

## **Inside-Out: Perception of Key Finance Professionals about Theory and Practice of Islamic Banking**

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### **Abstract**

*Islamic banking has shown tremendous growth in the first decade of 21<sup>st</sup> century. By the end of 2008, global volume of assets under Islamic banking reached US\$951 billion. In Pakistan, Islamic banking has displayed a tremendous annual average growth of 76% during the last seven years and accounts for 6% of the market share (SBP-2010). However, keeping in view the religious ideologies of the significant majority of Pakistanis, Islamic banking industry has expanded at less than its expected potential. This study documents the perception of key players in finance industry about Islamic banking, to highlight the underlying issues directly responsible for slower-than-potential-expansion of this industry. Findings suggest, although theoretically, that the industry perceives Islamic banking correctly, however professionals do not feel content with its practice.*

**Keywords:** Perception, Survey, Islamic Banking, Islamic Finance, Pakistan

**JEL Classifications:** G 12, G 32

### **1. Introduction**

Islamic banking has shown tremendous growth throughout the world during the first decade of 21<sup>st</sup> century. According to an estimate, the volume of assets under Islamic financial system has crossed FigureUS\$951billion by December 2008(IFSL, 2010). In Pakistan too, Islamic banking grew by an average of about 76% per year over the period 2004-10. (Hanif, 2011).Although, this growth is very healthy for a new business sector, however, growth comparison of Islamic banking industry with other general businesses would not be appropriate, as Islamic banking has been developed on the basis of a religious philosophy (of avoidance of interest in financial dealings). Chief reason for the development of Islamic banking is to abide the Sharia (Islamic law) by eliminating interest from the economy; however, economic rationales were also developed later on.

If we accept the avoidance of interest (Sharia compliance), the single largest motivating factor in the establishment of Islamic financial system, it becomes the religious duty of every Muslim living in Pakistan to practice Islamic banking. Therefore, the recent growth in Islamic banking seems insufficient as for market penetration is concerned. Islamic Financial Institutions (IFIs hereafter) working in Pakistan captured only 6.4% of market share (SBP-2010)of the banking industry since its inception which is insufficient keeping in view the religious linkage of this business sector and the proportion of Muslim population in Pakistan.

Lower-than-expected growth in Islamic financial system can be attributed to a number of reasons including (1) skeptical operations of IFIs; (2) incapacity of human resources engaged in the practice of Islamic financial system; (3) non conduciveness of existing accounting, legal, and business frame work; (4) lack of trust between IFIs and customers; and (5) lack of awareness about the philosophy and operations of IFIs among masses. This study is conducted to document the perception of finance professionals, working in academia and business/industry, about the theory and practice of Islamic banking.

Understanding and positive change in the perception of finance professionals is vital for the success of Islamic financial system keeping in view the important role of these professionals in financing and investment decisions of business and industry. We designed a questionnaire (see appendix), and collected responses through professional survey hosting web<sup>1</sup>, by circulating web link via email. About 27% of respondents are of the view that interest free economy cannot survive and a majority (63%) endorses operation of IFIs parallel to conventional banking. Furthermore 3/4<sup>th</sup> of respondents perceive the future of Islamic banking very bright in local market and that the youth should consider it seriously as a prospective employing industry. The rest of the study proceeds in the following order. Literature review is presented in Section II, followed by purpose and methodology presented in Section III. Section IV presents results and discussion, while Section V concludes the study.

## **2. Literature Review**

Ahmad and Haron (2002) documented that Malaysian corporate customers had little understanding of Islamic financial system, despite the fact that this system was introduced there in the mid-eighties..They also found that the market perceived a better chance of expansion of Islamic financial system if the costs of products offered by IFIs were low. In another study, Abdullah and Dusuki (2006) documented the need for educating customers about products of Islamic financing, after surveying 203 customers in Malaysia.

Bleyand Kuehn (2004) studied the perception of students about Islamic financial system in UAE. They found that the UAE students had a better understanding of conventional banking as compared to Islamic banking. They also reported that the religion was the main reason, among students, for opting Islamic banking. However, Hoq and Amin (2010) concluded that Islamic banking is not merely of interest to Muslims alone, as non-Muslim customers can also benefit from this system.

Haque, et.al. (2009), surveyed 485 banking customers in Malaysia and concluded that service quality, social and religious perspective, and availability of services are the three factors that contribute significantly in formulating customer perception. Ahmad et. al. (2010) surveyed 720 banking customers in Pakistan and documented that customers of Islamic banks have greater perception towards service quality than the customers of conventional banks.

It is very clear from above citations that in these countries although experience of Islamic banking is continued however awareness among masses about operations of IFIs is lacking and demands action from policy makers. It is important to study perception in Pakistan where Islamization of financial sector is started second time and document the opinion of professionals about the industry.

