Benefits of islamic banking methods

Life

Italian philosopher Niccolò Machiavelli (1961) used to say that people tend to forget the death of their loved ones more easily than that of their finances. When it comes to money matters, people are usually more careful and paranoid and it is up to banks to develop trust-based relationships with their costumers. Many studies have been conducted about consumer risk perception and the factors that make costumers choose a bank instead of another, however, very few researchers have focussed on Islamic banks, which, according to Knight (Bank for International Settlements, 2007) represent a very interesting niche market that has been growing quite significantly over the past two decades.

The present paper will illustrate the main characteristics of Islamic banks, identifying their strengths and weaknesses and measuring costumer's perception of risk associated with the services and products they offer.

The principles that underpin Islamic banking methods are considerably different from the ones traditional banking methods are based on, however, the former adhere to the teachings of Islam, which the majority of consumers are not familiar with.

This paper will attempt to explain why anyone who is not driven by religious motives should choose an Islamic bank over a traditional one and what Islamic banks can do to become more competitive in an increasingly globalised world.

Literature review

When consumers choose services and products, they base their decisions on quality, value, trust, loyalty and many other factors that are worth exploring.

However, banks are not like all other product providers, for they are financial intermediaries that conduct current accounts, make payments, collect checks and perform many other money-related tasks on behalf of their costumers.

It goes without saying that if consumers had a negative feeling about a certain bank, it wouldn't take long for that bank to go bankrupt. This statement is based on the assumption that banks, just like any other business, need to gain people's trust in order to strengthen their market position and reduce competition.

According to Mitchell and Greatorex (1993), one's risk perception has a significant impact on their buying decisions and, in order to gain a deep understanding of consumer behaviour, a researcher should consider services and products as separate and different.

Unlike products, in fact, services present a number of characteristics, such as intangibility, perishability, inseparability and heterogeneity, which contribute to increasing consumers' perceived risk.

Even though banks offer " financial products", Mitchell and Greatorex (1993) classified these products as services, for they all have at least one of the aforementioned characteristics; in order to measure perceived risk, seriousness and certainty for various services and goods, they carried out a survey among 75 undergraduate students, asking them to rate six services and six goods in terms of the certainty felt at the moment of purchasing them, the seriousness of consequences, in case the service or good turned out to be unsatisfactory and overall risk. Banking services were so rated: 2.

20 in average certainty, 3. 34 in average seriousness and 5. 54 in overall risk, on a scale of one, indicating absolute certainty and no seriousness whatsoever, to 4, indicating absolute uncertainty and high seriousness.

In other words, Mitchell and Greatorex (1993)'s study revealed that financial services are perceived as highly risky.

Goods, on the other hand, obtained higher ratings, in terms of certainty and lower ratings, in terms of perceived risk and seriousness, probably because when a costumer purchases a product, they can see it and touch it and tangibility contributes to making the whole purchase experience more pleasant. George (1977: 88) went into greater detail about the difference between products and services, observing that:

" After a day of buying services, the costumer still has an empty market basket…consumers perceive services as compared to goods, to be characterised by higher prices, less consistent quality, less reputable brands, a lower overall satisfaction. "

That being said, Islamic banks perform transactions in accordance with Shari'a Law, i. e. Islamic Law, which consists of numerous rules that are not always applied in the same way, for there is not a particular organisation or person that has the authority to interpret Islamic Law, on behalf of Muslim people.

However, there are a few tenets that do not leave room for personal interpretation, such as the prohibition of Riba , i. e. usury and the elimination of uncertainty and ambiguity. In order to avoid committing " Riba", Islamic banks have developed sophisticated methods, which allow consumers to open accounts, request loans and access to traditional financial products, without having to pay interest on their transactions, at least not officially.

As explained by Ahmad and Shabbir (n. d.), Islamic banks operate on the basis of a principle known as “ profit and loss sharing”, according to which when a client experiences losses, the bank will share those losses. Moreover, the bank can not deal in activities that involve Riba, whether its clients are Muslim or non-Muslim, for the Quran is not the only book that prohibits lending money at interest.

In Islamic banking, money is linked to real assets, which means that transactions are backed by wheat, gold, houses or any other tangible assets, so that they contribute towards economic development and do not cause inflation. (Ahmad, I., Shabbir, G. , n. d.)

Returning to Mitchell and Greatorex (1993), tangibility is one of the four characteristics that reduce customer’s risk perception, therefore the fact that Islamic banking transactions are all based on tangible assets should create a general positive inclination towards Islamic banks.

