Challenges of Islamic Banking in Gulf Corporation Council

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Abstract:

The purpose of this article is to identify major challenges for Islamic banking in the Gulf Corporation Council (GCC) context. The study reports the results of interviews that were undertaken with senior officials of several key financial institutions who have had many years of experience in dealing with Islamic banking. The interviews revealed that, lack of differentiation between Islamic and conventional banking is the bigest challenge facing Islamic banks in GCC and is fostered by the second challenge which is lake of standardization of rules about Islamic financial products. Finding staff having the required technical expertise of Islamic banking is not a serious challenge according to respondents, but awareness of the basic principles and the ultimate goals of Islamic banking is the problem.

Keywords: Islamic Banking, Challenges, Islamic-conventional Differentiation, standardization of Islamic products, Islamic banking regulation, Shariah law, Shariah-compliant.

Introduction:

Islamic Banks are seeking to prove themselves in today financial world, as it still occupies less than required levels in the Arab reality because of the perceptions and ideas about these banks that seek by all means and ways to apply the principles of Islamic law in its daily banking transactions.

Islamic banks are an integral part of the Islamic finance industry which is growing at a simple pace in order to compete with all commercial banks which occupied broad business position with its customers.

Accordingly, the process of knowing the future of Islamic banks in the Arab world in general and the Gulf region specifically requires a focus on the important elements and necessary variables in order to translate expectations, which are likely to face the region, to directions and starting point of action in order to enhance the status of these banks in comparison to peer local and global commercial banks.

The research seeks to answer the following questions:

1. To what extent the Islamic banks in the Gulf region will be able to meet the challenges of international pressure towards Islamic finance institutions?
2. What's the impact of the low level knowledge, capacities and capabilities of professionals responsible for the industry in these countries on the dealing of such challenges?

Study problem:

Islamic organizations in Muslim countries are facing a transformational process from traditional commercial transactions to that which rely on the principles of Islamic law, This motivated many of huge funds owners, especially in Muslim countries in general and the Gulf in particular, to search for ways to increase profits in consistent with the principles of Islamic Sharia. The approach of dealing with Islamic banks requires physical and psychological preparedness to deal with it.

Focused research problem is to sober and enhance capabilities, thinking, and leadership abilities of high management of Islamic banks in the Gulf region to be able to face future challenges facing the region and to achieve the vision, mission competitiveness these banks seeking to consolidate in mind of customers dealing with them.

Study Significance:

The importance of the study could be summarized in the following:

1. Reduce barriers and obstacles facing investors in the Gulf region when they choose Islamic banks.

2. The dominance of the Gulf Cooperation Council (GCC) to more than 80% of the assets of Islamic banks, while they make up only 8% of the population of Muslims in the world who are dealing with these banks.

3. Statement of legal and governmental legislation and the role of governments in the region towards the work of these banks within its financial environment.

4. The availability of huge liquidity circulating in the Islamic banks in the Gulf Cooperation Council (GCC), which need to financial and legislative care to protect from market volatility faced by the region's markets.

5. Increase awareness among investors and dealers with these banks, the potential and capabilities of these banks to meet their requirements in accordance with the principles of Islamic Sharia.

6. Enhance the quality of service provided by the banking Islamic banking to customers so as to enhance mutual trust between the two parties at the completion of banking transactions in accordance with Islamic Sharia items.

7. Adoption of GCC governments, particularly in the United Arab Emirates and Bahrain, a consultation mechanism regarding the development of the financial industry in these countries.

8. Support the role of Islamic banks in strengthening the economies of the Gulf region.

Objectives of the Study

The research sought to achieve the following objectives: -

1. Provide systematic work contribute to the containment of environmental variables that serves as a strong challenge to the survival of these banks in the Gulf region.

2. The adoption of future standards work environment compatible with the requirements of the work of Islamic banks in the Gulf region.

3. Definition of environmental variables that are expected to occur in order to determine these banks, the nature of the departments to handle and reduce the severity of them.

