

THE UNIVERSITY OF HULL



Islamic Banking Sustainable Growth, Bahrain as an example

Being a Dissertation submitted in partial fulfillment of the requirements for
the Degree of Master of Business Administration
in the University of Hull

by
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April 2008

ACKNOWLEDGMENT

It is with sincere gratitude that the researcher acknowledges:



the immeasurable grace from *Al Mighty Allah* (God),

the support of Mr. Ebrahim H. Ebrahim, Chief Executive Officer of Khaleeji Commercial Bank for his continues encouragement and sponsorship of the Master's program,

the generous supervision and valuable guidance of Mr. Derek Searle all through the writing and preparation of this thesis,

the full support and motivation of my wife, children, and the rest of my family all through the Master of Business Administration (MBA) program,

the support of my friends, colleagues and all MDCI-Bahrain staff in finalizing the thesis,

without which, this thesis; despite the long period of rigorous work needed, would not have come to a reality.

Tariq Al Arabi

ABSTRACT

Islamic banking is a growing industry that attracts many business organizations, investors and monetary authorities due to the fact that the concept of Islamic banking represents a new era for the banking industry.

This research, **“Islamic Banking Sustainable Growth, Bahrain as an example”** aims at determining the growth factors of Islamic banking in the Kingdom of Bahrain, its challenges and the recommended measures to mitigate these as well as its future prospects. The main research questions that were addressed are:

1. Why has Islamic Banking in the Kingdom of Bahrain showed growth?
2. What challenges and measures to be addressed to sustain this growth by Islamic banks in Bahrain?
3. What are its future prospects?

Included in this paper is a brief background of Islamic banking, its origins, principles, and current market size. Meanwhile, to gather the research data, the researcher used questionnaires and semi-structured personal interviews as well as related literature being reviewed. The feedback, extracted from all research tools, reflected the findings of respondents' personal views and experiences and related literatures with regards to Islamic banking. Additionally, the researcher used secondary data such as newspapers, books, journals, papers presented in Islamic banking forums and dissertations related to the subject, in developing the questionnaires and the semi-structured interview questions.

The overall findings of this study revealed that the growth factors for Islamic Banking in the Kingdom of Bahrain are mainly due to good government support by having reputed regulations and legislation which were the gateway for international banks to have their branches and Islamic windows in Bahrain. The other main factors were economic growth in Bahrain and, recent innovation and product development by Islamic banks as well as increased awareness among the public apart from other minor factors. Nevertheless, Islamic banking should address the following challenges to continue its growth:

1. Lack of Unified Banking & *Sharia* 'a Code.
2. Lack of Human Resources.
3. Competition , Innovation & Product Development.
4. Other challenges.

This research is recommending that Islamic banking should mitigate these challenges by having the measures of setting a unified banking & *sharia* 'a code, be competitive in the market by continuous innovation and product development as well as enhancing customer services by utilization of information technology to narrow the gap with conventional counterparts. It further suggests that they need to develop human resources in terms of employees and *sharia* 'a advisors, enlarge their size by either capital increase or mergers and acquisitions, manage their risks and enhancement of corporate governance, as well as developing secondary markets.

Hence, Islamic Banking in the Kingdom of Bahrain is expected to grow further once the above challenges are realized by the aforementioned measures which will no doubt increase its growth rate.

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CHAPTER I

INTRODUCTION

Muslims have been trading for centuries on a major principle in their life which is prohibition of interest. Allah (God) has instructed them through his prophet Mohammed (peace be upon him) not to deal in *riba* (usury). Over years, this has led Muslims to start thinking of establishing a new banking industry called Islamic Banking. One of the fundamentals of Islamic banking is the outlawing of *riba*- a term that encompasses not only the concept of usury, but also that of interest – which is accepted as part of the Islamic religion, yet it is questionable for others who accepted many of its guiding principles. The majority of these principles of Islam are based on simple morality and common sense, which form the basis of many religions, including Islam (Moore, 1997).

Although conventional Banking has been there for the last four hundred years, modern Islamic Banking has developed only within the last thirty years. It started in Egypt with the establishment of Mitghamr saving Bank in 1963, and subsequently other small savings banks have followed. However, the first Islamic Bank appeared in the Gulf region in 1974 when Islamic Development Bank was established in Saudi Arabia. Later, Dubai Islamic Bank was established in 1975 and Bahrain Islamic Bank in 1979. Consequently, many Islamic Banks have been established offering different products and services worldwide, mainly within the Gulf region and Malaysia (Vogal & Hayes, 1998).

The rapid growth of Islamic Banking estimated at 15% annually is attracting more and more attention, today (Khandelwal, 2007). The high rate of innovation in the past years and entry into areas previously thought as impossible to enter, possibly due to

perceived limitations from the laws of *Shari'a*, are propelling this growth. The success of such Islamic banking system is challenging to the conventional banking, because it is growing and offering substitutes to it; which is evidenced by many foreign banks establishing Islamic branches and windows - such as HSBC Amanah and Citi Islamic - to capture these opportunities. Currently, almost 275 Islamic Institutions are managing total assets of more than US\$ 280 billion worldwide (Khandelwal, 2007). Nevertheless, one of the aspects of the Islamic renewal is the growing importance of Islamic banking organizations in economic life. Assisted by the oil boom, Gulf countries found surplus liquidity which had to be invested somewhere. Meanwhile, modern Islamic scholars have contributed much to the growth by innovating new products.

However, the long term success of Islamic banking depends on its potential to evolve into the international system, capable of serving all customers. The key challenge moving forward for the Islamic Banking will be to build their internal capacity to lead and manage change in an ever-dynamic sector while still upholding the fundamental principles of Islam and providing quality customer services. Many Islamic Banks for example cite the common goals of improved revenue performance, cost reduction, increased market competitiveness and the adoption of complementary skills, as critical to future growth. Others highlight the importance of developing in-house capabilities, product diversity and a strategic geographic focus.

Meanwhile, Islamic banking in the Kingdom of Bahrain has witnessed substantial growth over years (Appendix H) which is due to many growth factors being an emerging banking industry in the region.

A. Statement of the Problem

Although Islamic banks have been accepted worldwide, their growth is at question. Someone may ask is it a sustainable growth, what challenges Islamic bankers need to address in order to expand more and provide effective and efficient counter measures necessary to sustain growth and conquer challenges in the passageway for further development. This research paper Islamic Banking Sustainable Growth, Bahrain as an example; aims to examine sustainability of Islamic banks growth and what are the challenges facing them especially in the Kingdom of Bahrain and the recommended actions to defeat such challenges. This study further aims to present different suggestions to realize new opportunities in the market in order to sustain Islamic banks growth and further develop the Islamic banking industry in the Kingdom of Bahrain. Because of its topicality, it may be worthwhile that the researcher try to examine the subject in greater depth, with a focus on the several challenges that accompanied sustainable growth of Islamic Banking in the Kingdom of Bahrain by answering these questions:

1. Why has Islamic Banking in the Kingdom of Bahrain showed growth?
2. What challenges and measures to be addressed to sustain this growth by Islamic banks in Bahrain?
3. What are its future prospects?

B. Scope and Limitation of the Study

This research on the sustainable growth of Islamic banks is a broad subject to deal with. Nevertheless, and for the principle of presenting findings in an apparent method, limiting the scope of the thesis has been considered necessary. As such, this study will deal specifically on the growth of Islamic banks in the Kingdom of Bahrain, its sustainability with focus on its challenges and recommended solutions to overcome these, and the available future opportunities for this economic sector.

C. Significance of the Study

Economists, practitioners and *sharia*'a scholars of Islamic banking in the Kingdom of Bahrain have recognized the Islamic banking growth with its threats and challenges. Similarly they have discussed these issues in many Islamic banking forums and conferences. Apart from these, many people still consider that there remain unresolved threats.

By presenting this study of Islamic Banking Sustainable Growth, Bahrain as an example, its challenges as well as efficient solutions to overcome these challenges and focus on new opportunities available in the market, this thesis is expected to further contribute towards strengthening the Islamic banking industry in the Kingdom of Bahrain, which no doubt will support its banking sector as one of the main financial centres in the region. Furthermore, it will sustain the Kingdom's position as a business centre in the region. Consequently, this study is considered significant.

CHAPTER II

REVIEW OF RELATED LITERATURES

For an extensive review and a deeper understanding of the subject under study - Islamic Banking Sustainable Growth, Bahrain as an example - various literatures have been reviewed. The different literatures investigated and their significant points gathered could be summarized as follows:

A. List of Literature Reviewed

1. **“Success Factors of Islamic Banks: An Empirical Study”** (Kahf, 2004) states that there are many factors affecting the growth of Islamic banks as follows:

a. Long Term Considerations:

1. Increasing Deposits

A bank must consider the rate of growth for all types of deposits in order to have the opportunities to generate earning assets, thus increasing long term profitability. Islamic banks have three types of deposits that increase shareholders returns, namely current accounts, unrestricted investment deposits in savings and *mudharaba* accounts and restricted investment deposits. As Islamic banks do not distribute return to current accounts, which increases their rate of profit and multiplier of assets/equity rate eventually increasing their profits. Besides, unrestricted investment accounts are attractive ways of increasing Islamic banks customers' base as well as increasing profit through agency activities.