However, as reported by Country Monitor (2009), Islamic banks have been affected by the recession just as severely as conventional banks, mainly due to a significant imbalance between fixed assets and short-term liabilities, resulting from excessive investments in the former. In other words, while many conventional banks’ subprime exposure has caused them to default, Islamic banks have made the mistake of “ putting all their eggs in one basket”, as the old saying goes. (Country Monitor, 2009)

Noteworthy are also the numerous debates that have made Islamic banks controversial.

According to economist El-Gamal (1997), in fact, the reason why many Islamic banks are criticised is that they imitate interest-based banking systems, whilst claiming to operate in consonance with Shari'a Law.

In Islamic countries where national and religious laws are not separate from each other like in liberal democracies, Islamic banks can afford to follow the principles of Shari'a without having to devise disputable plans to be able to compete with different banking methods. That is why El-Gamal (1997) believes that Islamic banks will survive and expand only if they give up the idea of competing with conventional financial institutions and start focussing on customers whose top priority is to borrow, invest, deposit, save and send money without violating Shari'a Law.

El-Gamal (1997) explicitly supported Ahmad (1992)'s position that:

" The sad reality is that though every one concedes that Islam prohibits interest, there is not a single Muslim country which is running its financial institutions without resorting to interest. The fact is that no one knows how to do it, and when political pressure mounts, they can only resort to some kind of subterfuge". (p. 16)

Key questions

This paper attempts to explore Islamic banks' main strengths and weaknesses, in order to offer them possible solutions to decrease costumer's risk perception and achieve better results in the future.

The following paragraphs will answer the following key questions:

1. Why should consumers trust Islamic banks more than conventional ones?
2. What are the main issues related with Islamic banks?
3. What can Islamic banks do to satisfy their customers?

A qualitative approach

Apart from discovering whether consumers consider the products offered by Islamic banks risky, this paper aims at understanding what factors have shaped their opinions on Shari'a-compliant financial products, whilst highlighting their needs, expectations and fears.

A quantitative approach to this kind of research would not stress the psychological implications that affect consumers' cognitive processes and, ultimately, their decisions.

To the contrary, qualitative research methods are the most appropriate ones to understand the reasons that cause people to behave in a certain way, instead of another.

Even though qualitative research is more time consuming than quantitative research, for data are in the form of words, objects or even images, which need to be analysed and interpreted in order to draw accurate conclusions from them. (Miles & Huberman , 1994

Interviews and focus groups are no doubt excellent instruments to gather qualitative data, for they allow the researcher to interact with their chosen participants and take note of apparently meaningless nuances that might turn out to be very important at the data analysis stage.

Seeing as Islamic banks are no longer confined to Muslim countries, but can be found in the United Kingdom, the United States and many other non-Muslim countries, the best way to obtain unbiased opinions on Islamic banks would be to interview a number of random people, assuming that they are familiar with Shari'a-compliant financial products and willing to share their experiences.

However, as many have correctly pointed out, most people don't even know what Islamic banks are, so such a method of inquiry would almost certainly produce unreliable and confusing data. (Vanguard, 2011)

That is why this paper will focus on individuals who have previous experience with Islamic banks, asking them precise questions about their impressions on Islamic financial products and services.

Measuring consumer's risk perception

In order to determine consumers' opinions on Islamic banks, 24 people were sent an invitation via e-mail to answer 10 open-ended questions through a forum dedicated to Emirates Islamic Bank's costumers.

17 customers accepted the invitation, but only the 10 who declared to be familiar with Islamic banking methods were selected, regardless of gender or nationality.

Further details about respondents are showed in the table below.

(Please double-click on the image to view entire table)

Provided that all of the respondents are familiar with the services offered by Islamic banks, it was possible to ask them direct and precise questions about the risks associated with Islamic banks, their impressions and opinions.

According to Engwall (1983), close-ended questionnaires are ideal if the researcher is looking for specific answers, whereas open-ended questions have the advantage of producing unexpected results. Even though the former allow to collect highly reliable data, interviewees’ answers would highly depend on how the questionnaire is structured and, since this study is not looking to support a particular thesis and is based on the answers of 10 interviewees, an open-ended questionnaire would no doubt suit its purpose.

Here is the set of questions that composed the questionnaire:

1. How long have you been a client of Emirates Islamic Bank?
2. How would you describe your experience with EIB?
3. How would you describe their services?
4. What financial products do Islamic banks offer?
5. What distinguishes Islamic banks from conventional ones?
6. Is there anything Islamic banks can do to strengthen their public image?
7. Why aren’t Islamic banks are popular as conventional ones?
8. Would you recommend EIB or any other Islamic bank to your relatives or friends? Why?
9. Islamic banks’ transactions are backed by tangible assets, like houses and various commodities. Does this mean that their financial products are riskier than the ones offered by conventional banks?