4. The need to develop units for risk management in Islamic banks to determine the risks surrounding the work of Islamic banks, how to deal with It, and to put the logical solutions.

Literature Review:

The GCC countries have a fairly high number of banks with an extensive network of branches. But Gulf banks are still small compared to the big international banks. Most banks are family-owned with modest government equity and a large number of specialized banks are fully owned by the government (Elton 2003). Banks in these countries are financially strong, well-capitalized and have adopted modern banking services (Srairi 2009). Their operations can be characterized by satisfactory asset quality, adequate liquidity and high levels of profitability (Islam 2003a).Local banks follow international account standards (IAS) and the central monetary authorities of Gulf countries have strengthened the prudential norms in recent years (Islam 2003b).

Amid industry efforts to pursue new avenues of growth, sharia scholars are increasingly voicing concerns over the future direction of the industry. The most common complaint is that the differentiation between Islamic and conventional banking isn't very visible. They point to the fact that the industry doesn't seem to be moving beyond synthetic product structures. (Hancook, 2011) Indeed, the scarcity of data and underinvestment in analytical tools means the focus of Islamic banks remains limited to a handful of asset classes.

The unique selling point of Islamic banking is the claim that it is a more fair and ethical form of conventional financing (Nazim, 2013). And If Islamic products are simply replications of conventional products then it calls into question the credibility of the existing system. The downturn has been a major catalyst for Islamic finance to put its house in order. (Nazim, 2013)

Nazim's viewpoint is a representative of a broader industry stance that Islamic banking is entering a period of housecleaning, with central banks looking to revise their sharia governance frameworks to properly audit the operations of financial institutions.

The desire to clean up existing frameworks was brought to the fore by the directive issued by the Qatar Central Bank in February, 2011 ordering all conventional banks to close down their Islamic windows by the end of 2011 amid worries over the comingling of funds. The directive will result in a field of 12 competing institutions being pared back to just four wholly Islamic banks.

Qatar's directive is unlikely to set a precedent that could spread to other Gulf countries, but it has sparked considerable debate about the ongoing development of the industry and its lack of standardization.

That lack of standardization between Islamic Shariah Committee in banks results in diverse interpretations and evaluations. In the opinion of Karbhari, et al, (2006), lack of standardization is not only time-consuming and costly, but it also leads to confusion about what Islamic banking really encompasses and, therefore, hinders its widespread acceptance.

The United Sharia Board was established in the UAE in 2009 with the aim of achieving a centralized sharia board for the Gulf's Islamic finance market. It now has two scholars from Saudi Arabia and one scholar each from Kuwait and Qatar. In the long term it hopes to boost corporate governance within the industry and limit the number of boards that individual sharia scholars can sit on. (sarairi, 2009)

There is a growing consensus that, in order for the GCC Islamic market to fulfil its potential, there is a need for the industry to sit together to develop products and structures that are acceptable to all banks. "More and more people are coming around to the view that, only by leveraging our collective expertise, can we push the regional boundaries of understanding closer towards each other." (Hancock, 2011)

There is an increasing move towards privatization in the Gulf region. (Global Investment House, 2010) GCC banks have a great opportunity for a regional niche in this area, but there is a need for the well-developed Gulf financial market to attract national funds currently being invested outside, and to direct them to regional private sector investments. Stock market development in the region will improve financial deepening and enable deficit business to raise needed capital.

In view of the above, there is an urgent need to establish a common financial market for the GCC countries along with a common exchange rate and a common and interlinked stock market along the lines of the single market in Europe. This will expand the financial market and the role and activities of the GCC banks. As a part of this process, a common banking sector could be established through the regional integration process. GCC banks can be linked electronically and this will attract more funds in the form of bank deposits and other investments.

There is also a need to strengthen the global linkages through further use of technology and an increased international presence to face the challenge of a growing level of competition unleashed by increasing computerization and other technological developments in banking operations.

