

**How challenges transform banking behavior of Islamic banks' employees: A
study in Pakistan**

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ABSTRACT

This study examines and helps to identify and recognize the challenges being faced by Islamic banks in Pakistan. In today's global and borderless market, financial institutions are facing a severe competition for their survival. Currently, many objections are raised on Islamic banks as they have to face many challenges up front not only for competing all through but for their necessary survival too.

The current world economic system is heavily dependent on interest based transactions due to which concentration of wealth is in the hands of selected few. It leads to a society with a wide gap between rich and poor. In contrast Islam encourages circulation of wealth, promotes sale and trade and discourages Interest (Riba). The objections raised on Islamic banks may include weak measures of service quality, improper institutional framework, lack of shariah supervisory role, knowledge gap and lack of understanding of shariah knowledge among customers and potential customers. It may further include improper training of staff and lack of resources. Hence, there are several objections raised by their competitors that Islamic banks have to face and to encounter them.

To compete with this interest based system, Islam has the most modest, equitable and perfect solution (The Islamic Modes of Finance or Islamic Capitalism) having a long lasting impact if adopted not only by his followers but for non-believers too. The overall Islamic banking industry of Pakistan needs to meet all contemporary challenges in order to grow at more pace in comparison with conventional banks.

To carry out a detailed research, both quantitative and qualitative measures will be used. It will enable us to have data in descriptive as well as in interviews format so that people can express more of their views regarding Islamic banking. This research will be helpful not only for the management personnel of Islamic banking industry at a wider

level but for industry itself. In short this study can lead to Islamization of banking industry or at least to move one step further for the betterment of Islamic banking in Pakistan.

Keywords: Islamic Banking, Contemporary challenges, Pakistan, Riba, Customers

Introduction

The struggle to Islamize Pakistan's financial system is as old as three and a half decades but the growth of Islamic financial system has been quite slow comparative to many other Islamic states of the world practicing Islamic banking (Haron and Azmi, 2009).

Started in 1977-78, Pakistan's progress for transformation of conventional system into Islamic hasn't provided remarkable achievements as yet. On the other side, many countries who started Islamic banking lately are way ahead comparative to Pakistan despite of being the most populated Islamic nation of the world after Indonesia.

Pakistan, being the second largest populated state among the Muslim countries has an enormous potential of Islamic banking. The problem lies where the gap exists, as there are many challenges being faced by Islamic banks in Pakistan. It has now become increasingly clear that many flaws characterizing the slow pace of Islamic Banking system are indeed a consequence of various issues pertaining to Islamic banking industry in this country. Comparative to conventional banks, it is worth to research on what are the prime factors Islamic banks in Pakistan are facing that should be addressed earnestly to beat the pace of conventional banks all through.

This problem can't be resolved until a research is carried out, identifying and recognizing all those challenges acting as a barrier in the growth of Islamic banks in Pakistan. There is a huge gap that Islamic banks have to minimize in terms of service quality, strong advertisement, and lack of internal and external control measures both in terms of management and shariah compliance. Apart from that, there are many other challenges that will be identified in this research which will ultimately help comparative to so many other Islamic countries e.g. Malaysia, Bahrain, Saudi Arabia, Bangladesh and Kuwait.

In order to identify all such problems or challenges Islamic banks in Pakistan are currently facing, the research questions will be asked not only from general public but from the management personnel of major Islamic banks in Pakistan too. General questions that can be asked from customers include knowledge of Islamic banking and

its operations, about their perception regarding Islamic banking, their opinions about flaws in Islamic banking etc. Similarly, the management personnel can be asked regarding Internal controls e.g. Shariah compliance, regulatory framework, employee's training specially of those coming from conventional banks etc. Thus, it's important to cover both the management and the customer's perspective in order to achieve the purpose of this research.

Challenges relating to Islamic Banking Behavior of Employees

An increasing trend of Islamic banking growth in Pakistan reflects that there is a huge potential for Islamic banks to capture a large share of banking industry in Pakistan. It further reflects that if the current challenges are addressed properly, Islamic banking can even go one step ahead to conventional banking. This research will help the general public (the potential customers) understand and clarify their doubts regarding Islamic banking. It will further enable the management of Islamic banking to cut short their discrepancies and to concentrate more on what is required by removing flaws in their system.