2. Improving Quality of Services to Clients

Monopolist Islamic banks in the markets pay little attention to this factor, yet it is now rising because of the multiplicity of Islamic banks in many countries and entry of conventional banks into Islamic finance markets which focus on enhancing customer services quality. Clarity of bank's vision for market segments, improves the quality of customers services provided. It is considered as a new way of marketing the bank, which in turns maximize its profits depending on three elements: professionalism, knowledge of clients and establishing personal relationships with them. This could be achieved through:

- a. Personalizing the banking services.
- b. Raising the professional level of employees.
- c. Targeting higher profit realization than rivals through providing better investment opportunities for customers.
- d. Improving the working environment.
- e. Providing noticeable social services to promote the bank.

3. Expanding the Base of Banking Services

Islamic banks need to pay attention to expand their services base offered to customers such as investment agencies and special investment accounts. Inventing different investment opportunities offers the customers attractive alternatives to divert their money to Islamic banks as well as increasing their new customer base. The continuous innovation process is the foundation and assurance of Islamic banking growth

through financial engineering management which is considered the engine behind better marketing.

4. Preservation of Capital

Protection of capital is an important consideration in maximizing Islamic banks profits in the long term because evaporation of capital will cause banks to loose new deposits and deprives them from achieving their objectives. The extent of bank's investments diversification and synchronization between investments and deposits maturities, are most important elements of such preservation as well as the structure and control of its risk management.

5. Humanitarian and Social Services

Providing humanitarian and social services to the community will no doubt strengthen the relationship between Islamic banks and its local society. This could be done by participating in charitable programs by allocating funds from annual budgets, which eventually will improve image and hence increase customer base.

b. Short Term Consideration

1. Pricing of Banking Services

Islamic banks must consider providing services at a reasonable cost to customers in order to compete in the market. It includes setting the range of charges on products and services provided and determining the *mudhareb* share of investment products after surveying the market.

2. Cost/Earning Efficiency

Islamic banks will be able to increase profitability by increasing the efficiency of its workforce, through training and satisfactory working environment, which could be measured by the ratio of total expenses to total earnings.

3. Selecting High Returns Investments

Return is a function of risk, so maximizing return will increase risk. As such, Islamic banks need diversify investment opportunities to maximize profits and set strategies for continuous growth either by geographical coverage or through mergers and acquisitions of other institutions.

4. Minimizing Idle Assets & Utilization of Economies of Scale

Islamic banks can minimize idle reserves by reconsidering its managerial philosophy, improving its style of applying prudence rules and seeks available opportunities to increase invested assets, thus maximizing profits and economies of scale.

However, his study over the performance of some Islamic banks has revealed that success factors; apart from theory are:

- a. Banking efficiency by increasing assets and maximizing profits.
- b. High level of trust in management and *sharia*'a board reputation.
- c. Efficiency of investment, financial engineering and marketing.
- d. Preservation of bank's and customers' assets.
- e. Provision of humanitarian and social services.

2. In **“Islamic Finance, Innovation and Growth”** (Archer and Abdul Karim, 2002),

Islamic banking has made significant progress during the last two decades since Islamic financial instruments earned due recognition in global financial markets which has paved the way for future growth. As a result, Islamic banks have grown in numbers but total assets are still small when compared with conventional banks. Also, a distinct feature of Islamic banking is the existence of religious scholars in *sharia*’a boards which regulates banks operations to comply with *sharia*’a standards. Meanwhile, many international banks realized the importance of emerging Islamic financial markets and started to offer *sharia*’a compliant products through Islamic windows or separate legal entities. However, although Islamic banks made progressive growth, still they face some challenges to sustain it. These are:

- a. Sustainable growth depends largely on a well-functioning secondary market and liquidity management.
- b. Industry is becoming highly competitive.
- c. Increased awareness and recognition of Islamic instruments with advanced technology, more experienced professionals by conventional rivals, has become another challenge.
- d. Globalization and market integration.
- e. Economies of scale.
- f. Necessary actions to implement proper risk measurements, controls, and corporate governance.
- g. Share, transfer and mitigate financial risk by financial engineering and innovation. This requires Islamic institutions to adopt appropriate risk

management systems not only for banks portfolio but to provide risk management services to clients.

- h. Realizing the need for operational risk systems to avoid failure of controls and processes.

Furthermore, Islamic banks observed the critical role of *sharia'a* supervisory boards in financial governance as it is common practice to maintain a *sharia'a* supervisory board for each institution. They recommended setting up a system-wide *sharia'a* board consisting of knowledgeable experts in *sharia'a* law, as well as finance to:

- a. Avoid duplication of individual boards and to be more efficient and cost effective.
- b. Uniformity of standards to be followed by individual institutions.

3. In “**A growth model for Islamic banking**” (Wiegand *et al*, 2005) concluded that the Islamic banking industry is robust and profitable in countries with significant Islamic communities because Islamic institutions are growing much faster than conventional banks. This is a result of strong demand for *sharia'a* compliant products. However, these successes are built mainly on regulatory advantages and a unique value proposition, yet they are threatened by the entry of international institutions that combine Islamic products with superior marketing and customer services skills to benefit from such growth opportunities. Many countries are now racing to create Islamic banking hubs to serve the Muslims around the world such as Bahrain, Dubai and Malaysia.

Meanwhile, the authors have summarized three factors impacting the performance of Islamic banks:

- a. **Market Profile:** such as customers segments, labor costs and competition all affect general profitability of Islamic banks.
- b. **Business Model:** Islamic banks that focus on retail customers are performing better than those targeting corporate clients, evidenced by higher return on assets.
- c. **Demand for Islamic Banking:** demand variations for Islamic products by customers in different markets are affected by higher financing cost, poor performance and poor services.

Nevertheless, many countries are changing their regulations to cater for industry developments. These have enabled international institutions to enter the markets which resulted in better services to customers who have many more options now. As such, incumbent Islamic banks have to follow the trend and actions needs to be taken to compete in the market including: target market segmentation, innovative products, operational efficiency, liquidity management and improved risk management. Besides, Islamic banks lack scale that drives cost-income ratios as some are below optimal scales by international standards. So, national consolidation will not be the solution to overcome this hurdle as total demand in some countries may never be large enough to create a single bank with efficient scale. However, cross border expansion including mergers and acquisitions is the available option, yet the differences in structure of products across countries and language barrier as well as complexity of Islamic products are other difficulties for such an option.

4. In the paper **“Islamic Banking and Development: An Alternative Banking Concept”** (Kahf 2005) is arguing that Islamic banking has three intrinsic characteristics that are developmental in nature and available for everyone: direct link to the real economy by financing projects and purchase of goods, integration of ethical and moral values in financing by restricting it to goods and services that are useful and refrain from financing harmful goods such as alcohol and tobacco or morally unacceptable services such as casinos regardless such products are legal or not in a given country; and reconstruction of relationship with depositors on the basis of sharing instead of lending. Furthermore, he considers financial intermediation is the major function of the modern banking system. Islamic banks are the same; nevertheless they use available funds from deposits for three financing modes: sharing, sale and leasing.

Moreover, a question is raised: is Islamic banking an alternative approach to conventional banking? To answer this question, we should understand that Islamic banking is a structure that mobilizes savings on the basis of profit/loss sharing which is fairer and more conducive to investment and development, although for Muslims a matter of faith. Also, Islamic banking has been expanding for the last three decades and many international banking institutions have joined it by establishing Islamic units, windows branches or full fledged Islamic banks to better serve their customers and capture the available opportunity.

Meanwhile, Islamic banking has been partially practiced in several international financial institutions in Switzerland, Britain and United States. In addition,

economists argued that social welfare will be higher with wider freedom of choice by introducing Islamic banking as an alternative concept as it focuses more on the merits of the business to be financed rather than only on the creditworthiness of the fund user.

It is worth mentioning that the innovation of Islamic banking in restructuring the financing relationship between the bank and its depositors on the one hand and the bank with fund users on the other hand, is religion neutral as it could be offered to everyone. However, limitations of Islamic banking are inability of management and staff to cope with its principles and approaches; and negative effects of the interest driven market they operate in. These caused actual practice of Islamic banks to copy and imitate the conventional counterparts. Nevertheless, many challenges still remain and its prospect will depend on Islamic banks ability to face these with resourcefulness and creativity as well as being trust worthy and understandable.

5. In the paper **“Islamic Financial Services Industry Development”** (Islamic Development Bank, 2007) states that the Islamic banking industry has grown rapidly in the last thirty years. It has experienced double digit growth due to raising demand for its services supported by the increased awareness and population growth.