The Gulf banks need to be more global in outlook and should focus on the increasing trend towards securitization of their assets. At the same time, banks should pursue a regional niche strategy by providing tailor-made products and services matching the needs and wants of the regional customers. Following the trends among international banks, GCC banks should diversify their product base into the areas of corporate finance, investment management including mutual funds, merger and acquisitions, consultancy services and information-related services. Otherwise, international banks will establish a better competitive edge in this region.

Bank regulation and legislation needs to be strengthened to suit the emerging trends. Supervisory systems in the GCC countries should be moved closer into line with contemporary supervisory practices. A strengthening of the prudential regulatory framework is required and improvements are needed regarding capital adequacy, liquidity management, insider transactions, credit reviews and public disclosure. Synchronization of the bank supervisory systems of the GCC countries towards the international supervisory standards and regulations would contribute to the safety of the banking system and banks' competitiveness.

There is a need for a segment-wide study which will be able to throw more light on the exact design and nature of new products/services to match the needs and wants of specific customers' segments. Dynamic promotional activities along with better customer service will be required to market these new products in competition with the international banks.

Since the personal quality of bank staff is the most important determinant of customers' perception of quality of bank services (as revealed by the empirical findings), training and development will play a crucial role in improving the staff's performance.

The need for superior quality of bank management and skill manpower is an important challenge facing Gulf banks. In recent times, the word "services" has begun to connote "demeaning work" owing to the rising affluence of Gulf citizens (Iqbal, 2008). At the same time, the majority of Gulf citizens are attracted by Government or public sector work. These kind of socio-cultural factors increase challenges to Gulf banks which are mostly in the private sector to increase the proportion of local manpower in the banking sector especially for the management cadre. (Bukhari, none)

In order to improve the quality of banks' management and the staff, appropriate human resources development through the local training and education has to play a greater role. The alternative strategy of sending people abroad for training may not be suitable for typical domestic banking operations because of the distinct features of domestic banking.

Many GCC countries especially Bahrain and UAE have substantially liberalized their deposit and lending rate structures. At the same time, indirect monetary control has been imposed instead of quantitative restrictions on credit allocation. Further deregulation is required, depending on the country, in the areas of:

- reserve requirement policies of monetary authorities which tend to result in higher funding costs for banks;
- price restraints represented by regulations governing interest rates and bank fees;
- restriction on banks' external capital transactions which tend to reduce bank return; and
- restriction of employment recruitment policy which may increase banks' operating costs. (Raza and Khurshidm 2012)

In order to attain the required level of efficiency and innovation consistent with the international competitiveness, domestic banks need to be fully exposed to competitive forces within domestic markets. (Iqbal, 2008)

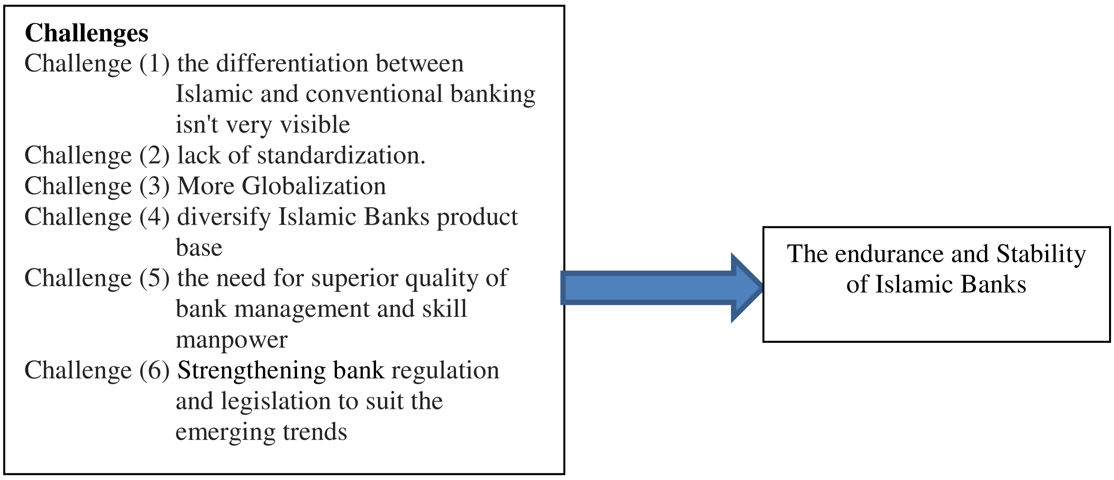
More commonly, banking and monetary policies need to be aimed at enhancing the role of banking and financial systems in mobilizing private savings. (Raza and Khurshidm 2012) A well-developed and inter-linked common financial market in GCC countries can contribute towards further financial expanding and efficient intermediation through efficient mobilization and allocation of financial resources under a deregulated environment.