It will further enable the regulatory authorities to regulate Islamic banking industry on what terms it is required to be regulated. Similarly, it will help central bank and the government while legislating for Islamic banks and to relaxed and strengthen keeping in view the exact necessity of the Islamic banks. Furthermore, this study will be useful to advance one more step towards Islamization of banking industry in Pakistan. It will subsequently help Islamic banking industry as a whole to structure their decisions and policies keeping in mind all the possible challenges and issues being faced by Islamic banks. Some of these challenges that are primarily related to the attitude of Islamic banking employees and influence their banking behavior are mentioned in **Table 1**

below. Fourteen hundred years before, Prophet Muhammad (P.B.U.H) prohibited to deal in any transaction whether financial or non-financial that is based on Interest (Riba). In Islamic jurisprudence sale and purchase (Trading) is encouraged so that any Interest based transaction can be avoided (El-Gamal, 2003). Similarly, the Quran says about the prohibition of interest as; “O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy.” (Surah Al 'Imran, verses 130-2).

People always tend to resist whenever there is a change in any system as a whole. There are always certain changes occurred in any field, processes or a system. These changes help system to improve. Islamic banking system is on the same grounds as people tend to resist due to conventional banking system because when this concept of Islamic banking system was introduced, a very few people were there to accept it. Similarly, as Islamic banking industry has grown much during the last decade, the people are more aware now and this mindfulness is helping the system run efficiently (Akhtar, Ali, and Sadaqat, 2011).

Table: 1***Challenges Faced by Islamic Banking***

| Sr. | Challenges | Explanation |
|------------|---|--|
| 1. | Slow Pace of Growth | Pakistan being a very populous Muslim state is facing the problem of slow growth in terms of Islamic Banking. It is not progressing with the same speed as compared to many other muslim countries. Islamic Banking is evolving day by day but still there is a need to match the pace of conventional banking in the country. |
| 2. | Unwillingness to accept Change | Most of the people don't accept change in any system as a whole. Islamic Banking is facing the same problem, as people tend to resist due to the conventional banking system. Very few people were there to accept the idea of Islamic banking system when it was introduced. |
| 3. | Absence of supervisory framework | Lack of effective supervisory framework is the key problem Islamic Banking system is facing. Islamic Banks are keenly observed by the central banks as well as the shariah |

counselling panels. A weaken management can violate the trust of the customers which will eventually creates barrier in the evolution of Islamic banking industry.

4. **lack of assurance and awareness among customers**

The most important of all is to gain the trust of the customers and to guarantee them that shariah department of the bank is working sincerely to eliminate the interest factor (Khan and Fasih, 2014). Currently, Islamic modes of financing is being practiced and customers are unable to distinguish between islamic and conventional banking structure. Lack of trust and awareness among customers is the main issue.
5. **Lack of firm investment opportunities**

Another problem faced is the absence of strick check on investment opportunities. Islamic banking organizations prohibits to put money into any interest related products. It is backed by real goods or assets.
6. **Restricted supply and cumulative demand**

Cumulative demand and restricted supply from Islamic Reserves is the main issue faced in Pakistan. Government should come forward with a solution to solve the short term liquidity problem (Ahmed, 2010).

7. **Lack of solid rules and regulations** There should be a strict check on the products offered by Islamic Banking. While developing the products, there are some serious rules and regulations that needs to be followed without any negligence or error. Islamic Banking is purely based on asset based financing to generate return.
8. **Absence of legitimate framework** The existing legal framework is not able to distinguish between the two banking systems . Proper legal framework will benefit Islamic systems to develop and grow as a whole.
9. **Shortage of exclusive products** Islamic Banking is competing with conventional banking but it is unable to provide different products or solutions. To solve this issue, Islamic banks have to step forward and take initiative that will lead to large scale expansion and sustainable progression of the Islamic Banking Systems (SBP, 2014).
10. **Need of corporate social responsibility** Corporate social responsibility is very important as it will play its role by investing in the companies who deals largely in certain activities considered allowable in Shariah.

Social behavior is one of the important ethical principle of Islam and it takes care of human well-being as a whole (Akram, Rafique, and Alam, 2011).

11. **Non-existence of benchmark** An important question raised by the customers is that why islamic institutions lack their own benchmark. Interest rate benchmarks are still used by Islamic banking to earn profit.
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Islamic banking, generally known as ethical banking in most of the western countries of the world is progressing quite remarkably. However, there is a serious need to work on almost all the contemporary issues or challenges faced by Islamic banking industry for its growth in both Muslim and Non-Muslim countries. Even Pakistan being one of the most populous Muslim countries could not pick up its pace in Islamic banking when compared to its counterparts (Ahmed, 2010). With the passage of time, various verdicts have been found that support Islamic banking and oppose the conventional banking system. We found different verdicts against conventional banks and in favor of Islamic banking system. In this regard, a very profound scholar and Justice of supreme court of Pakistan, Wajihuddin Ahmed occupied high positions in the judiciary. In his presence, Shariah bench passed the historic verdict on riba in December 1999 stating that any financial transaction that is based on compensation over and above of the principal amount is riba (Interest) and to curb down the ill of interest, government should make serious efforts to promote Islamic banking in Pakistan. (Zaidi, 2003).

