Islamic branches of conventional ("commercial") banks

After holding several preparatory meetings and coordinating with the concerned banks, Qatar Central Bank has recently issued, specific directives to each of the conventional banks that have Islamic branches, directing them to stop opening new Islamic branches, accepting Islamic deposits and dispensing new Islamic finance operations. As for the Islamic branches' current assets and liabilities including deposits and finance operations, Qatar Central Bank has given a time frame up to December 31, 2011 to manage these assets and liabilities by collecting the balances, in accordance with the conditions and maturity dates agreed upon and by paying Islamic deposits upon maturity save with regard to finance operations. After this deadline, the conventional bank will continue to manage the remaining Islamic assets in a special portfolio, through its financial position, with the possibility of transferring some of these assets to the Islamic banks. Subsequently, the conventional bank can use the premises of the Islamic branches, upon the end of the specified period, to open conventional branches if need be.

The rationale for the present directive can be summarized as follows:

I- **Supervisory issues:** Article (1) of Qatar Central Bank Law No. 33 of the year 2006 has differentiated between the banks, which pursue banking activities on conventional bases and the Islamic banks, which carry out their activities, pursuant to the Islamic transactions provisions, in accordance with the definition stated in the Law. The financial system in Qatar presently has well-established Islamic banks with a significant branch network that fulfils the local demand on Islamic products, in addition to conventional banks. A recent phenomenon has been the emergence of Islamic branches of conventional banks, leading to a co-mingling of their assets and liabilities. The overlapping nature of non-Islamic and Islamic activities of conventional banks made it difficult for them to properly manage the risks encountered by these banks, mainly with regard to the following:

1- Bank Risks

Islamic finance is characterized by certain risks of a more complex nature than conventional financing, particularly with regard to the return, liquidity, credit and market risks relating to *Mudaraba, Musharaka, Istisnaa and Ijara* finance operations. This issue becomes more complex when a large part of these activities receives their funding from the customers' conventional fixed-income deposits, which are not based on the same distribution of profits as the Islamic deposits. Moreover, these two types of risks are getting reflected in the same financial position of the bank. As a result, applying oversight instruments and prudential ratios and indexes used for risk management and preserving the various depositors' rights are becoming more complex.

2- Financial Reporting

The overlapping nature of non-Islamic and Islamic activities of conventional banks made it difficult and complex for them to prepare consistent financial reports governed by unified international standards since each type has different international standards, thus impacting negatively on the proper financial analysis of these reports at the level of the financial system in Qatar, as well as on both regional and international levels.

3- Capital Adequacy

Qatar Central Bank is currently working on the preparation of separate instructions to be issued to Islamic banks on capital adequacy, in accordance with the Islamic Financial Services Board (IFSB) standards. Upon the Board's introduction of the new amendments, these instructions will differ significantly from the instructions on capital adequacy relating to conventional banks, which are based on Basel (2) and then Basel (3) standards.

QCB believes that it is difficult for conventional banks that have Islamic branches to combine these two types of instructions in one financial position for the aforementioned risk management reasons.

On the practical and legal levels, the Islamic branch capital cannot be separated from the bank's capital for independent risk weighting, especially in the next phase since banks are preparing for the implementation of Basel (3) requirements.

4- Financial stability

The conventional banks’ combination between non-Islamic and Islamic banking activities constitutes a prejudice to the competitive neutrality between conventional and Islamic banks, as well as the rules of transparency and objective disclosure, thus posing a difficult challenge for Islamic banks to maintain their stability and growth rates, and negatively impacting on the stability of the entire system.

II- **Monetary policy issues**:

In view of the evident difference between the bases and the methodologies pertaining to the conventional and the Islamic banking activities, since for instance, the impact of each type differs from the other in the ability to create money and increase money supply, the use of monetary policy instruments available to Qatar Central Bank faces significant challenges due to the current overlap between non-Islamic and Islamic activities of conventional banks operating within the State. This overlap hinders the optimal use of those tools, negatively impacting on the monetary policy performance and efficiency, and impeding the creation of new tools, which enhance the monetary policy effectiveness. At the same time, the segregation of the conventional and Islamic banking activities will enable Qatar Central Bank to have a systematic framework of liquidity management and improve the efficiency of open market operations. On the other hand, this will also open new prospects for the monetary policy to develop new instruments targeted at these two types of banking activities according to the size and relative weight in the market, in addition to the degree of influence thereof on money supply. The monetary policy instruments will then have a faster and more efficient impact on the operational, intermediate and ultimate objectives.