Theoretical Model

The study adopts the following Model:

1. The independent variable: This variable describes the challenges that Islamic banks facing in the Arabian Gulf region. In particular the factors and elements that have a significant impact on the survival and continuity of these banks in the region, particularly to face the challenges of differentiation between conventional and Islamic, lack of standardization, as well as a need for the well-developed Gulf financial market, diversification of Islamic banks product base, The need for superior quality of bank management and skill manpower, and Strengthening bank regulation and legislation to suit the emerging trends

2. The dependent variable (the future of Islamic banks): the respondent intuitions regarding the severity of the challenges facing these banks and might affect endurance and stability of Islamic banks in the Gulf region.



RESEARCH HYPOTHESES

The research seeks to prove or disprove the following assumptions:

1. There are no impact of the invisible of differentiation between Islamic and conventional banking on the survival and stability of the work of Islamic banks.
2. There is no effect for lack of standardization in islamic banks on its survival and stability.
3. There is no effect for the need to more globalization of islamic banks on its survival and stability.
4. There is no effect of the need to diversify Islamic Banks product base on its survival and stability.
5. There is no effect for the need for superior quality of bank management and skill manpower of Islamic banks on its survival and stability.
6. There is no effect for strengthening bank regulation and legislation to suit the emerging trends of Islamic banks on its survival and stability.

Table 1. Summary of Respondents Who Took Part in the Interview

Organization	Individual	Respondent's Occupation
A	A1	Chief Executive
	A2	Deputy Chief Executive
	A3	Manager
B	B1	Managing Director
C	C1	Manager
D	D1	Executive
E	E1	Audit Manager
F	F1	Manager
G	G1	Manager

DATA COLLECTION

To provide empirical evidence on the challenges and problems facing the Islamic banking system in GCC, it was important to obtain information from those directly involved in the field. We therefore decided to collect data by undertaking a series of focused interviews. 11 Islamic banks offering Islamic banking services in the GCC were chosen. Consequently, these banks were contacted via e-mail requesting an interview. The use of the e-mail secured three interviews. A formal letter backed up with telephone requests followed this. Seven of the 11 banks agreed to participate in the study. Ultimately nine, in seven organizations, out of those contacted participated in the study. The participants included chief executives, deputy executives, and senior management who have had many years of experience in the field. All of the participants were based in Bahrain, Qatar, UAE, and Saudi Arabia and work either for Islamic banking units within Islamic financial institutions or for Islamic units within conventional banks. A summary of the respondents who agreed to be interviewed is given in Table 1.

The focused interviews were undertaken in the expectation that the experience of the respondents in the field will provide valuable insights into the main problems and obstacles facing Islamic banking in the GCC. This will assist in predicting future opportunities.

RESULTS AND ANALYSIS

The respondents provided a variety of answers to the question about challenges facing Islamic banking. Each of the respondents seems to have his own concept of what the biggest problem is. Following are their perception regarding challenges that may affect the survival and endurance in Islamic Banks at the GCC region.