## **3. Purpose and Methodology**

This study is conducted to document the perception of finance professionals about the theory and practice of Islamic banking being operational in Pakistan. Through this study, we aim to uncover the inner feelings of finance professionals serving in academia, business, and industry about the theory and operations of Islamic financial system. Perception of these professionals, contributing to and in some cases directly responsible for the financial management of business and industry, is vital for the success or otherwise of Islamic financial industry. In addition, this perception study shall provide an opportunity to the Islamic finance industry to correct itself by taking appropriate measures as suggested by the corporate customers and develop a positive image in the eyes of finance professionals, the ultimate clientele of Islamic financial system.

We designed a questionnaire (appendix) to get the responses of finance professionals including teachers and middle to senior level finance managers. Majority of respondents are members of local professional accounting body (ICMAP), working in business and industry. Perception of working accountants about Islamic banking has a policy impact for leaders of Islamic financial system, as corporate financial decisions are very much influenced by these professionals. This questionnaire consists of ten questions. Questions one to four deal with demographic, qualification, experience and frequency of interaction with banks. This information is needed to determine the capacity of respondents and their exposure to banking services. Questions five to eight directly relate to the theory and practice of Islamic banking in its operational form in Pakistan. Question nine is about the future prospects of the industry and prospective career choice for business/finance graduates. Question ten takes suggestions and recommendations from the respondents.

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<sup>1</sup> Survey monkey survey hosting web

Convenience sampling technique is used in the study. All respondents are contacted through E-mail by sending link of the website,<sup>2</sup> hosting the survey. Incomplete responses were not included and finally 100 responses are included in compiling the results of the study. The sample of 100 could be treated as a reasonable representation of finance professionals keeping in view the profiles of respondents. We used MS Excel for data analysis. The results are presented using bar and pie charts.

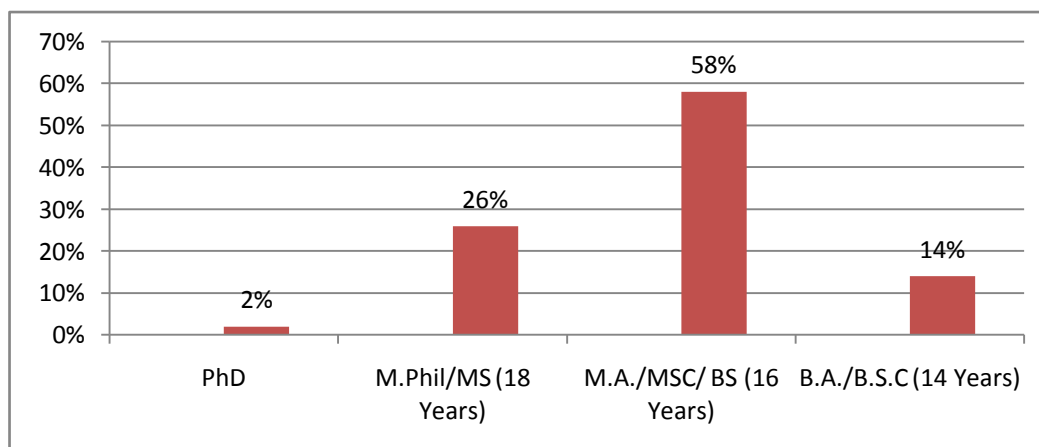
## 4. Results and Discussion

### 4.1. Findings

The first question of the survey (see appendix) is about the demographic information of respondents including gender, experience, city, and country. Of the 100 respondents, 95 are male meaning that the sample is dominated by males. This Figure is not surprising keeping in view the ratio of males versus females in working groups and of course the choice of profession in the local market. Mean and median experience of the respondents is 14.52 years and 12 years showing their maturity and deep understanding of the financial industry. Most of the respondents are from the three major cities of Pakistan, that are Karachi (21%), Lahore (20%) and Islamabad/Rawalpindi (43%). This shows that the survey is representative of Pakistani financial sector from the North to the South. Overall, 93% of the respondents are from Pakistan and the rest are from abroad (UAE) overseas Pakistanis.

The second question is about the formal education of respondents. Figure 1 depicts qualification of respondents. Out of 100 respondents, 58% has a master/bachelor degree (16 years of education), 26% has an M.Phil/MS degree (18 years of education), 14% has a BA/BSC (14 years of education), and only 2% possess a PhD. Hence, the sample is dominated by the respondents with 16 years of education. An overwhelming majority (64%) are professional accountants having membership of a local accounting body, in addition to an academic qualification. Overall, the sample consists of well-educated people with majority of them being qualified accountants with professional financial education. Most of them are members of ICMAP<sup>3</sup>, working in business and industry and dealing directly with financing of firms.