Meanwhile, the following factors have also contributed to its growth:

a. Ease of Implementation

Assets and liabilities risk characteristics of Islamic banks are different from those of conventional banks. They have the unique nature of profit sharing investment accounts and fee based services, while financing services are asset based financing or partnership contracts. Hence, it makes Islamic banking not difficult to implement.

b. Strengths of Islamic Banking

Islamic banking is expected to contribute for better utilization of financial resources and support financial stability in the society. It supports this by its internal control and corporate governance under the *sharia'a* supervision and self regulation as well as reallocating financial resources to more socially responsible area for greater social wellbeing. Also, Islamic finance is based on real assets not cash advancement and equity type profit sharing facilities which contribute to balance between debt and equity, thereby fostering stability as well as emphasize on projects feasibility and real economic activities. Furthermore, providing *sharia'a* compliant services enhances accessibility of different population to financial services, which has positive proposition to social justice.

c. Technology

The use of advanced technology by Islamic banks in terms of product innovation and financial engineering through risk management systems in order to reduce cost and improve customer services has contributed much to its growth. Also, it reduces boundaries of legal jurisdictions, transaction costs

and information asymmetries which enhance quality of services. Many Islamic banks nowadays are using e-banking and electronic delivery systems which attracted new market segments.

d. Markets

Emergence period of Islamic banks during the last three decades witnessed financial liberalization and globalization and financial instabilities of conventional markets which resulted in growing demand for greater product mix. These conditions forced many banks to cross-segment mergers, acquisitions and takeovers as well as internal expansion of product differentiation. As a result, a strategic initiative within Islamic banking such as innovation and product differentiation as well as mergers and acquisitions have become important to avoid such market conditions; since most Islamic banks are considered small and lacks economies of scale.

e. Laws and Regulations

Major developments worldwide in the supervisory and regulatory policies have implication for Islamic banking as they are regulated by central banks along with other conventional banks and no such other separate body that can regulate the industry. Meanwhile due to its nature, some activities of Islamic banks are not considered as banking which exposes them to different regulatory authorities. However, regulations such as Basel II have contributed to the trust and growth of Islamic banks although indirectly.

However, Islamic banks are still facing the following challenges:

a. Human Resources Requirement for *Sharia'a*

The most important challenge for Islamic banks is the requirement for *sharia'a* governance system that monitors the compatibility of banking products and services as well as its trading activities with *sharia'a* rules. Hence, the requirement of competent *sharia'a* human resources is needed as scholars and internal auditors within banks. They are required to have technical and professional skills of *sharia'a* and banking.

b. Appropriate Legal Framework and Tax Neutrality

An appropriate legal, institutional and tax framework is a vital requirement for establishing sound Islamic banking system. Currently, there is no separate framework for Islamic banks in some countries which forces them to use conventional laws that might sometimes be against *sharia'a*. Also, Islamic asset based financing contracts are treated as normal purchase and resale assets and taxed twice.

c. Enabling Supervisory Framework

Prudential regulations and effective supervision will no doubt enhance and strengthen the efficiency of Islamic banks and develop the market further, taking into consideration its specificities. These include transparency and disclosures, risk management, corporate governance and internal control systems.

d. Unresolved *Sharia'a* Issues

Islamic banks lack availability of standard financial contracts and products which could cause ambiguity and dispute rather than cost. Such unresolved issues raise question to the sustainability of Islamic banks and reduces the trust in some banks. Hence, coordination among *sharia'a* supervisory boards is a must for the future of the industry.

e. Liquidity Management

Development of money market instruments is an essential requirement for Islamic banks. They need these products to employ excess liquidity as well its availability when required for urgent needs. Lack of such products limits the operation of Islamic banks and put restrictions on them. Hence, Islamic banks should work for the establishment of these markets along with *sharia'a* scholars for the development of efficient Islamic industry.

6. In “**Expanding the Frontiers of Islamic Finance**” (Thomas, 2008) is of the opinion that Islamic finance had enormous development over years especially during 2007 where Islamic banks balance sheets have grown by 40% due to issuance of new *sukuk* (Islamic bonds), expanded to new frontiers and improved business aspects in established markets. Islamic project finance market in terms of real estate, modernization of hydrocarbon sector on a global basis or investments in petrochemical and plastics business is providing a good opportunity since many business leaders of these projects are seeking Islamic financing. Meanwhile, new market opportunities have emerged during last seven

years due to improvement of economic standards in many Muslim countries as civil order or economic growth have been restored and the petroleum boom. Varieties of products ranging from normal to highly sophisticated structured products have been introduced to the market as well as new frontiers have been approached like Turkey and Egypt for new investments.

Although some analysts believe that the volume of new Islamic institutions is unsustainable, the reality is the opposite. In markets where conventional banks exist, every aspect of financial services is addressed by an Islamic choice somehow. This growth of alternatives gives depth to the market and contributes to its long term stability. Nevertheless, with its growth; the industry faces great challenges: are there sufficient qualified people, are Islamic banks able to pick up the slack created by retreating global banks, and will regulators implement the rules that allow a well ordered business to compete on a level playing field?

7. In **“Islamic Financial Services Sector Report”** (Khammash 2007) sees that Islamic financial services sector become a dynamic and fast growing global phenomenon, evolving into a feasible and competitive segment of the overall financial industry. Its average annual growth is 15% and expected to continue at the rate of 10-15% over the next decade due to high oil prices and growing demand for *sharia’a* compliant products. As a result, some conventional banks such as Kuwait Real Estate Bank and Industrial Development Bank of Jordan converted to fully-fledged Islamic banks and many Islamic banks are going global to serve other Muslim communities; as well as other international banks are establishing Islamic windows and branches to compete in the market.

Meanwhile, the following factors will impact the growth of Islamic banks:

a. Customers Characteristics

Customers who are religiously motivated with surplus wealth like to deal only with Islamic banks demanding for suitable investments. On the other hand, banks need to take the initiative to increase customers' awareness of the industry in order to solicit more business.

b. Integration with Existing Financial System

As Islamic banks operating in the market are increasing, it will increase competition, thus will raise the need for innovation to create new products and services. Also, the interest of international players in the industry will heighten the attention of global financial market and will draw growing number of customers.

c. Variety of Products

To remain competitive, Islamic banks need product innovation that meet risk/return investors' requirements, *sharia'a* requirements, offer diversified opportunities and cost effective.

On the other hand, the industry is facing a number of hurdles that can be summarized as follows:

- a. Lack of liquidity as Islamic banks is short of money market instruments.
- b. Islamic banks need to reach the scale required to compete with conventional banks by continued growth of the industry and increase public awareness of Islamic products and services.
- c. *Sharia'a* scholars and human capital shortages is another constraint to the industry. Growth of the Islamic banking can't be achieved without finding a solution to this hurdle.
- d. Lack of harmonization in *Sharia'a* rulings among scholars creates doubt and uncertainty in the industry which negatively affects trust and confidence needed for its growth.
- e. Efficiency, reliability and transparency within the market and corporate governance as well as regulatory and supervisory factors all contributing to the growth of the industry. A vital issue is the standardization of regulations which will enhance integration of Islamic banking into the global market.

8. In “**Islamic Finance and Penetration of Financial Services**” (Grais, 2004) is of the opinion that Islamic banks have grown over decades and they are expected to pursue market innovation and improvement in the regulatory framework governing its operations for the development of its market and achieving growth. Islamic banks need to promote public confidence in their operations in order to sustain growth while regulations, supervision and risk management contribute significantly to the same. Meanwhile, by adopting and practicing sound corporate governance; Islamic banks will contribute to efficient supervisory

activities and will enhance their competitive potential. He further argues that Islamic banks are pursuing stakeholders' values in terms of investors and shareholders returns, while conventional banks are pursuing shareholders values only. This is clearly observed in profit sharing concept of Islamic banks.

9. In “Islamic Finance Gears Up” (El Qorchi, 2005) believes that Islamic finance is developing at a remarkable rate. Worldwide Islamic institutions have risen from one in 1975 to over 300 in more than 75 countries with total assets exceeding \$250 billion at an estimated growth rate of 15% per annum. Also, two indices were launched in 1999 to provide a benchmark for equity prices for investment by Islamic institutions: the Dow Jones Islamic Market Index in Bahrain and the Financial Times Stock Exchange Global Islamic Index series. Questioning what are the reasons behind such a growth? He states that the strong demand from Muslims for *sharia*'a compliant financial services, the growing oil wealth with demand for suitable investment products and the competitiveness of many products are attracting investors. Besides, Islamic banks have contributed to the development of many economies in the Muslim world. Yet affirming that despite the growth, Islamic banking remains limited and tiny compared to global financial system. Meanwhile, the following hurdles to the growth of Islamic banks are of concern to Islamic banks:

- a. Developing money market instruments.
- b. Regulating and supervising Islamic finance.
- c. Standardization of policies and procedures.
- d. Separation of fund management and investment activities from commercial banking.

- e. Operational risk management enhancement.
- f. Islamic banks data collection.
- g. Product innovation.

Nevertheless to overcome these challenges, concerned central banks and institutions should enhance their multilateral cooperation and create the appropriate environment and conditions to provide the infrastructure needed for the industry's market driven development.

10. In “The Development of Islamic Banking in Bahrain” (Al-Sadah, 2005)

recognizes Bahrain as being the hub of Islamic banking due to its progressive approach towards Islamic finance. Islamic banking has developed over thirty years not only in Bahrain but also across the world to become major global industry. Apart from local banks, many international institutions have their Islamic banking business in the country including BNP Paribas, CITI Islamic Investment, ABC Islamic and UBS. The first Islamic bank in Bahrain was established in 1979 and the progress was slow until 1994 where there were only five Islamic investment banks and one offshore banking unit. After the Gulf war, demand for Islamic products has increased due to increased oil revenue which supported the establishment of many Islamic institutions in the region. Besides, as the regulatory body in Bahrain; the Bahrain Monetary Agency has provided best practice regulatory framework for Islamic banking after facing complex challenges for this sector. Regulatory policies were introduced to protect customers, investors and all businesses within the system and the Bahrain Institute for Banking and Finance (BIBF) was established to facilitate training

and education of Islamic banking to support the future growth of the industry. Meanwhile, the leading standard setter for Islamic banking is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is based in Bahrain provides the standards that Islamic banks have to follow to increase transparency and standards for accounting, auditing and governance within the sector. Additionally, he states that the Islamic banking has witnessed an annual growth rate of 10% every year and it will succeed further with a projected growth rate within the Middle East & North Africa region to be 10-15% per year while the global Islamic sector is expected to grow by 20% by 2010.

