal risk.

A second critical regulatory component concerns **clear rules on the segregation of Islamic and conventional funds**. This issue is particularly important for commercial banks operating Islamic windows or Islamic branches within a conventional banking structure.

International best practice requires: separate balance sheets or sub-ledgers for Islamic operations; independent tracking of assets, liabilities, income, and expenses related to Islamic products; prohibition of commingling Islamic funds with interest-based funds.

In addition, regulators must provide **prudential guidance** on: capital adequacy treatment of Islamic contracts (especially profit-and-loss sharing instruments); risk-weighting of Shariah-compliant assets under Basel frameworks; Treatment of investment accounts that resemble equity more than deposits.

Liquidity management poses a specific challenge, as Islamic banks cannot use conventional interest-based money market instruments. Therefore, regulatory frameworks must facilitate access to **Shariah-compliant liquidity instruments**, such as Islamic interbank placements, central bank facilities based on commodity murabaha or wakala, and sovereign sukuk.

Robust **Shariah governance** is a defining feature of credible Islamic banking systems. Regulatory authorities in advanced jurisdictions mandate structured Shariah governance frameworks that operate alongside conventional financial supervision.

Key regulatory requirements typically include: establishment of an independent **Shariah Board or Shariah Committee** at the bank level; clear qualification criteria and independence standards for Shariah scholars; mandatory Shariah

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review, audit, and compliance reporting; product certification processes prior to market launch.

In addition to bank-level governance, some countries have adopted **centralized Shariah oversight**, whereby a national Shariah advisory council issues binding rulings to ensure consistency across the banking system. This approach reduces interpretational fragmentation and strengthens public confidence.

Another decisive factor in the successful adoption of Islamic banking services is **tax and accounting neutrality**. Islamic financial transactions often involve multiple underlying asset transfers (e.g., sale–leaseback structures), which may unintentionally trigger: double taxation (e.g., multiple stamp duties or VAT); higher transaction costs compared to conventional loans.

To address this, regulators and tax authorities in leading Islamic finance jurisdictions have: adjusted tax codes to ensure Islamic products are treated no less favorably than conventional ones; introduced exemptions or equivalence provisions for asset-based financing; issued accounting guidance aligned with international standards (IFRS) while accommodating Islamic finance specifics (often referencing AAOIFI standards).

Accounting clarity is essential for transparency, financial reporting, and investor confidence, particularly for cross-border operations and sukuk issuance.

Countries with advanced Islamic finance ecosystems demonstrate that **coordination between regulators, legislators, and market institutions** is essential. A prominent example is the central bank–led model implemented by Bank Negara Malaysia.

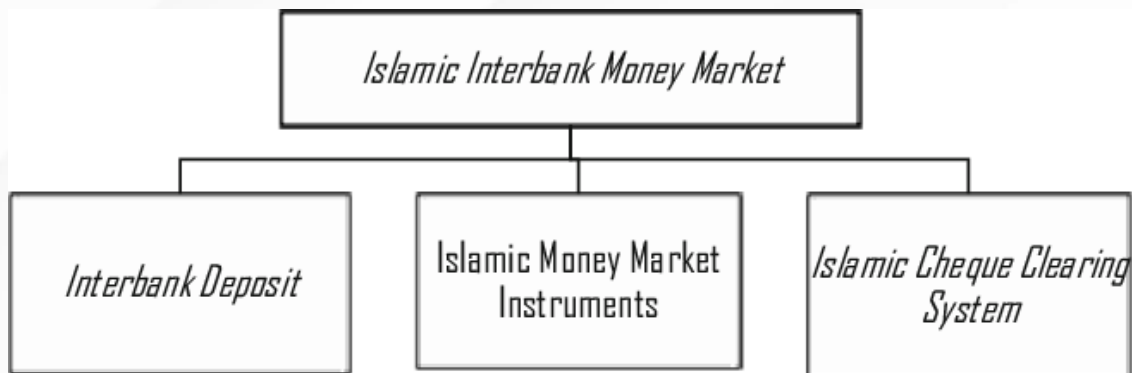
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Malaysia has developed:

- Dedicated Islamic banking legislation alongside conventional banking laws;
- specialized supervisory units within the central bank focusing exclusively on Islamic finance;
- centralized Shariah Advisory Council whose rulings are legally binding;
- Comprehensive market infrastructure, including Shariah-compliant interbank money markets and government sukuk programs.

This **coordinated regulatory approach** has enabled Malaysia to successfully scale Islamic banking services across the entire financial system — including full-fledged Islamic banks, Islamic windows, and Islamic branches — while maintaining financial stability, consumer protection, and systemic resilience.

International experience clearly indicates that regulatory clarity is not merely a supportive factor but a **precondition** for sustainable Islamic banking integration. For commercial banks, a well-defined regulatory environment: reduces compliance and reputational risks; facilitates product development and innovation; enhances customer trust and market acceptance; enables effective risk management and liquidity planning.

Conversely, fragmented or ambiguous regulation often leads to underdeveloped Islamic windows, operational inefficiencies, and limited contribution of Islamic finance to overall banking sector growth.

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Malaysia — integrated, supervisory leadership and market infrastructure
Malaysia is widely cited as a global model: it developed the Islamic windows policy early (1990s), established centralized Shariah advisory structures, and built market infrastructure (Islamic interbank, sukuk markets). Malaysia's dual banking system allowed conventional banks to offer Islamic products while also nurturing fully Islamic institutions. A proactive central bank and a National Shariah Advisory Council (to harmonize Shariah interpretations) contributed to market confidence and product standardization.