**Figure 1- Qualification (formal education) of Respondents.**

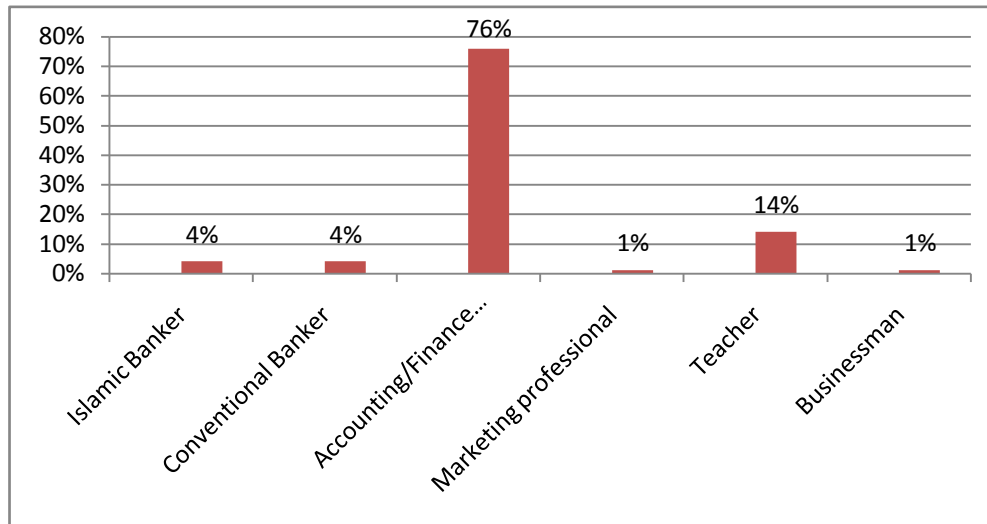


Third question is about the profession of the respondents. Figure 2 depicts the profession of the respondents. It shows that out of 100 respondents, 76% are accounting/finance professionals, followed by 14% academicians, 4% each associated with Islamic and conventional banking, and 1% each are businessmen and marketing professionals. Accounting/finance professionals dominate the sample, followed by academicians and being frontline professionals their perception about Islamic financial industry is vital for its success.

<sup>2</sup> Survey Monkey website is used for this survey.

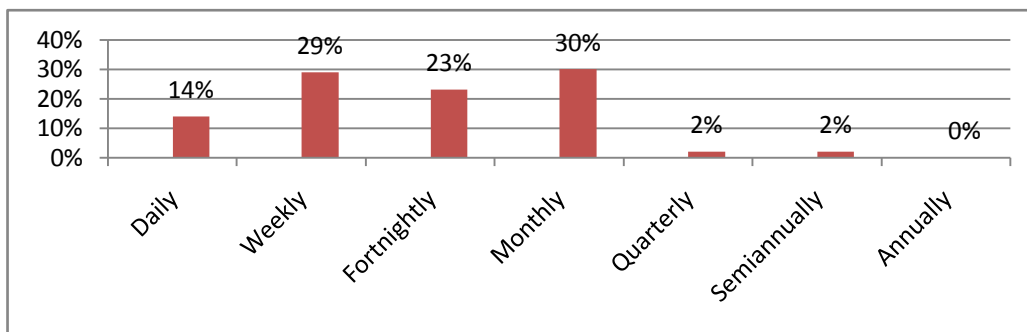
<sup>3</sup>ICMAP stands for Institute of Cost and Management Accountants of Pakistan.

**Figure 2- Profession of Respondents.**



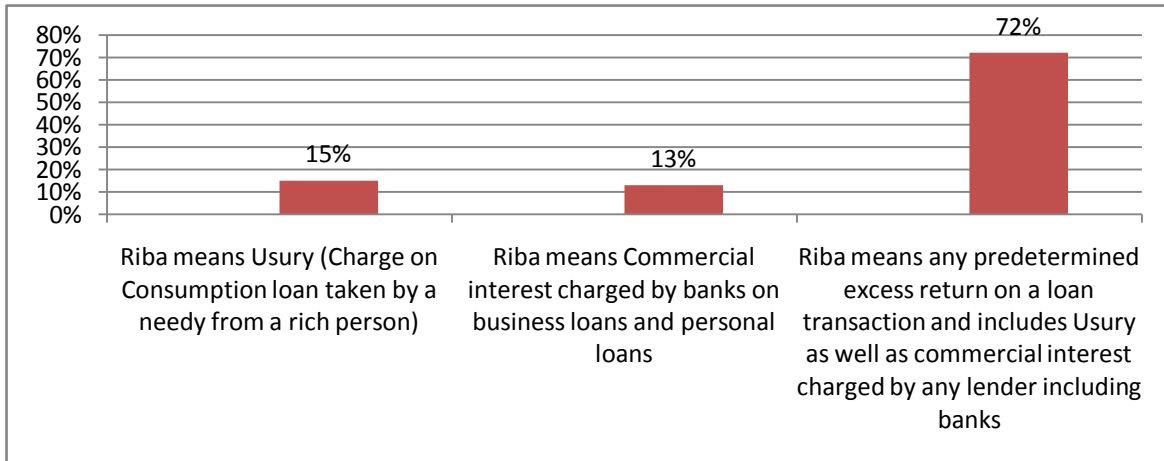
Fourth question is about the usage of banking services (interaction with bank). Figure 3 shows the frequency of banking services used by the respondents. In this question, respondents had seven options to select from (daily, weekly, fortnightly, monthly, quarterly, semiannually and annually). The results indicate that 30% of the respondents use banking services once every month, 29% once every week, 23% once every fortnight, and 14% at least once every day. The remaining 4% interact with a bank either quarterly or semiannually with 2% belonging to each category. These results indicate that most of the respondents (96%) use banking services at least once every month showing its demand and usage.