On the other hand, he further agrees that Islamic banks sustainable growth depends on investor and customer confidence, a secure regulatory framework, support organizations, further product innovation and skilled talent development. Meanwhile, Islamic banks need to become more international in their outlook to cope with expansion and development of the sector and a prosperous future is expected for the industry by facilitating the support organizations and offering of high caliber training for its workforce. As demand for Islamic products grow, worldwide expansion looks positive.

11. In the paper **“the growing importance of Islamic finance in the global financial system”** (Knight, 2007) describes the growth of Islamic banking as still modest in size relative to conventional banking, but it is rapidly becoming visible through expanding the range of *sharia*’a compliant products and services. One example is the global market interest in Islamic bonds (*sukuk*) which are

increasingly being issued and bought worldwide. The focus is also witnessed by international banks offering Islamic financial services. Compared with conventional banks, Islamic banks have some similarities in terms of corporate governance, rigorous risk management and sound capital adequacy requirements which need the attention of Islamic bankers to have a growing industry.

12. In “Islamic Finance, Today and Tomorrow” (Khandelwal, 2007) of the view that modern Islamic financial services is enhancing its sophistication and more significant role is played by Islamic banking in the global financial markets. Its basic principles are prohibition of *riba* (usury or interest) and non dealing in alcohol and gambling as well as social justice. It employs the concept of participation in enterprise, utilizing the funds at risk on a basis of profit and loss sharing. Recent trends in Islamic banking emphasize the need for greater innovation and flexibility to facilitate wider acceptance of its products and services. It is estimated that there are more than 275 Islamic institutions operating in 75 countries with assets size of \$ 280 billion as well as financial investments of \$400 billion with an annual growth rate of 15% in last five years. Although the industry is growing globally, it is still considered small when compared to global conventional markets. Moreover, he is of the view that this growth is likely to be affected by a number of challenges:

- a. Shortage of Islamic banking experts, both scholars and employees.
- b. Absence of accounting and auditing standards.
- c. Lack of uniform standards of credit analysis.
- d. Differences with central banks due to its specialty nature of business.
- e. Differences with domestic banks and foreign banks.

- f. Enhancement of customer services, quality returns and transparency.
- g. Innovation of different products and services.
- h. Improvement of corporate governance and risk management policies.
- i. Revision of usual tax regimes to meet Islamic banks specialty products.

In addition, with increased demand for Islamic products; growth of Islamic banking is expected to continue. Yet the industry faces competition from well established western based conventional banks willing to expand operations in Muslim regions. As such, it is expected to remain for different reasons:

- a. Growth of the wealth in Middle East.
- b. Growing awareness of Islamic products and services.
- c. Islamic products are becoming more competitive, compared to conventional products.
- d. Variety and wider availability of Islamic financial products.

13. In the paper “**Islamic Banking- opportunity or threat?**” (Wilson, 2007) states that during the last four decades, Islamic banking has become a substantial industry. Viewed by many western banks, Islamic finance is considered as a business opportunity, not a threat. It provides business opportunities for all parties involved, including bankers, lawyers and insurers. Furthermore, it is about extending choice, not restricting options as each institution has its own *sharia*’a board which effectively privatizing its compliance rather than a common matter. Islamic banks have been able to provide attractive products and growing client base, for example Al Rajhi Bank of Saudi Arabia has become the world’s largest

Islamic retail bank which its range of services and delivery channels compares favorably with the best western banks. He is of the opinion that Islamic banking is there to stay, it is an opportunity rather than a threat and will have a brighter future. However, gaps remain to be treated to have a better future for the industry. Eventually, such a development of Islamic banking to be welcomed and facilitated as it is about the emergence of a distinctively Islamic form of capitalism that may co-exist and interact with other nations.

14. In “Islamic Banks at the Threshold of the Third Millennium” (Kahf, 1999)

describes Islamic banking revealed three innovations in traditional banking: a new kind of banks and depositors relationship, integration of financial and real market in financing, and ethics and moral values incorporation in investments decisions. Moreover, he believes that Islamic banking offers innovation that proves its own merits by contributing to contemporary banking practices. However, Islamic banks encountered serious challenges over the last three decades:

- a. Objectives of Islamic banks must be served by functional liberalization of banking activities, as deregulation provides scope for banking innovations in fund mobilization and utilization.
- b. Islamic banks are still considered as new and small, yet globalization forces them to compete with the international banking giants. They are unable to benefit from this trend which empowered several western banks with abilities to compete at the international level.

- c. Islamic banks lack standardized opinions of their *sharia*'a boards.
Also, there is no consistent way of appointing them, or in the authority to which they report.
- d. Insufficient training of Islamic banks personnel since emergence and growth of Islamic banks occurred rapidly which did not allow proper training for employees.

Nevertheless, the paper suggests that improvements and actions to be taken by Islamic banks to mitigate these challenges by:

- a. Adoption and improvement of strategic methodology such as increasing Islamic banks size through mergers.
- b. Standardizing operations, reporting and financial statements.
- c. Creation of efficient customer service.
- d. Development of short term liquidity products.
- e. Expansion and diversification of products.

15. In “Islamic Private Banking – Now and in the Future” (Gainor, 1999) describes the growth in Islamic banking as a result of increase in Muslims wealth, compounded by the fact that usury is prohibited in Islam. His view is supported by the fact that Islamic banking is not biggest, in market share terms; in the most Islamically conservative markets, but instead in those market that developed a larger middle income group and where economic life has developed so banking became a must. Another factor is that the industry is getting more efficient and sophisticated, and the volumes have aggregated to higher levels. Its quality and cost are improving rapidly which closes the gap with conventional

banking. He further explains the growth as a result of effectively tailoring and anticipating the needs of Islamic banking customers. Hence, Islamic market is experiencing increased competition which resulted in higher returns for investors and closer to conventional benchmarks. In addition, the product offering has become more sophisticated and structures are more complicated and demanding such as short term investment funds, leasing funds, real estate funds, equity funds and commodity funds as well as project financing. Meanwhile, Islamic banking has improved to be more service oriented business that target high networth individuals and provide them personal services.

Moreover, the author summarizes the following future opportunities for Islamic banking:

- a. More specialist cooperation is needed among Islamic banks to meet the competition.
- b. Product innovation such as Islamic trust services, insurance products and index funds.
- c. Providing value added *sharia'a* services to customers such as tax and *zakat* (personal tax in Islam) planning.

16. In the paper “**Perspectives on Challenges and Opportunities Confronting Islamic Banks**” (Puri, 2003) confirms that Islamic banks have done well so far and Islamic banking represents a significant growth opportunity which is derived from increasing acceptance by new customers, underlying asset volume growth and availability of products range. Besides, Islamic banks have benefited from

limited competition but this is changing. Nevertheless, further growth of Islamic banks to be addressed by the following challenges:

- a. Potential lies within new market segments and products differentiation which requires significant improvement of customer services.
- b. Imbalance of business model in the current Islamic set up with over reliance on retail deposits and corporate financing.
- c. Lack of sufficient scale of market players that undermines the ability to reap scale economies.
- d. Accelerated conventional banks competition and increasing transparency as well as comparability of products and services.

17. In “**Islamic Banking**” (Ariff, 1988), explains that Islamic banks are not a temporary phenomenon rather it is there to stay and there are signs that it will grow and expand. He argues that Islamic banking has three distinguishing features: it is interest free, multi purpose; not purely commercial and strongly equity oriented which has contributed substantially to economic development in many countries. It is concerned with the viability of the projects being financed and profitability of operations, not the size of the collateral as it is based on profit sharing basis. Also, Islamic banking is a viable proposition that can result in efficient resource allocation since it faces fewer solvency and liquidity risks than their conventional counterparts (Iqbal & Mirakhor 1987). In addition, Islamic banks have preference for trade finance and real estate investments which indirectly donate to the economy (Khan 1983).

18. “Hurdles to the Development of Islamic Banking in Bahrain” (Janahi, 1999) is

of the opinion that Islamic banking has shown significant growth due to wealth increase of some Muslims as well as the increased demand for *sharia’a* compliant products and has the potential for further growth. Yet, the industry faces some challenges as follows:

- a. Lack of cooperation among Islamic banks and financial markets for placing or raising funds on any established pattern.
- b. Non-uniformity of *sharia’a* practice.
- c. Absence of unified accounting standards which impacts the reporting and interpretations of annual reports by Islamic banks.
- d. Excess liquidity which has an impact on the industry’s development since there is insufficient short term investment opportunities.

19. In “How Can Islamic Banks Develop New Services” (Al-Jowder, 2002) sees that

although Islamic banking have progressed over time and managed to grow worldwide, but it is measured as small when compared with global markets. Nevertheless, he suggests that in order to develop further; Islamic banks must consider the following:

- a. Increasing availability of *sharia’a* compliant business opportunities to provide different types of financing.
- b. Meeting market expectations by innovating new products and services by addressing investors’ needs.
- c. Utilization of information technology to develop processes and enhance customer services.
- d. Availability of reliable market data and transparency.

- e. Develop training programs for employees to have sufficient understanding of Islamic banking.