Being second most populated country among the Muslim world, Pakistan has an enormous potential for Islamic banking. Therefore, it is important to improve its financial system and resolve all the issue of this industry. The rules, regulations and practice of Islamic banking in Muslim countries also all over the world can be better understood keeping in view the Islamic banking practices in such countries. Islamic banking in Pakistan is no doubt progressing but still there is a big gap to match the pace of conventional banking in the country. The average growth rate of Islamic banking in Pakistan is encouraging with 12% per anum.(Imran, Samad, and Masood, 2011).

Islamic banking and conventional banking have run through side by side. Despite overall low performance of Islamic banking, the growth in comparison with conventional banking is better (SBP, 2010b).

Islamic banks have been questioned with reference to monitoring and control. The overall control of Islamic banks is observed weak in comparison with the conventional banks. According to Havrylchuk (2006), foreign banks are more efficient and they might profit from better risk management. Lack of efficient monitoring and control is considered as one of the weakest points of the prevailing system of Islamic banks. Islamic banks are monitored not only by their shariah advisory boards but from the central banks too. The measure of controls in supervisory role and shariah compliance role needs to be streamlined and strengthened. Islamic banks and their respective growth is directly related to the fact that upto how much extent, the bank is able to maintain strict adherence to Shariah rules and regulations. The supervision role, if weaken can cause trust deficit in customer's view point and ultimately creates barrier in the growth of Islamic banking industry. There are several reasons reflecting that why all such regulations and guidelines are important. Among such reasons the most important of all is the trust building of the customers and to ensure that the shariah department of the bank is working earnestly to shun down the interest factor (Khan and Fasih, 2014).

Islamic banks are supposed to give even more sophisticated services compared to conventional banks. Their procedures and practices should reflect equality and justice. This is what service quality is all about as it measures the difference between the customer's expectations and the actual performance provided to them. An Islamic bank is more prone to face such challenges as majority of the customers think of it to deal and to act completely within the guidelines of Shariah (Abedniya and Zaeim, 2011).

Proper check and balance is required on investment platforms (preferably short term) as it is one of the most important challenges that Pakistan's Islamic banking industry faces today. Being shariah compliant an Islamic bank cannot invest in conventional or an interest-based debt instruments. These conventional or interest based instruments may include T-bills and Pakistan Investment Bonds etc. It is therefore, a key challenge as far as short term liquidity management of an Islamic bank is concerned. An alternative for this given by Shariah boards of different Islamic banks in Pakistan is Ijarah Sukuk, concept given in 2008. However, limited supply and increasing demand from Islamic treasuries are some of the major challenges Islamic banks in Pakistan have to face in terms of Sukuk. A short term liquidity solution is still awaited from the government. (Ahmed, 2010).

Another question raised on Islamic banking products is to check that whether the products being offered by Islamic banks in Pakistan are Shariah compliant or not. While developing Islamic banking products, certain conditions are needed to be stipulated and strictly adhered to without having any error or negligence. As per the report of State bank of Pakistan, Islamic banking products are designed in accordance to the need of the depositors that mainly rely on asset based financing to generate return. Figures from the SBP for the period ending March 31, 2010 indicate a heavy concentration of Murabaha, that is an asset based product (a product includes cost plus profit) and contributes to almost 37% of the total Islamic banking portfolio of Islamic banking industry. Including Murabaha and other major modes of financing including Ijarah and Diminishing Musharakah that all are asset based constitute more than 80% of the financing portfolio of Islamic banks in Pakistan (SBP, 2010b).

Legal framework of Islamic banking is one of the most important elements that enables sustainable growth and development of Islamic banking industry as a whole.

Unfortunately, the existing legal framework is unable to distinguish between conventional banking and Islamic banking and Banking Companies Ordinance. Moreover, severe concerns are being raised by many schools of thoughts stating that Islamic banking is largely providing alternatives to conventional products and services and is unable to provide exclusive different products or solutions. For mitigation of this issue, Islamic banks have to take initiative that is necessary not only for their sustainable growth but for a large scale development of Islamic banking industry as a whole (SBP, 2014)

Islam caters rights of individuals whether these are related to financial matter or in civil rights. Similarly, in Islamic banking a great responsibility lies on every individual Islamic financial institution to protect rights of every customer. Islam is one of those religions that support people who are socially responsible. As per the Islamic teachings, one must take care of others just like he/she takes care of himself/herself. The measures of service quality in Islamic banking is not only related to customer satisfaction but also to determine more serious measures towards banking products. Similarly, investments of Islamic banking industry should be done in those organizations that are engaged in activities considered permissible in Shariah thereby reflecting corporate social responsibility. In ethical principles of Islam social behavior is one of the principles and Islam takes care as a whole of human well being (Akram, Rafique, and Alam, 2011).