**Figure 3- Frequency of banking services demand.**



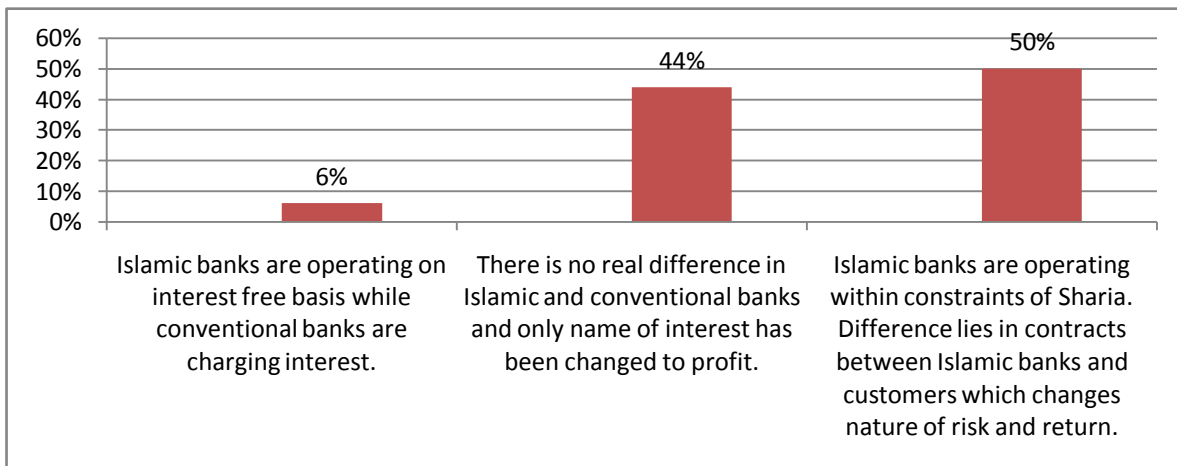
Question five is about the understanding of the term “Riba”, as referred to in The Holy Qura’n. Respondents were offered three definitions of Riba: (1) Riba covers usury only; (2) riba covers commercial interest charged by banks only; and (3) a consensus definition that Riba covers both usury and commercial interest. Respondents were also offered to give their own definition. None of the respondent gave any definition. Figure 4 depicts the definitions chosen by the respondents. Interestingly, a significant majority(72%) of respondents is well aware of the concept of Riba as explained by the contemporary clerics that riba covers both usury and commercial interest, whereas 15% are of the view that riba means usury—charge on consumption/needly loans—and astonishingly, 13% respondents are of the view that Riba is commercial interest and not usury. Overall, the majority of the respondents (72+13=85%) believe that that Riba includes the interest charged by the modern commercial banks.

**Figure 4- Selection by respondents of meaning of Riba.**



Sixth question was about the difference between the Islamic and commercial banks. Respondents could choose one of the following three options: (1) interest is the only difference between the Islamic and commercial banking; (2) there is no difference as the word ‘interest’ is replaced with ‘profit’; and (3) Sharia compliance by Islamic banks in all operations makes it different from conventional banking. The respondents were also given the opportunity to explain any other difference; however none of them gave their own opinion of the difference. Figure 5 depicts the choices opted by the respondents. It shows that most of the respondents (50%) correctly understand the difference between Islamic and conventional banking that underlies in Sharia compliance. However, a sizeable percentage, (44%) of respondents perceives no difference in conventional and Islamic banking in practice. This is alarming both for practitioners of Islamic banking and policy makers. It indicates that well planned and determined efforts are required to educate the masses about the true practices of Islamic banking. Finally, only 6% of the respondents perceive that the difference between the two banking systems is due to the interest charge.