Lessons: regulatory leadership and common Shariah standards reduce fragmentation; market infrastructure for liquidity management (Shariah-compliant assets) is critical.

Turkey — participation banks and gradual expansion

Turkey's Islamic finance sector operates through dedicated participation banks and Islamic windows/branches of conventional banks. Participation banks have had modest market share but benefit from targeted instruments and a growing regulatory focus on participation banking strategies. Challenges include public awareness and integration into broader financial markets. Turkey's experience shows how participation banks can coexist in a largely conventional banking system, but also that market penetration requires outreach and competitive product design.

Pakistan — conversion and Islamic branches growth

Pakistan has pursued a mix of approaches: dedicated Islamic banks, Islamic branches of conventional banks, and conversion efforts. The State Bank of Pakistan has actively promoted Islamic banking through guidance, growth targets, and support infrastructure. The sector's growth demonstrates demand potential but also underscores the need for consistent governance and risk frameworks to maintain service quality.

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United Kingdom — market-driven Islamic finance in a non-Muslim majority jurisdiction.

In the UK, Islamic banking services are offered mainly through specialized banks and windows focused on wholesale and retail banking to serve both domestic and international clients. The UK experience highlights the role of common-law flexibility and market demand in accommodating Shariah-compliant structures (e.g., Islamic mortgages using lease-purchase models), but also the challenge of creating sufficient Shariah-compliant liquidity instruments domestically.

When a commercial bank decides to introduce Islamic services, several operational domains require adaptation: Shariah Governance and Compliance - appoint an independent Shariah Board (or committee) with clear responsibilities for fatwas, product approval, and ongoing monitoring, implement Shariah compliance units and internal audit processes to ensure transaction-level adherence. Product Design and Standardization - map conventional products to Shariah-compliant equivalents (murabaha, mudarabah, musharakah, ijara, wakala, sukuk structures), ensure documentation, disclosures, and sale processes reflect unique contract features and risks. Accounting, Reporting & IT Systems - maintain segregated ledgers for Islamic funds and transactions; adjust IT systems for contract-based profit-sharing and non-interest revenue recognition, adopt accounting practices consistent with AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) guidance where applicable and local GAAP/IFRS requirements. Liquidity & Asset Management - develop Shariah-compliant liquidity instruments or rely on market facilities (e.g., central bank Islamic windows) to manage short-term idle funds. Lack of sukuk or Shariah-compliant interbank instruments can constrain windows. Human Capital & Training - recruit staff with Islamic finance expertise; invest heavily in training for relationship managers, treasury, risk, and operations teams. Risk Management & Prudential Treatment - adapt credit-risk models to account for profit-and-loss sharing exposures; define capital treatment for Islamic contracts

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and off-balance-sheet arrangements; regulatory clarity on these points reduces bank-level uncertainty.

Benefits, Risks, and Market Impacts of Implementing Islamic Banking Services in Commercial Banks

Category	Aspect	Description and Market Impact
Benefits	Market expansion and financial inclusion	Introduction of Shariah-compliant banking services enables commercial banks to attract customers who avoid conventional interest-based products for religious or ethical reasons. This expands the customer base, increases deposit mobilization, and promotes financial inclusion, particularly among underbanked populations.
	Product diversification	Islamic banking allows banks to diversify their product portfolios through fee-based services, trade finance instruments (murabaha, wakala), leasing (ijara), and partnership-based financing (mudarabah, musharakah). This diversification reduces reliance on interest income and creates alternative revenue streams.
	Resilience and risk-sharing potential	Many Islamic financial contracts are asset-backed and based on profit-and-loss sharing, which can reduce excessive leverage and align risk between banks and clients. This structure may enhance financial system stability and mitigate systemic vulnerabilities during economic downturns.
Risks and Challenges	Operational complexity and start-up costs	Establishing Islamic windows or branches requires segregated accounting systems, dedicated IT infrastructure, Shariah governance mechanisms, and specialized staff. These requirements increase operational complexity and initial implementation costs for commercial banks.
	Regulatory and accounting ambiguity	In jurisdictions lacking comprehensive Islamic finance regulation, uncertainty may arise regarding the prudential and accounting treatment of Islamic products, particularly profit-sharing investment accounts. Such ambiguity can complicate risk assessment, capital adequacy calculations, and financial reporting.
	Liquidity management constraints	Limited availability of Shariah-compliant money market instruments and sukuk can restrict effective liquidity management. Banks may face difficulties in managing short-term liquidity and meeting regulatory liquidity ratios using Islamic instruments.
	Reputational and Shariah-compliance risk	Inadequate enforcement of Shariah compliance may undermine customer trust and damage the reputation of both the Islamic banking unit and the parent conventional bank. Although Islamic windows offer an efficient market-entry strategy, empirical evidence suggests they require strong governance, internal controls, and transparency to remain credible and sustainable.

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International experience shows multiple viable pathways for commercial banks to offer Islamic banking services. Islamic windows and dedicated branches allow faster market entry with lower capital investment, while full conversion and stand-alone Islamic banks establish clearer identity and governance. The success of any approach depends on regulatory clarity, robust Shariah governance, segregated operations and accounting, market infrastructure for liquidity, and proactive customer education. Countries such as Malaysia provide a template for coordinated policy and infrastructure; Turkey and Pakistan illustrate the potential and operational challenges in markets with mixed adoption. Commercial banks that invest in governance, systems, and talent can capture the expanding demand for Shariah-compliant finance while managing associated risks.

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