20. In “**Problems Facing Islamic Banking**” (A.Aziz, 2000) states that Bahrain has grown to be the centre for development of Islamic banking products in the region associated with the growth Islamic banking had during the last thirty years. This growth is owing to the petrodollar boom and the increase of Muslims population which ultimately increased the demand for Islamic products with the support of sound development of regulations and policies by the Bahrain Monetary Agency in Bahrain. As a result, Islamic institutions have initially developed products to attract Muslim customers to satisfy their religious needs. However at a later stage; different Islamic products and services have been innovated to meet the needs of Muslims and non Muslims customers, as solicited by international investors.

The researcher further states that optimism; growth and success lie ahead the way in which Islamic banking is taking shape. Islamic products and services that are *sharia’a* compliant; are being used by investors outside the Islamic world which supports the argument that substantial growth of Islamic banking is feasible, taking into consideration the below limitations to be tackled:

- a. Lack of employees’ knowledge for Islamic banking, aside from the industry not having a software system that is specifically tailored to suit the needs of Islamic institutions.
- b. Differences among *sharia’a* scholars for similar transactions processed by different banks. Although the core principles are

commonly agreed, the discrepancy is seen in certain secondary issues.

In addition to this problem, the lack of *sharia* 'a scholars' knowledge in the field of economics and business is another issue.

- c. Liquidity management issues since banks need cash and liquid assets to meet short term obligations which are rarely available in Islamic banking market.
- d. Difficulties in standardization of accounting and auditing standards which are encountered by Islamic banks as many of Islamic instruments are different. For example, Islamic banks have to solve presentation problems of customer investment accounts which are neither liabilities nor equities.

B. Summary of Literature Reviewed

Twenty related literatures have been reviewed for Islamic banking growth together with the challenges for further development encountered by Islamic banks as well as proposed measures to mitigate these. The different literatures investigated and their significant points gathered could be summarized as follows, however for citation purposes; the twenty studies reviewed are numerically referred to as superscripts 1,2,3...20:

1. Growth of Islamic Banking:

All the researchers have agreed that Islamic banking is growing over years, yet five of them estimate the growth rate to be 15% per annum^{7, 9, 12, 15& 19} while one is estimating it to be 10% per annum and will increase by 2010 to reach 20%¹⁰. To the contrary, one researcher estimated the growth to be 40% during 2007 due to issuance of new *sukuk* (Islamic bonds)⁶ while another is of the opinion that it is a double digit growth⁵. Another is arguing that it is still modest in size compared to conventional banking but rapidly visible¹¹. Meanwhile, they identified the growth factors to be:

a. Innovation and High Returns Investments

This factor was recognized by eleven researchers who mentioned that recent product innovation by Islamic banks especially investments with high returns have played its role in Islamic banking growth⁶. Meanwhile, variety of products offered by Islamic banks has contributed to it^{7, 16&20} as demanded by customers looking for new *sharia'a* compliant products^{9, 11&12} where Islamic banks are effectively tailoring and anticipating their needs¹⁵. Moreover, Islamic banking is extending the choice for investors¹³ where it has revealed three innovations: a new kind of banks and depositors relationship, integration of financial and real transactions, and ethics and moral values incorporation in investment decisions¹⁴. Besides, Islamic financial instruments earned due recognition in global financial markets².

b. Increased Demand and Awareness

The increased demand for *sharia'a* compliant products as a factor of growth has been recognized by eleven researchers. Increased awareness and

recognition of Islamic instruments with existence of religious scholars in the *sharia*'a boards of Islamic banks, has no doubt affected this growth^{2, 3, 7, 9, 10, 12, 15&16}. Furthermore, Islamic banks introduced the new concept of profit/loss sharing principle of Islamic banking which raised awareness and confidence in Islamic banks⁴. It has experienced growth due to raising demand for Islamic banking services supported by increased awareness and population growth^{5&20}.

c. Economic Growth

Seven researchers have identified this factor as they claim that high oil prices has led to economic growth eventually subscribing to Islamic banking growth^{7,9,10&20}. It is a result of increase in Muslims wealth who prefer to deal with Islamic banks¹⁵. Meanwhile, another issue is that more significant role is played by Islamic banking in the global financial markets¹². Additionally, Islamic banking has three distinguishing features: interest free, multi purpose and strongly equity oriented which has contributed to economic developments in many Muslim countries¹⁷.

d. Other Factors

The researchers have further acknowledged other factors for the growth of Islamic banking such as availability of regulatory framework^{9, 10&20} and enhancement of customer services^{1, 3&4} as well as provision of humanitarian and social services by Islamic banks^{1&5}.

2. Challenges Facing Islamic Banking:

The twenty researchers have concurred that sustainable growth of Islamic banking is subject to the following challenges to be measured by Islamic banks:

a. Competition

Twelve researchers have identified this challenge due to its importance for sustaining Islamic banking growth. Improving the quality of services offered by Islamic banks is vital in this regard where continuous enhancement of customer services is a must as industry is becoming highly competitive^{1, 2, 12&14}. Furthermore, it focuses on permanent innovation of high return investments and variety of products of Islamic banks^{1, 7, 9, 10, 15&19}. Meanwhile, increasing the customer base with different market segments is also a requirement^{1, 3, 8&16}.

b. Absence of Unified Banking Code

As well, this is one of the main challenges facing Islamic banks as encountered by nine researchers. They state that Islamic banks lack availability of standard financial contracts⁵ while lack of harmonization of *sharia'a* rulings among them is the other part of the story^{7, 14, 15, 18&20}. Meanwhile, there is a need to regulate and supervise Islamic banking and finance in order to sustain growth^{9, 12&19}.

c. Human Resources Issues

This was considered by eight researchers who include inability of management and employees of Islamic banking to cope with Islamic banking

principles and approaches⁴. Hence, requirement of competent *sharia'a* human resources such as scholars and internal auditors is needed for Islamic banks^{5&20}. Moreover, there are insufficient qualified people as employees and scholars^{6, 7, 12}. Nevertheless, insufficient training of Islamic banks personnel to understand Islamic banking is another hurdle which limits their growth^{14&19}.

d. Lack of Secondary Markets

Liquidity issues have been recognized by seven researchers. Sustainable growth depends largely on a well functioning secondary market and liquidity management by development of money market instruments^{2, 7&9}. Meanwhile, Islamic banks should develop such products to reduce liquidity risks and better employment of assets¹⁷ while excess liquidity should be invested in short term investment opportunities^{18&20}. Furthermore, they require these instruments to employ excess liquidity as well as its availability when required for urgent needs⁵.

e. Risk Management & Corporate Governance

Such challenge has been identified by six researchers who recommend that necessary actions to implement proper risk measures, controls and corporate governance by Islamic banks². Moreover, reliability and transparency within the market, adoption of good corporate governance and regulatory factors all contribute to their growth^{7, 8, 11, 12&16}.

f. Other Challenges

The researchers have identified other challenges such as globalization and liberalization which will have impact on Islamic banks to compete in markets especially with entrance of international banks who are well experienced and having better customer services^{2, 3, 6, 10&14}. On the other hand, appropriate legal and supervisory framework is vital for establishing sound Islamic banking system^{5, 6&9} while lacking of such secure system is another challenge for Islamic banks¹⁰.

3. Overcoming the Challenges:

Similarly, the researchers have proposed the following measures to overcome these challenges which could be summarized as follows:

- a. Avoid duplication of individual *sharia'a* boards and to be more efficient and cost effective as well as uniformity of standards to be followed by individual institutions².
- b. Islamic banks need to reach the scale required to compete with conventional banks by continued growth of the industry and increase public awareness of Islamic products and services. Furthermore, *Sharia'a* scholars and human capital shortages is another constraint to the industry. Growth of the Islamic banking can't be achieved without finding a solution to this hurdle. In addition, efficiency, reliability and transparency within the market and corporate governance as well as regulatory and supervisory factors all

contributing to the growth of the industry. A vital issue is the standardization of regulations which will enhance integration of Islamic banking into the global market⁷.

- c. Islamic banks need to increase awareness of Islamic products and services while they are becoming more competitive, compared to conventional products. Also, variety and wider Islamic financial products should be available¹².
- d. Adoption and improvement of strategic methodology such as increasing size through mergers and acquisitions will be essential for Islamic banks. Besides, standardizing operations, reporting and financial statements, creation of efficient customer service and development of short term liquidity products as well as expansion and diversification of products will enable them to compete in the market¹⁴.
- e. Increasing availability of *sharia'a* compliant business opportunities to provide different types of financing by meeting market expectations through innovating new products and services addressed by investors needs, will no doubt contribute to growth of Islamic banks. Meanwhile, utilization of information technology to develop processes and enhance customer services as well as availability of reliable market data and transparency will add to that. Nevertheless, Islamic banks need to develop training programs for employees to have sufficient understanding of Islamic banking¹⁹.

CHAPTER III

RESEARCH METHODOLOGY

A. Data-Gathering Methodology Employed

In order to solicit necessary data and information needed for this research, two data gathering techniques were used: questionnaires and semi-structured interviews. Understanding the advantages and disadvantages of questionnaires and personal interviews as data-gathering tools, both of them were used in order to enhance the outcome of the research. The researcher did not use tabulated questions in both techniques, so that respondents can express their own opinions rather than directing them to certain conclusions.