10. Are Islamic banks immune from global financial crises and/or default risk?

It is evident that the questionnaire was designed to gain an understanding of consumers' perception of Islamic banks. The advantage of selecting the respondents from among a group of current and previous clients of an Islamic bank is that they are all familiar with Islamic banking methods and their judgements are not swayed by what they were told by the bank's clerks or read on promotional leaflets, but result from their personal experiences.

The questionnaire was sent to the selected interviewees, with the assurance that their contact and personal details wouldn't be disclosed.

Qualitative Research Findings

In the first place, it should be noted that 6 out of 10 respondents are expats and, as such, were not raised in Muslim countries, which explains their critical approach to most questions, whereas Muslims obviously have a natural tendency to trust Shari'a-compliant financial products, for they reflect their own beliefs and values.

Apart from E. C. M. and S. S. R., who defined their experience with Emirates Islamic Bank as " extremely positive" and " very good" respectively, all other respondents did not seem too satisfied with the customer service received.

When asked to describe EIB's offered services (Question 3), J. C. noted that the bank doesn't send regular bank statements and its call centre fails to resolve issues, L. A. complained about their inexistent costumer assistance, Y. R. defined them as " deceitful" mainly due to a negative experience he's had with a Dubai-based Islamic bank, A. W. accused the bank of being unresponsive but specified that issues get sorted out eventually and C. H. classified them as “ poor”. All other respondents expressed positive opinions on EIB.

When asked what financial products Islamic banks offer, all respondents recognised the “ Islamic” nature of their products, except for B. R. and Y. R., who argued that there is no difference between Islamic and conventional products, since the former, similarly to the latter, entail the payment of monthly fees and interest.

Question 5, then, invited respondents to elaborate on the differences between Islamic and non-Islamic banking systems and all interviewees, except for B. R., expressed appreciation for the benefits they offer, their integrity and avoidance of excessive risk.

Question 9 focussed on the relationship between perceived risk and tangibility, asking interviewees what they thought about Islamic banks’ dependence on tangible assets. The majority of respondents expressed very positive judgements, stating that Islamic banks’ reliance on commodities gives them a feeling of safety and indicates stability. A. W. however, specified that safety comes with a price, which is the form of lower returns.

The other questions centres around the quality of services offered by Islamic banks and most respondents declared themselves unsatisfied and disappointed and observed that customer service is one of the areas that Islamic banks should improve in order to compete with other financial institutions.

Conclusion

A number of significant conclusions can be drawn from the data illustrated in the previous paragraph. To start with, it emerged that the majority of those who have used Islamic financial services has a positive feeling about them and does not associate any grave risks with them. Behind this sense of trust and safety Islamic banks have managed to transmit to their clients, is the fact that their transactions are backed by tangible assets and, as Mitchell and Greatorex (1993) pointed out, people tend to be afraid of services because, unlike products, they can not touch them, see them or divide them; in other words, they are abstract entities.

That explains why people feel more satisfied when they purchase a product and the general scepticism that dominates consumers when they have to choose a certain bank, a certain insurance policy, et cetera. (Mitchell and Greatorex, 1993)

From the questionnaire results it can be deducted that Islamic banks will have to fix those issues that cause uncertainty and distrust in consumers, such as the lack of consistent rules to which all banks should adjust, which has been causing many controversies ever since the first Islamic banks were established, for it appears that while some of the operate by the teachings of the Quran, some others tend to ignore them, charging fees and interest, as one of the interviewee pointed out.

With regards to risk perception, however, it is evident that Islamic banks have succeeded in informing consumers on the rules by which they operate.

Their aversion to excessive risk and prohibition of usury, among the other things, are clearly the points that consumers appreciate the most.

Recommendations

A word of caution before proceeding to give practical advice on the basis of the data gathered and analysed in the present paper: Islamic banks have been established in non-Muslim countries as well, so it would be useful to keep account of sociological, ethnographic, macroeconomic and microeconomic factors in order to gain a deeper understanding of the associations with Islamic banks that consumers of different nationalities and with different beliefs have.

In order not to lose the trust of those Muslim clients who expect Islamic banks to offer financial products that are strictly adherent to Shari' a Law, it is crucial that Islamic banks should team up to fix rules and set standards for all institutions to follow, so not to be accused of incoherence or imitating western banking systems, as observed by El-Gamal (1997).

Only then will Islamic banks gain the credibility necessary to start promoting their services.