The differentiation between Islamic and conventional banking isn't very visible

It would seem evident from the earlier discussion in literature review that the involvement of the conventional banks in Islamic banking activities would raise the problem of the invisibility of differentiation between Islamic and conventional banking. All our interviewees strongly believed this to be the case. One of these, the chief executive of organization A1, commented:

> People may be a little suspicious to start with. I think conventional banks should do Islamic banking as long as the people that are doing it are serious people. As along as a Shariah board exists that will ensure activities are carried out strictly according to the Islamic banking principles, any provision of Islamic banking services will make people more aware of Islamic banking.

On the other hand, respondent A1 states:

> Anybody providing any properly Shariah-compliant Islamic banking services should be welcomed. I have conversations with people who say Muslims should run Islamic banking. I think it does not matter.

In his assessment of the conventional banks offering Islamic banking services, respondent A2 commented:

> I think the phobia comes from ignorance, and the fact that now more people talk about Islamic banking makes it less odd. If you've got a commercial bank that is offering something here, well, one day, in five years' time, there'll be an Islamic bank there.

The need for superior quality of bank management and skill manpower

When attention is turned to staffing and training, the majority of respondents revealed that recruiting was a major problem for their organizations. Respondent C1 was the only respondent who said it was not a problem in his organization, while respondent D1 commented on this question by addressing different levels of management:

> Well, we do not find it difficult to recruit personnel at a higher management level, but at middle management levels we do have difficulties. There are not many people who come in and move from the lower levels to the top management. However, we try to bring in fresh graduates from outside the market to increase the pool of people working in the field.

The chief executive of organization A, however, believes that the principles of Islamic banking should not be difficult to grasp for recruits, as long as they have technical banking abilities. He explains:

> What is required first is not the knowledge of Shariah. What are needed first are the hard technical skills to deal with financial analysis and banking. I think the problem back in the 1980s, and still to some extent today, is that people were employed on the basis of their knowledge of Islamic banking, rather than telling a good deal from a bad deal.

The respondent further argued:

> It's great to know all about Shariah, but what do you know about banking? What do you know about liability management? Do you know how to calculate a risk asset ratio? Because if you don't, you cannot run a bank. You're just going to lose people's money.

Respondent E1 observed unusual remark to some extent where he pointed out that the problem is not in finding qualified and skilled workers in the Islamic banking sector, but finding those skilled who believe in the legitimacy of the Islamic financial transactions.

It is evident from the responses that recruitment is not a problem. This, however, is not to say that knowledge of Shariah or Islam is sufficient to carry out Islamic banking. Personnel need to be equipped with all the technical banking knowledge as well as sufficient knowledge about Islamic banking principles. Staff, therefore, need to be qualified in both areas to be adequately equipped for the Islamic banking profession.

Lack of standardization.

The respondent answers regarding this challenge were unanimated, but there was a lot of concentration about the role of Shariah Supervisory Board.

> G1 said: There is no harmony among the Shariah scholars who give ruling about Islamic financial products. All the Islamic banks have their own Shariah Supervisory Board (SSB) who has knowledge of both finance and religion. The challenge facing Islamic bank is the diversity among the Shariah scholars, due to which leading consumers and investors are uncertain whether the particular practice or product, is Shariah compliant
>
> F1 argued even common Muslims have unclear concept about the different products offered by Islamic banking.
>
> A2 pointed out that the biggest problem of the Islamic banking system is that people are not clear about what Islamic banking constitutes. In C1 view, the confusion about Islamic banking is caused by the Islamic Shariah Committees' various interpretations of what is and is not Islamic

More Global:

The majority of the respondents stressed on the need for well-developed Gulf financial markets, and the imperative of an Islamic institutional response to the financial globalization.