There were 32 respondents for this research (Appendix A) which have been categorized into two groups to facilitate data gathering, Group A composed of 20 respondents and Group B; composed of 12 respondents. Group A respondents were asked to fill up the same set of questionnaires (Appendix C) while those in Group B were interviewed using prepared set of semi-structured interview questions (Appendix E).

Meanwhile, the researcher has collected secondary data on Islamic banking from books, journals, newspaper articles, conference papers, documents and the Internet. It was employed by the researcher as background information to formulate the questionnaires sent out to the first set of respondents, as well as in originating the questions raised for the second set of respondents during the personal interviews conducted.

The grouping of the respondents was advisable due to the fact that during the data gathering, the researcher encountered a problem of shortage of Islamic banking and related field personnel who are willing to be research respondents. Meanwhile, it was complicated to get respondents from conventional banking since the researcher is working for an Islamic bank, yet he managed to get some as he has previous conventional banking relationships.

Initially, targeted respondents were 60 for Group A and 30 for Group B. However, when the questionnaires were distributed; only 20 were available from Group A who were given questionnaires to fill up with narrow questions focusing on the main points of the research; the growth of Islamic banking in the Kingdom of Bahrain, its factors, its competitiveness and challenges facing Islamic banking as well as its future role in the kingdom's economy. The respondents were given the freedom to answer the questions without the researcher being present.

On the other hand, the researcher had face-to-face interviews with Group B in order to address more issues than those asked in the questionnaires which would elaborate and enhance data gathering for the study. In Group B; 20 participants have agreed to be interviewed. Unfortunately, only 12 were available on the agreed interview dates. During the interview phase of data gathering, both methods of tape recording and hand written notes were used by the researcher to verify information gathered which proved to be helpful referrals during the data collection process of the study.

Besides, the researchers figured out that the idea of filling up questionnaires and being interviewed for bankers; whether Islamic or conventional would mean

providing some time from their busy schedules to attend such activities, which in their opinion is loss of business opportunities. Furthermore, these top officials were busy with job-related matters as well as participation in conferences which confined them to be available for interviews. In addition, some targeted respondents were hesitant to answer questions pertaining to giving away secret information.

Although theory suggest that a large number of respondents should be targeted, the researcher understands that having such limited number of respondents for a research of this type is considered as a weakness and could not lead to objective and comprehensive outcomes for the Islamic banking sustainable growth in the Kingdom of Bahrain and it might lead to biased results. However taking into consideration that Islamic banks in the Kingdom of Bahrain are few and it is a small country, such number of respondents could provide a path for the outcome of such researches. On the other hand, the respondents profile provides a good mixture of different levels within the Islamic banking industry in the Kingdom of Bahrain as well as maintaining good banking experience; summing up to 179 years. In addition, respondents include key experts in Islamic banking such as a General Manager with more than 30 years of experience and an Assistant General Manager of more than 40 years in banking, of which 20 years are in Islamic banking as well as the Director of Islamic Banking Directorate of the Central Bank of Bahrain. Apart from others, it includes a *Sharia'a* scholar with a PhD certificate having an experience of more than 30 years and other professionals such as a specialized lawyer in Islamic banking for last 10 years and a Head of a supporting organization for Islamic banks maintaining experience of more than 25 years. In addition, the list of respondents includes other fields such as Human Resources, Financial Control, Credit & Risk Management,

Internal Audit, Wealth Management, Customer Services, Investments, Information Technology and Corporate Communication (Public Relations).

Nevertheless, the Islamic banking system in the Kingdom of Bahrain consists of 6 full commercial banks, 3 offshore banking units, 16 investment banks, 2 representative offices, 4 investment business firms and 2 financing companies as well as 1 brokering company (Appendix F). In addition, there are 3 Islamic banking support groups (Appendix G) as well as conventional banks with Islamic windows. The research respondents were selected from all categories within the Islamic banking industry which no doubt would cover any shortcoming of the small number of participants in this research. However, employees of the representative offices, Islamic financing companies and the Islamic investment broker were not cooperative to participate in this research, due to the fact that they are reluctant to provide information they assume it is confidential.

B. Profile of Respondents

Group A respondents profile could be recapitulated as 16 working for Islamic institutions while 4 are working for conventional banks. They are 15 male and 5 female; with average age of 36 years, having at average 9 years of work experience and their educational qualifications are 7 MBA, 11 BSC and 1 CPA as well as 1 professional Diploma. Their job titles varies to 2 Assistant General Managers, 3 Senior Managers, 3 Managers, 2 Assistant Managers, 6 Officers, 1 Administrative Associate, 1 Investment Coordinator and 2 Customer Services Representatives. Meanwhile, all are familiar with Islamic banking as 7 deals with Islamic banks, 3

with conventional banks while 10 are dealing with both Islamic and conventional banks.

On the other hand, Group B consisted of 10 male and 2 female respondents. They are 1 General Manager, 2 Assistant General Managers, 2 Senior Managers, 1 Lawyer, 1 *Sharia'a* Scholar, 1 Director of Islamic Banking at the Central Bank of Bahrain (CBB) which is a regulatory body of Islamic banks, 1 Financial Controller, 1 Head of Investments and 1 Investment Analyst as well as 1 Head of a Supporting Organization for Islamic banks.

Group A respondents were asked to answer 13 questions while Group B respondents were asked 15 interview questions and fortunately all have been answered although some parts of the questionnaires were remained unanswered, which provided an average of 80% response rating for the research. The total 32 respondents of the research have been considered as 100% to ease the percentages calculation for the outcome of the research.

C. Citation Methodology Employed

For easy illustration and better referencing to responses provided by the respondents of this research, Group A respondents will be referred to sequentially as superscripts 1, 2.... 20 and consequently respondents in Group B will be referred to as superscripts 21, 22 32. Meanwhile, a complete list of the respondents from both Groups is in Appendix A.

CHAPTER IV

ISLAMIC BANKING SUSTAINABLE GROWTH, BAHRAIN

OVERVIEW OF PRESENTATION OF FINDINGS

The findings of the 32 respondents of the research of Islamic Banking Sustainable Growth, Bahrain as an example; as provided in Appendix I, indicate the growth factors of Islamic banking in the Kingdom of Bahrain, its challenges and the measures to overcome such challenges in addition to its future prospects. These could be summarized as follows:

A. Factors of Growth

All research respondents have agreed that the Kingdom of Bahrain has experienced growth in Islamic banking during recent years. The factors affected the growth of Islamic banking are as follows:

- 1. Regulatory Support:** The substantial regulatory and legislation support offered by the Government and the Central Bank of Bahrain has contributed to this growth according to 60% of the respondents who agreed that Bahrain is supportive to the new business model and made significant efforts to maintain it. However, 16% of them said it will become the hub of Islamic banking in the region, and 9% argue that it is mainly due to Bahrain being a financial centre for conventional banks; it has supported its position. Meanwhile, 31% are of the opinion that such governmental support and

industry infrastructure have encouraged international banks to consider Bahrain as their gateway to Islamic banking.

2. **Increased Awareness:** Almost 44% of the respondents believe that increased awareness has been a factor for this growth while 25% of them consider religious reasons have contributed to it. In contrast, 13% refer the growth to the communications and media roles, while 19% respondents support the growth due to phenomenal success of Islamic banks during recent years.

The rest of respondents did not comment on this.

3. **Availability of Local Expertise:** Local qualified, well educated and skillful workforce have supported this growth as referred by 38% of the respondents, as well as availability of other experts in the country according to 6% of them. Meanwhile, 19% believe that these qualified Bahrainis have reached top managerial levels within their organizations; which proves the said argument.

The rest of respondents did not comment on this.

4. **Economic Growth:** The economic boom during recent years in the Gulf region has played a role in the growth of Islamic banks as stated by 16% of the respondents. Meanwhile, other 28% believe that excess liquidity generated from oil exports has supported this growth. Nevertheless, other 19% of them argue that stability of Bahrain's economy has led to this growth

and gave confidence to international banks to operate their Islamic branches and windows in the country.

The rest of respondents did not comment on this.

- 5. Better Investment Returns:** 13% of the respondents stated that innovation and product development of higher returns investment opportunities, have encouraged customers to deal with Islamic banks; while other 9% believe it is only recently done as they were copying conventional banks products earlier. However, product innovation has enabled Islamic banks to have a competitive edge over conventional counterparts by diversifying their risks with better investment returns, as argued by 34% of the respondents.

The rest of respondents did not comment on this.

- 6. Other Factors:** The growth of Islamic banks is due to different other factors such as availability of supporting organizations in Bahrain that has facilitated its emergence as considered by 16% of the respondents. In contrast, 9% of them argue that growth is supported by telecommunication infrastructure availability in the country, while other 9% refer Islamic banks growth to the expatriate professionals who worked for many years in Bahrain having good and comfortable work environment and social life.

The rest of respondents did not comment on this.

B. Challenges of Growth for Islamic Banking

The 32 respondents of the research as provided in Appendix I; have summarized the following main challenges for Islamic banks growth in the Kingdom of Bahrain:

- 1. Lack of Human Resources:** This is one of the main challenges facing Islamic banks according to 38% of the respondents who stated that it is not easy for banks to attract, recruit and retain high caliber staff. Meanwhile, 9% of them believe that Islamic banking is growing at a higher pace than human resources development. To the contrary, 19% of the respondents argue that Islamic banks maintain good quality of employees while other 13% are of the opinion that they attract conventional banks employees and provide them with *sharia'a* training to develop the human resources. Nevertheless, 16% of the respondents consider BIBF as a vital tool in developing the staff of Islamic banks.