Currently, Islamic modes of financing being practiced in Islamic banks in Pakistan are no different than conventional system (Khan, 2010). The reason behind this argument is that nothing can be charged on consumables including money. Only rent can be charged for the use of tangibles like property or any asset. The issue is in the ideology of making an impermissible thing into permissible. The technique is to convert the

money into asset and then sell the asset on profit or give the asset on rental basis to earn profit (Sheikh, 2007).

Another popular question being asked by many customers and potential customers of Islamic banks that why Islamic financial institutions don't have their own benchmark. They are of the view that using interest based benchmark (KIBOR) as used by conventional banks puts Islamic banks as well as their customers at the mercy of movements in the interest-based money market. This creates a negative perception among the clientele of Islamic banks as they think that there is no real difference in Islamic banking products because they also use the same interest based benchmark. However, to address the issue of benchmark, some Pakistani banks have now taken the initiative and work has already started to develop an Islamic benchmark (Ahmed, 2010).

In reply to this argument, a profound scholar and Shariah board's chairman of Meezan bank limited, Mufti Taqi Usmani stated that KIBOR is not a measure to check that whether a transaction is Islamic or not, it is just a profit rate or a capping rate upto which any financial institution is allowed to earn profit (Ali, 2013).

DISCUSSION AND IMPLICATIONS OF RESEARCH

A comparative study of Pakistan and Malaysia shows that Malaysia was the first country who has contributed a lot in establishing a successful Islamic banking system. Pakistan, on the other hand is much older than Malaysia in Islamic banking as initiatives taken on government level in late 1970's. However, currently the trend of Islamic banking industry in Pakistan is also increasing. It is anticipated that number of branches in this industry will also escalate just like it was observed between year 2008 and 2010

(SBP, 2008, 2010a). Previously, there were around 649 branches in 2008 and currently it stands on 751 branches throughout the country (SBP, 2010a).

As one of the major differences between conventional and Islamic bank is that the latter is known as an asset-based banking. In case Islamic bank utilizes natural resources from a specific region, it should compensate the people of that area and can avoid the regional disparity (Ullah and Jamali, 2010). An illustration of the issues discussed in previous section is shown in **figure 1** below.



Figure 1:

Islamic Banking Challenges that Transform Banking Behavior

Haron and Hock (2007) are of the view that mostly Islamic banking transaction is based on non-risk sharing so in such transactions, an Islamic bank does not share risk. In the same way there are some non-materialistic transactions, which means that there is no real transfer of title in the sale and purchase. Similarly, there are many similarities e.g. fee charges or service charges alike commercial banks and this is exploitation in the

name of Islamic banking. Criticizing on the argument that Islamic banks do Shariah compliant business, they said that the transactions named as contract and termed as Islamic are indeed impermissible as it is very clear from above debate that all the products, functions and certificates are non-Islamic and we are just using the name Islamic (Haron and Hock, 2007). Among many objections raised on Islamic banking includes one stating that the many local laws including commercial, banking and company laws in most of the Islamic countries are based on the western patterns. These laws are quite similar to conventional laws e.g. provisions that narrow the scope of activities of Islamic Banking within conventional limits. It depends on the parties to contract who can structure their agreements according to the true sense of Islamic principles for which the enforcement of those agreements in courts may require extra efforts and costs. Such laws would facilitate the operation of Islamic banks side by side with conventional banks (Iqbal, Ahmad, and Khan, 1998).

On the contrary, the Islamic banks performed better as compared to Conventional banks in Pakistan. As the time passes there is a potential for growth and an increased efficiency of the Islamic banking system (Bader et al., 2008). The central bank plays vital role in establishing and promoting Islamic banking in accordance with the rules of Islamic jurisprudence. Similarly, by the end of December 2001, State Bank of Pakistan took initiative regarding Islamic banking system in Pakistan in order to promote Islamic banking that has led to constitute a Shariah department to regulate and monitor Islamic banking business protocols (Ahmad and Saif, 2010). It is expected that in the years to come, the central bank will introduce new policies and regulations to govern Islamic banking with separate central banking protocols and standard operating procedures. This will not only rationalize the need of a central bank for Islamic banking institutions

but will also establish Islamic banks as a unique entity opposed to the conventional banking system.

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