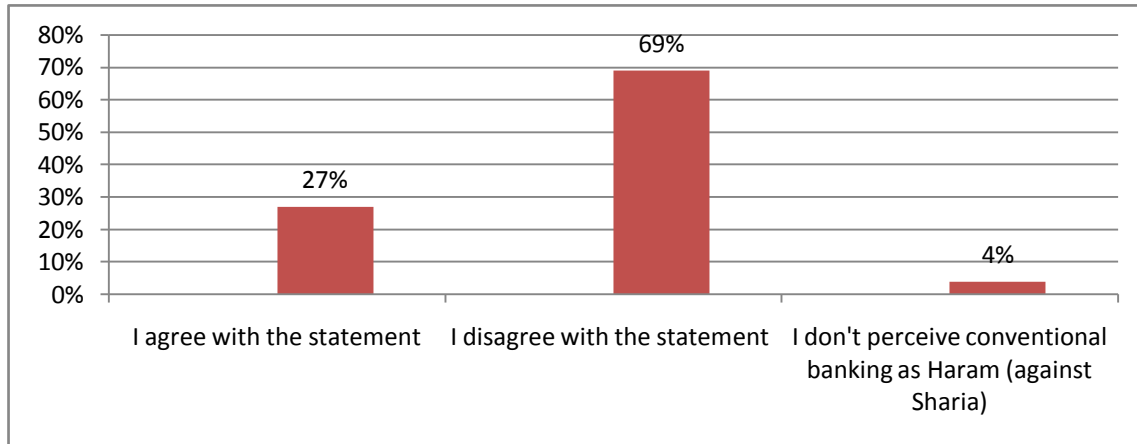
**Figure 5- Respondents’ understanding of difference between Islamic and conventional banking.**



Question number seven was about the existence and viability of an economy without interest based financial system. Respondents were asked to choose one of the following options or to give their own reason. Options provided were:(1) although interest based financial system is *haram*(unlawful),however economy cannot work without it; (2)interest should be eliminated from financial system as economy can work without it; and(3)needless to exclude interest from economy as charging interest is not *haram* (prohibited by Sharia).The responses are presented in Figure 6. A vast majority (69%) perceive that interest free economy is viable and sustainable in modern times, followed by 27% of respondents who think that modern economy cannot work without an interest based financial system, and a very small minority (4%) thinks that there is no need to change the system from interest based to interest free as interest is no *haram*.

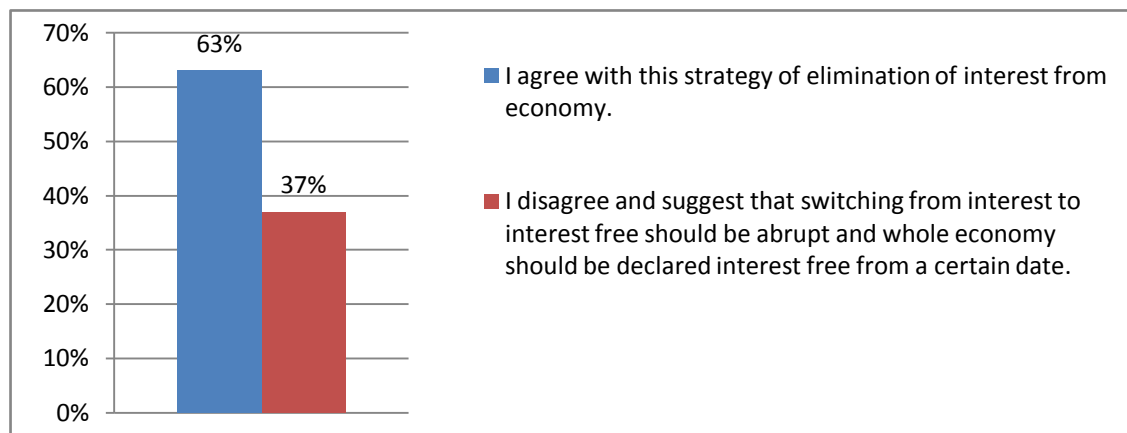
The results indicate that overall 31% of respondents are skeptical about the sustainability of an economy in the presence of an interest free banking system. This result points out that the policy makers and advocates of a full fledged Islamic financial system need to develop programs of creating awareness among the masses about the existence and sustainability of such a system, for example, by using financial engineering to develop to a range of Sharia compliant products.

**Figure 6- Responses about working of interest free economic system economy.**



Eighth question was about the strategy to eliminate interest from the economy. Respondents were asked either to select an option from the given two choices or to suggest their own strategy. The two suggested strategies to Islamize the economy were: (1) parallel working of Islamic banking with conventional banking in the interim period to increase market share (strategy currently in practice) to about 70%; and (2) abrupt switching from interest based system to interest free financial system from a certain date. Responses are depicted in Figure7. The majority (63%) of the respondents show their confidence in the present strategy while 37% of respondents think the change should be abrupt.