The rest of respondents did not comment on this.

- 2. *Sharia'a* Issues:** A consistent challenge for Islamic banks is the *sharia'a* issue as judged by 19% of the respondents. Moreover, 19% of them believe that some *sharia'a* scholars lack economic and financial background which makes their job much complicated, differing than 3% who said that some scholars are studying business to enrich their knowledge. Besides, Islamic banks started to hire internal *sharia'a* staff to overcome such issues according to 9% of the respondents. Additionally, 16% believe that scholars

are not performing their tasks of product development and innovation properly. Furthermore, 13% of the respondents consider disagreements among scholars as a challenge; however other 6% consider such disagreements as a favor for customers to have different choices of products.

The rest of respondents did not comment on this.

3. Competition by Local and International Banks: 47% of the respondents are of the opinion that internal and external competition is a main challenge facing Islamic banking. Moreover, 19% of them believe that globalization and liberalization of markets will be another challenge. In contrast, other 13% consider Bahrain as an open market that will not be affected by international and regional banks. In addition, 16% of respondents stated that Bahrain is a small market and it will not be targeted by international banks Islamic windows and branches.

The rest of respondents did not comment on this.

4. Innovation and Product Development: According to 28% of the respondents, Islamic banks are offering limited products compared to conventional counterparts. Moreover, 19% of them believe that interference of *sharia'a* boards in Islamic banks operations caused another limitation. Meanwhile, other 22% stated that although currently minor development is done; limited utilization of information technology and disagreements among

scholars for innovation of different products are another limitation. Quite the opposite, 38% of the respondents considered Islamic banks are offering competitive products and they are different than conventional banks products.

The rest of respondents did not comment on this.

5. Customer Services Enhancement: A vital challenge for Islamic banks where they need to narrow the lacking gap with conventional banks according to 16% of the respondents. Meanwhile, according to 16% of them; Islamic banks don't build long term relationship with customers, apart from sophisticated investment customers. Alternatively, other 38% argue that Islamic banks offer good services by recruiting conventional banks staff and provide them *sharia'a* training.

The rest of respondents did not comment on this.

6. Unified Banking Code: Lack of such code is another obstacle for Islamic banks according to 38% of the respondents who refer it mainly to Islamic banking being in early stage and *sharia'a* disagreements among scholars which limits the growth of Islamic banks. In addition, 9% argue that *sharia'a* boards restrict the process within Islamic banks. To the contrary, other 9% believe that absence of such code will lead to more innovation and product development as each bank will have its own product.

The rest of respondents did not comment on this.

7. Risk Management and Corporate Governance: Islamic banks face the same risks of conventional banks as per 9% of the respondents, yet they are exposed to higher risks for financing facilities according to other 13%. On the other hand, 31% of them are convinced that Islamic transactions carry lower risk due to its relation to each transaction, while other 19% state that *sharia'a* boards provide a comfort for reducing risks involved.

In addition, 6% of the respondents believe that Islamic banks have same corporate governance issues as conventional banks, while other 9% feel that they need to address Basel II requirements. In addition, other 13% believe that Islamic banks should widen their acceptance of corporate governance and the adoption of the concept of transparency and delegation where lack of academic research in this field is a hindrance for them. Also, according to other 9% of the respondents; Islamic banks should develop their information technology systems to cater for such issues. Instead, 22% of them believe that *sharia'a* boards of Islamic banks impose some internal corporate governance and 13% consider Islamic banks employees as doing their job on ethical standards which complies with its corporate governance.

The rest of respondents did not comment on this.

8. Absence of Secondary Markets: Absence of such markets is another challenge for Islamic banks according to 13% of the respondents, while regulators should coordinate with them to develop such markets as per other 9%. Moreover, currently Islamic banks do not face liquidity shortages according to 34% of the respondents, however; 16% of them state that Islamic banks have excess liquidity which should be invested.

The rest of respondents did not comment on this.

Meanwhile, for better illustration of the findings of the research, the below table summarizes the outcomes of the responses of the questionnaires and personal interviews conducted:

Table 1: Islamic Banking Sustainable Growth in the Kingdom of Bahrain

(Summary of Responses)

Outcome	Description	Respondents (%)
Growth Factors	1. Government & Regulatory Support:	
	- Regulations & Legislation Availability.	60
	- Gateway for International Banks.	31
	- Conventional Banking Financial Centre.	9
	2. Awareness:	
	- Increased Awareness.	44
	- Religious Purposes.	25
	- Phenomenal Success of Islamic Banks.	16
	- Media & Communications.	13
	3. Innovation and Product Development.	56
Challenges for Growth	4. Economic Growth.	63
	5. Availability of Human Resources.	44
	6. Other Factors.	25
	1. Lack of Human Resources.	66
	2. Lack of Unified Banking & <i>Sharia</i> 'a Code.	76
	3. Competition	66
	4. Innovation & Product Development.	69
	5. Risk Management & Corporate Governance.	50
	6. Absence of Secondary Markets.	38

Note: Some respondents gave more than one answer to some questions.

C. Measures to Overcome These Challenges

To overcome these challenges for growth faced by Islamic banks in the Kingdom of Bahrain as provided by the research respondents in Appendix I, the following summarized measures have been proposed:

- 1. Developing Human Resources:** As per 13% of the respondents, Islamic banks should realize this measure and include it in their objectives and strategies. In addition, proper sponsorships and educational programs are to be made by Islamic banks according to other 16% of the respondents. Meanwhile, supporting organizations in the country are playing a good role in this regard as per other 16%. Furthermore, Islamic banks are requested to encourage universities to have Islamic banking as a major subject in their syllabus, as stated by 6% of the respondents. Alternatively, other 6% of them requested Islamic banks to allocate certain percentage of their profits for human resources development.

The rest of respondents did not comment on this.

- 2. Unified Set of Banking Policies:** The measure for this challenge can be considered by following standard *sharia'a* rules and set up unified practices by Islamic banks, according to 25% of the respondents, although it difficult to do so. Other 13% are stressing that AAOIFI and Central Bank of Bahrain should play better role in this regard.

The rest of respondents did not comment on this.

- 3. Being Competitive:** According to 22% of the respondents, Islamic banks should target new markets and new segments. In addition, they need to have Research & Development departments to support product development and innovation as per other 9%, while other 9% of the respondents recommend that *sharia*'a boards play better role in this regard.

The rest of respondents did not comment on this.

- 4. Customer Services Enhancement:** In order to enhance their services, Islamic banks need to hire skillful employees and develop training programs for customer services staff as considered by 16% of the respondents. Meanwhile, other 16% believe that they should encourage education programs and seminars to increase public awareness.

The rest of respondents did not comment on this.

- 5. Information Technology Development:** Islamic banks need to consistently develop their systems to compete in the market as requested by 16% of the respondents. Meanwhile, Islamic banks managements must include this vital issue in the strategies of the banks as per other 6% of them.

The rest of respondents did not comment on this.

- 6. Be Large Enough:** According to 9% of the respondents, Islamic banks need to consider mergers and acquisition to survive in the market with the globalization being considered. Alternatively, they should increase their capital base as per 6% of them. Also, they need to be the leaders in large Islamic transactions as stated by other 9%.

The rest of respondents did not comment on this.

- 7. Managing Risks:** 13% of the respondents believe that Islamic banks should resolve the issue of defaulters with scholars; and they are there to support the banks in achieving their objectives, as per other 9%. Also, they should find ways to reduce the risk involved in financing transactions, according to 9% of the respondents.

The rest of respondents did not comment on this.

- 8. Developing Secondary Markets:** According to 16% of the respondents, Islamic banks need to develop secondary markets where Liquidity Management Centre, based in Bahrain can play a good role. Moreover, they need to be more transparent to provide information to the market to achieve such measure, as requested by other 16%.

The rest of respondents did not comment on this.

D. Future Prospects of Islamic Banking

According to 34% of the respondents, Islamic banking has contributed much to the economy of Bahrain and it will continue; by establishing new business opportunities in the economy, financing major projects and yielding higher returns to customers. Meanwhile, it has contributed to the welfare of the society by increasing the awareness of customers and providing better job opportunities, as per other 13%. In contrast, 6% of them believe that Islamic banks are considered a factor in the boom of real estate in the country which has affected lower income population.

Furthermore, 16% of the respondents state that Islamic banking with the support of the government has substantiated the reputation of Bahrain as a financial centre. Also, other 16% are in agreement that Islamic banking will continue to grow as far as oil exports is increasing, supported by good regulatory and legislation bodies in Bahrain.

The rest of respondents did not comment on this.

CHAPTER V

CONCLUSION AND RECOMMENDATION

A. Conclusion

The research findings through the questionnaires and personal interviews conducted, as summarized in chapter IV for Islamic Banking Sustainable Growth, Bahrain as an example; have concluded that the growth of Islamic banking in the Kingdom of Bahrain has almost the same factors and challenges, as similarly identified in the related literatures review in chapter II. These could be concluded as:

1. Growth Factors of Islamic Banking in the Kingdom of Bahrain

Islamic banking growth over years in the Kingdom of Bahrain is a result of many factors. One of its main factors is the Government support by having reputed regulations and legislations through the Central Bank of Bahrain and other regulatory bodies. This was the gateway which encouraged international and regional banks to have branches and Islamic windows as well as supporting organizations for Islamic banking; in Bahrain.