> Summarizing different answers by F1 it can be concluded that financial globalization is an evolving reality. Because of its atheistic, materialistic, undemocratic, non-universal and interest-based world view and character, financial globalization has been posing a serious challenge to the contemporary Islamic countries' agenda of economically empowering and developing themselves through the integration of their economies along the universal Islamic lines exhibited in the form of one Islamic Ummah.
>
> B1 said that it is impossible for the Islamic countries to realize their mutual financial integration along interest-free and universal Islamic lines within the twenty-first century global scenario of the most recent Hot War launched by the exponents of the capitalist ideology against the Islamic ideology. In the light of the aforementioned facts, it is naturally inevitable to constructively address the imperatives of financial globalization within inherent interest-free as well as universal Islamic economic framework which allows us to focus on the nature of financial implications of the financial globalization for the economies of the Islamic GCC countries as well as on the corresponding actual and prospective development policy responses of the contemporary Islamic world.

Diversify Islamic Banks product base

Remarks of respondent's shows that there is an urgent need for banks to adopt aggressive marketing strategies for further growth and survival in the tough, somewhat flat and overbanked market of the region. It also shows that there is a need to conduct regular market surveys to gain information on consumers' behavior, attitude and perception as well as segment-wide studies on specific products.

> According to A2 trust in terms of "privacy and confidentiality" still remains the most crucial factor in selecting a bank's products/services in this region. The personal quality of bank staff, marketing approach to selling banking services and appropriate product management are the other crucial areas.
>
> Respondent C1, on the other hand, indicates that technical issues relating to instruments are the main problem for them. An executive at organization D believes that the biggest problem for them is educating customers about Islamic banking and their products.

The aforementioned diverse set of problems could well be used to illustrate what the Islamic banking system is facing in the GCC. Since the respondents have their own experiences, it is natural to see differences in their responses.

Strengthening bank regulation and legislation to suit the emerging trends

All the intervied agreed on the need for new legislation and/or government authorization necessary to establish Islamic banks

> For example G1 stated that existing banking laws GCC do not permit banks to engage directly in business enterprises using depositors' funds. But this is the basic asset acquiring method of Islamic banks. For example laws in GCC don't include any articles governing contracts, mortgages, and pledges. Similarly no law has been introduced to define modes of participatory financing that is Musharakah and PTCs.
>
> E1 says strict regulation on licensing and other related matters may limit such competition. GCC banks need to open branches in the underdeveloped areas of the region and there should be mergers or exit in those areas which are already over-banked.
>
> A1 also state that law was developed to protect mainly the credit transactions; its application to other modes of financing results in the treatment of those modes as credit transactions also. Banks doubt whether some contracts, though consistent with the Islamic banking framework, would be acceptable in the courts. Hence, incentives exist for default and abuse.
>
> B1 point out that there is a lack of proper definitions of property rights may have constrained bank lending. Thus far there has been no precise legislative and legal expression of what is viewed as "lawful and conditional" private property rights.
>
> A3 said: there are many legal difficulties still to be solved as we have seen above. In other Muslim countries the authorities actively or passively are participating in the establishment of Islamic banks on account of their religious persuasion.

Respondent A3, however, considered regulatory issues as the major threat. He added:

> I guess the other problem is that there are a lot of other institutions that possibly see Islamic banking as an easy target perhaps and they don't take into account the underlying sentiment of the whole thing.

Conclusion:

The overall conclusion, is that Islamic banks do face major problems and challenges in the twenty-first century. Most of the sample interviewed agrees mostly on the challenges facing Islamic Banks, the most important is the lack of differentiation between Islamic and conventional banking this challenge is fostered by the scorned challenge which is lake of standardization. Standardization need criteria and this is usually put by regional or international bodies, in the case of Islamic banks this kind of body should be in an Islamic country.

Regarding the problem related to recruiting professional staff. Finding staff having the required technical expertise of Islamic banking is not a serious challenge according to respondents, but awareness of the basic principles and the ultimate goals of Islamic banking is the problem. It is, therefore, important for Islamic Banks to provide such knowledge and training to those who want to participate in Islamic banking.

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