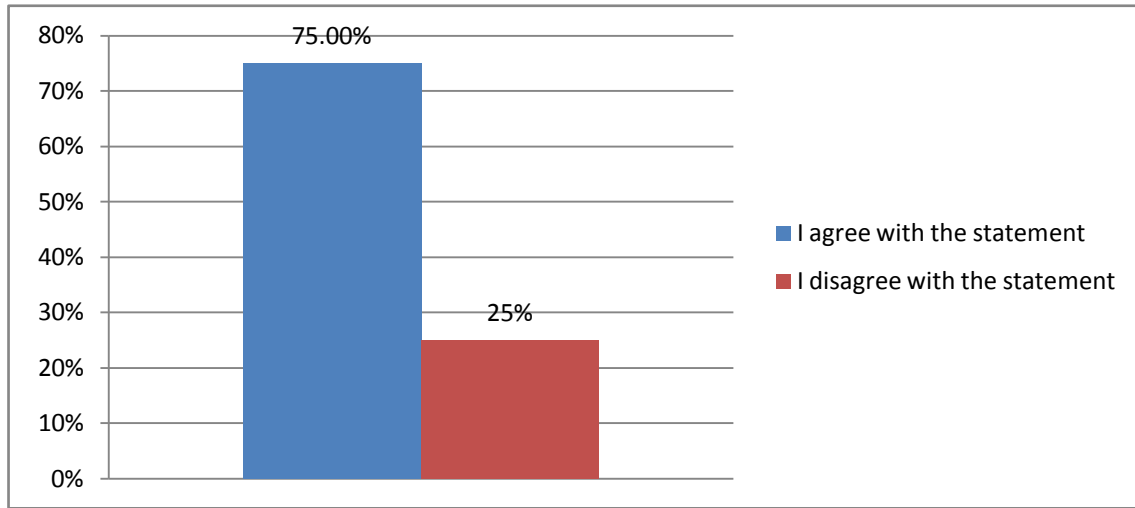
**Figure 7- Responses about strategy for elimination of interest.**



Question number nine was about the future prospects of Islamic banking in the local market and the provision of skilled human resource. Respondents were provided with the following statement: *Islamic Banking has shown unprecedented growth world over in general and an average annual growth of 76% in Pakistan in last six and half years. In your opinion, this sector will continue its momentum of growth and expansion and business graduates should target it as a prospective employing industry and equip themselves with relevant skills; and business schools should teach a course on Islamic financing.* The respondents were asked whether they agree or disagree with this statement. Responses are displayed in Figure8. It shows that an overwhelming majority (of 75%) of respondents perceive the bright future of Islamic banking in Pakistan and that business graduates and business schools should target the Islamic financial system as a prospective employing industry by acquiring relevant knowledge and skills to meet its increasing human resource demand. However 25% of the respondents are not very enthusiastic about future of Islamic financial industry.

Although 25% is relatively a smaller percentage in comparison to 75%, however, policy makers must continue to create awareness and educate the masses to change this perception to make the Islamic financial industry a success in Pakistan.

**Figure 8- Perception about future prospects of Islamic banking.**



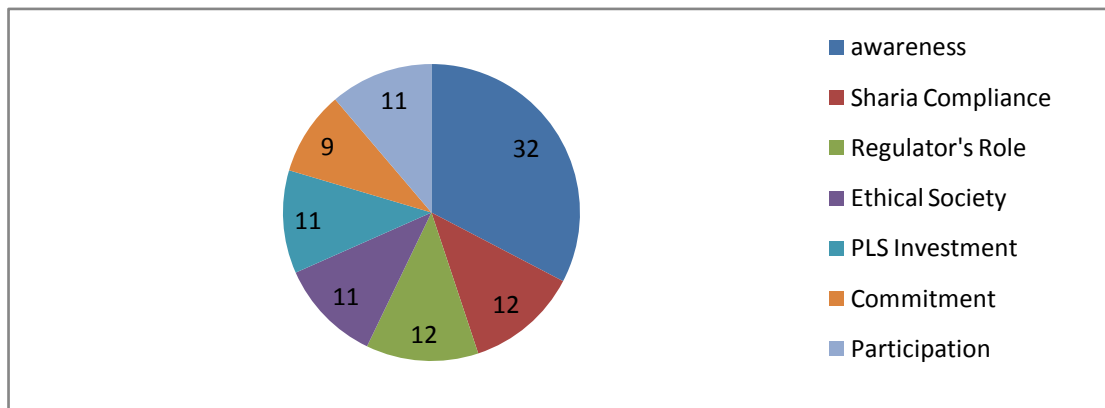
**4.2. Suggestions and Recommendations**

Tenth question requested the respondents to give suggestions and recommendations for the growth and promotion of Islamic banking. We received valuable suggestions that are summarized in this section. Figure 9 depicts the responses in a graphic form.

**4.2.1 Awareness**

A large number (32) of respondents suggested that an awareness campaign should be launched by the Islamic financial industry to overcome the misperception of masses about a sustainable Islamic financial system. Awareness can be created by offering courses at the graduation level to business students and by arranging research conferences, seminars, road shows and through the media. Another avenue for creating awareness could be to utilize the mosques, for example, at weekly *Juma* congregations. IFIs should strengthen their linkages with the religious community especially *Imams* (prayer leaders) and *Khateeb*s (speakers at *Juma* congregations).

**Figure 9- Recommendations by Respondents.**



**4.2.2. Sharia Compliance**

Twelve respondents recommended that IFIs should focus on Sharia compliance (the primary differentiating feature between conventional and Islamic financial systems) and should not mix it with any aspects of conventional banking and must not compromise due to any excuse. For example, linking the profit percentage with the interbank offer rates (KIBOR, LIBOR), and serving depositors in a fashion similar to that of conventional banking makes the operations of IFIs skeptical in the eyes of a common man.

Sharia compliance can be ensured through capacity building of Sharia advisors and Sharia boards of IFIs both locally and internationally. At present Sharia advisors lack required financial knowledge hence it is difficult to ensure 100% Sharia compliance in the operations of IFIs (one example is profit calculation by IFIs through application of time value formulas). Sharia compliance in operations of IFIs could be enhanced by strengthening Sharia audit at regulatory level. There is a dearth of Sharia auditors in private sector and policy makers must consider the development of human resources in this area.

#### **4.2.3. Regulator's Role**

Twelve respondents suggested enhancing the role of the regulator to nurture and promote Islamic banking.<sup>4</sup> Some of them even suggested that the State Bank of Pakistan (SBP) should make it compulsory for every bank to shift some of their branches from conventional to Islamic banking. Others suggested that the government should make sincere efforts to promote Islamic financial system. At present, SBP is really doing well. As far as providing guidance is concerned, prudential regulations are being developed by establishing an Islamic banking department, however, certain issues (such as no return on statutory reserve maintained with the central bank by IFIs and an independent law for the regulation of Islamic financial industry) require urgent attention of the regulator.

#### **4.2.4. Ethical Society**

Eleven respondents recommended the creation of an ethical society conducive to practicing Islamic banking. Transparency international reports<sup>5</sup> indicate the existence of massive corruption in less developed countries like Pakistan, which must be addressed by the society as a whole including the masses, the government, the regulators, and the judiciary. In order to practice the Islamic financial system in its truest form, uplifting of the morals of society are prerequisites. <http://www.transparency.org/publications/gcr>

#### **4.2.5. Profit and Loss Sharing**

The use of profit and loss sharing (PLS) modes of financing in the operations of IFIs is recommended by 11 respondents. At present, only deposits are collected on PLS basis, however, the share of PLS in financing and investment portfolios of IFIs is negligible. At the end of September 2010, the share of Musharaka and Mudaraba financing in the portfolios of IFIs working in Pakistan was less than 2%.<sup>6</sup> Economically and operationally, the most important feature of IFIs should be to provide financing through Musharaka and Mudaraba, which has so far been left ignored by the IFIs. This is the time that the practitioners and policy makers of Islamic finance pay due consideration to promote the profit and loss sharing modes of financing.

#### **4.2.6. Commitment by IFIs**

Nine respondents are of the view that IFIs should show commitment and stick to the principles of Islamic banking. Supposedly, with the passage of time, society would feel the difference and appreciate the Islamic financial system. In order to remain in business, IFIs would have to invest in human resources as well as developing new products. One of the major issues faced by IFIs is the availability of trained human resources. At present, two streams of professionals are graduating from local educational institutions consisting of trained conventional bankers and Sharia experts. IFIs require the services of those professionals who have the understanding of both the relevant Sharia laws and banking systems. At present, most of the IFIs employ officers trained in conventional banking; however they lack the required understanding of the philosophy of Islamic banking. That is the reason that we observe little focus on Sharia based modes of financing (Musharaka and Mudaraba) and a relatively higher share of Sharia compliant financing (Murabaha, Ijara and diminishing Musharaka) in the portfolios of IFIs (SBP-2010).

#### **4.2.7. Enhanced Participation**

A few respondents recommended increasing the participation of all the stakeholders, for example, of businessmen, academia, financial industry, regulators, civil society, clerics and intelligentsia in promoting and implementing Islamic financial system.

<sup>4</sup>State Bank of Pakistan regulates the banking sector in Pakistan.

<sup>5</sup> <http://www.transparency.org/publications/gcr>

<sup>6</sup> Musharaka is partnership in capital while Mudaraba is partnership of capital and skill. For details please see [http://www.amazon.com/Islamic-Banking-Financial-Reporting-Perspective/dp/146107259X/ref=sr\\_1\\_9?ie=UTF8&qid=1304135551&sr=8-9](http://www.amazon.com/Islamic-Banking-Financial-Reporting-Perspective/dp/146107259X/ref=sr_1_9?ie=UTF8&qid=1304135551&sr=8-9)



Practitioners and policy makers of Islamic financial system should pay due attention on this recommendation and chalk out a plan to increase the participation of the society.

#### 4.2.8. Miscellaneous

This subsection notes some of the suggestions that could not be classified in any of the above subsections. Some rightly suggested investing in research and development of products and processes by IFIs, for example, by employing financial engineering. Gold standard should be introduced in the economy. Others recommended that a full-fledge Islamic economic system should be developed and implemented instead of Islamizing the banking sector. Some recommended that the products of IFIs should be low cost in comparison to those offered by the conventional banks to attract more customers and the profit rate should be delinked from KIBOR. Marketing campaigns should be launched by IFIs to promote Islamic financial systems. Government should provide tax concessions for certain time period to Islamic financial industry and that Islamic capital markets should be established.

#### 5. Conclusion

Although IFIs have shown tremendous growth during the first decade of 21<sup>st</sup> century globally and an equally very healthy growth in Pakistan, however, this growth is still not consistent with the potential, keeping in view the religious association of Muslims (96% of population) with this industry. This study documents the perception of finance professionals about the Islamic financial system. Survey results suggest that although the market correctly perceives the theoretical framework of the Islamic financial system, however, practices of IFIs working in Pakistan is not above board as perceived by participants. Almost half of the respondents (44%) are of the view that there is no difference in the practices of conventional and Islamic banks which is alarming for policy makers and promoters of Islamic financial system in Pakistan. A majority of the respondents (63%) endorses the parallel working of Islamic and conventional banking and 75% of respondents are confident about the bright future of the Islamic financial system in Pakistan. A relatively small number of respondents (27%) perceive failure of interest free economy in the present day modern business framework. For the promotion and implementation of Islamic financial system it is recommended, by survey participants, to policy makers and practitioners of Islamic financial system to pursue a plan of actions covering general awareness among masses, positive role of the regulator, participation of all factions of society, generous use of profit and loss sharing modes of financing, Sharia compliance in operations, capacity building of human resources practicing Islamic financial system, and a general uplift in the ethics of society.

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**Appendix (Questionnaire)**

1. Please introduce yourself.

Name \_\_\_\_\_ (optional) \_\_\_\_\_ Company \_\_\_\_\_

(optional) \_\_\_\_\_

Experience \_\_\_\_\_ (in \_\_\_\_\_ years) \_\_\_\_\_ Sex \_\_\_\_\_

(Male/Female) \_\_\_\_\_

City/Town \_\_\_\_\_ Country \_\_\_\_\_

—  
Email \_\_\_\_\_ Telephone \_\_\_\_\_

(optional) \_\_\_\_\_

2. Please let us know about your formal education.

1. PhD
2. M.Phil/MS (18 Years)
3. M.A./MSC/BS (16 Years)
4. B.A./BSC (14 Years)
5. Other (please specify)

3. Kindly let us know about your profession.

1. Islamic Banker
2. Conventional Banker
3. Accounting/finance Professional
4. Marketing Professional
5. Teacher
6. Businessman
7. Other (please specify)

4. If you have a bank account or a loan account with bank kindly let us know about frequency of interaction.

1. Daily
2. Weekly
3. Fortnightly
4. Monthly
5. Quarterly
6. Semiannually
7. Annually

5. According to Holy Quran Riba is Haram (Unlawful) Sura 2 Verse 275. Which of the following is correct interpretation of word "Riba" in your opinion.

1. Riba means Usury (Consumption loan taken by a needy from a rich person).
2. Riba means Commercial interest charged by banks on business loans and personal loans.
3. Riba means any predetermined excess return on a loan transaction and includes Usury as well as commercial interest charged by any lender including banks.
4. Other (please specify).

6. In your opinion, What is the difference in practices of Islamic Banks and conventional banks?

1. Islamic banks are operating on interest free basis while conventional banks are charging interest.
2. There is no real difference in Islamic and conventional banks and only name of interest has been changed to profit.
3. Islamic banks are operating within constraints of Sharia. Difference lies in contracts between Islamic banks and customers which changes nature of risk and return.
4. Other (please specify).

7. In theory conventional banking is Haram (Unlawful) however keeping in view the existing business framework and financial needs of Muslim countries it is not possible to survive if we eliminate the interest from economy.

1. I agree with the statement
2. I disagree with the statement (please give your comments in following box)
3. I don't perceive conventional banking as Haram (against Sharia)
4. Other (please specify).

8. One of the strategies to eliminate interest from economy is Current practice of Islamic banking in various countries including Pakistan is to work in parallel to conventional banks and increase market share. Once the market share reaches up to certain level (e.g. 70%) then it would be easier to switch to interest free operations in whole economy.

1. I agree with this strategy of elimination of interest from economy.
2. I disagree and suggest that switching from interest to interest free should be abrupt and whole economy should be declared interest free from a certain date.
3. Other (please specify).

9. Islamic Banking has shown unprecedented growth world over in general and average annual growth of 76% in Pakistan in last six and half years. In your opinion, this sector will continue its momentum of growth and expansion and business graduates should target it as prospective employer and equip themselves with relevant skills; and business schools should teach a course on Islamic financing.

1. I agree with the statement
2. I disagree with the statement (please comment in following box)
3. Other (please specify).

10. Please give your suggestions for expansion, growth and promotion of Islamic Banking.

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