The other main factor for this growth is the economic development in Bahrain due to the increased income from oil exports and stability of the country's economy. Meanwhile, recent innovation and products development by Islamic banks; especially restricted investment products that yield higher returns to customers provided them added value, which contributed to this growth.

Besides, increased awareness among the public due to higher demand for religious products, phenomenal success of Islamic banks lately and availability of human resources as well as the increased effect of media and communications (The Internet) are other factors of growth.

2. Challenges of Growth for Islamic Banks in the Kingdom of Bahrain

As identified by the respondents, in order for Islamic banking in the Kingdom of Bahrain to continue its growth; the following challenges should be addressed:

- a. Lack of Unified Banking Code:** Absence of unified code for Islamic banks is one of the main challenges. They need to develop such code to streamline operations and to unify *sharia'a* rulings in order to enhance customer services. The conflict arises from scholars being followers of different *sharia'a* schools of the religion. These disagreements challenge Islamic banking and may influence its credibility over years. Meanwhile, some scholars lack the training in business and finance which prevents them from understanding the business environment well. Moreover, absence of unified policies and procedures takes this challenge further.
- b. Competition:** is another main challenge for Islamic banks that are in difficult position as they face internal and external competition from local and international banks. Although they have grown substantially, they are still considered small and can't compete with regional and international banks. Internally, they compete with conventional banks to provide better

services and products to customers, while externally they face the threat of entrance by regional and international banks.

Moreover, Islamic banks should continue innovating products to compete and remain in the market; by having their Research & Development departments who will gather information from the market and develop new products. As well, these departments will support customer services enhancement and provide necessary data for the same as Islamic banks are still in need to enhance customer services. Nevertheless, Islamic banks need to develop their Information technology to cap with current market situations in order to compete.

c. Shortage of Human Resources: Difficulty of attracting and recruiting quality staff is another challenge. It is believed that Islamic banking is growing faster than training and qualifying human resources in this field which ascertain the shortage of qualified employees for the sector. Apart from that, shortage of *sharia'a* scholars adds to it as there are not many scholars available to provide enough support to banks and to train their employees.

d. Risk Management & Corporate Governance: Islamic banks face similar risk management issues as conventional banks, yet they need to develop financial risk management to better compete in the market. Some *sharia'a* principles such as initially buying the asset and then selling it to

the customer; needs to be addressed properly, as well as the issue of financing defaulters.

Apart from the above challenges, development of secondary markets for Islamic banks is another minor issue; so that liquidity problems could be solved easily. They are still behind conventional banks and they depend on them to structure secondary markets due to their limited size.

It is evident from the above conclusions that some growth factors and challenges of Islamic banking are internal while others are external where Islamic banks should focus on; to develop further and to sustain growth over years.

B. Recommendation

Recently, Islamic Banking in Bahrain is growing at higher pace than conventional banking. Many new Islamic banks have been established during recent years compared to few conventional counterparts. This should be a great influence for Islamic banking to further develop and expand. Moreover, with the increase of oil prices supported by good regulations and other factors mentioned above, Islamic banking in Bahrain will continue to grow despite the challenges facing it.

However, Islamic banking needs to sustain its competitive edge over conventional banking by enhancing the aforementioned growth factors and trying to develop them further. Meanwhile and in order to grow further, the challenges facing Islamic banks in the Kingdom of Bahrain, are to be mitigated by the

following recommended measures related to the findings of the research and the literature review:

1. Necessity of Unified Banking Code

In order for Islamic banks to function suitably in the future, the followings are recommended:

- a. Development of a unified set of banking policies which is a necessity. Islamic banks should consider having unified *sharia'a* rulings to overcome the issue of disagreements among scholars, avoid duplication of individual boards and to be more efficient and cost effective as well as uniformity of standards to be followed by individual institutions.
- b. The Central Bank of Bahrain is suggested to accelerate the process of formulating and issuing a unified set of Islamic banking laws, to be followed by Islamic banks in the country.
- c. *Sharia'a* scholars need to make themselves familiar with banking and finance issues in order to enhance their banking knowledge and ease Islamic banks functions.

2. Competitiveness

Unfortunately, Islamic banking was introduced over thirty years, it is yet considered by many as in its early stage and needs to consider many issues to be competitive in the market. It is suggested that:

- a. Islamic banks should enhance their customer services by hiring the right people to do the job. Basically, having the right people in the right place.
- b. They should provide adequate training for those staff that has direct relationships with customers, for example customer services and investment placement staff.
- c. Islamic banks should be innovative and continuously launch new products to the market, through having Research & Development departments who will provide necessary support to other departments to tap the market. Also, they are required to address customers' needs by developing new products and services to satisfy them and gain larger customer base as well as provide alternatives to those offered by conventional counterparts.
- d. Based on the responses of the managerial positions, Islamic banks are still considered small and they need to survive in the market. They need to expand geographically and should take into consideration globalization that no doubt will bring new entrants to the market including those regional and international banks. They will be forced either to increase their capital base or have the other option of mergers and acquisitions.

3. Developing Human Resources

It is recommended that Islamic banks should consider this measure as important and to be included in their strategies and objectives. Meanwhile, they are advised to do the following:

- a. Proper on job training, workshops and conferences attendance is vital for Islamic banks employees to develop.
- b. They should provide adequate training for their new staff who are not familiar with Islamic banking.
- c. They should sponsor university students to assist them to study *sharia'a* and banking in order to narrow the gap of human resources shortages.
- d. As suggested by the respondents, Islamic banks should allocate certain percentages of their yearly profits to human resources training and development, which will no doubt defeat the deficiency in this field.

4. Enhancing Risk Management and Corporate Governance

In order to manage risk properly, Islamic banks need to address and take actions towards some previously mentioned *sharia'a* issues such as:

- a. The defaulters of financing which should be charged extra profits for the delay in repayment of financing facilities.
- b. The risk associated with the purchase of an asset on behalf of a customer and then selling it.

- c. As suggested by respondents, they need to focus on operational risk management which is currently been considered as a significant issue of risk management.

However, corporate governance and transparency need to be addresses and Islamic banks should not just rely on *sharia'a* boards to impose rules and regulations. They should develop their own policies in this context.

5. Development of Secondary Markets

Although the number of Islamic banks in Bahrain is in early stage of growth, it is suggested to arrange joint meetings in coordination with the Central Bank of Bahrain to discuss this issue and come up with a time frame to start developing such markets in presence of their *sharia'a* boards. Meanwhile, they should identify secondary market for their investment products so that customers can freely trade in these investment products which will eventually increase their customer base.

CHAPTER VI

PERSONAL REFLECTION

Being an employee of a recently established Islamic bank with 3 years of Islamic background and good conventional banking experience, this research into Islamic banking sustainable growth, Bahrain as an example; has provided the researcher good lessons and coaching of Islamic banking, its growth, challenges and measures to overcome these as well as its future prospects.

The research has pointed out some results that require further investigation which could be summarized as follows:

1. Would the research results and recommendations be different if the researcher was having enough Islamic banking experience?
2. Why Islamic banking is growing at this pace while conventional banking is lower?
3. Do Islamic bankers and scholars realize the importance of resolving the long standing unresolved *sharia'a* issues?

Due to specialty and time constraint, these issues could not have been dealt with in this research. They can only be dealt with in a more detailed research to be conducted by an Islamic banker.

APPENDIX A

List of Respondents

Group A

1. Assistant General Manager, Corporate Banking.
2. Assistant General Manager, Credit & Risk Management.
3. Senior Manager, Human Resources.
4. Senior Manager, Distribution Channels.
5. Senior Manager, Internal Audit.
6. Manager, Financial Control.
7. Manager, Corporate Communication.
8. Manager, Wealth Management.
9. Assistant Manager, Customer Services.
10. Assistant Manager (Lecturer), Bahrain Institute of Banking & Finance.
11. Officer, Information Technology.
12. Officer, Investment Placement.
13. Officer, Investment Analyst.
14. Officer, Wealth Management.
15. Officer, Media & Branding.
16. Officer, Corporate Banking.
17. Administration Associate.
18. Investment Coordinator.
19. Customer Services Clerk.
20. Customer Services Clerk.

Group B

21. General Manager.
22. Assistant General Manager, Commercial Banking.
23. Assistant General Manager, Investment.
24. Senior Manager, Corporate Finance.
25. Senior Manager, Head of Branches.
26. Financial Controller.
27. Director of Islamic Banking Directorate.
28. *Sharia'a* Scholar.
29. Head of supporting organization for Islamic banks.
30. Lawyer, Islamic Banking.
31. Head of Investments.
32. Investment Analyst.

Note:

Names and relevant personal data of interviewed persons have not been disclosed for confidentiality purpose.

APPENDIX B

Questionnaire Cover Letter

Dear Sir/Madam:

I am currently doing my Master of Business Administration course with The University of Hull, United Kingdom. I am doing a dissertation on **“Islamic Banking Sustainable Growth, Bahrain as an example”**, a task that I am aware could not be accomplished without the cooperation of those in Islamic banking sector as well as others in the conventional banking.

I seek your cooperation in filling up at your earliest, the attached questionnaire which no doubt will enrich my study and once completed, you are kindly requested to e-mail or hand- deliver it to me at your earliest. Meanwhile, please feel free to contact me by telephone or e-mail in case of any enquiries.

I am looking forward for your feedback and thank you for your assistance.

Truly yours,

Tariq Al Arabi

Telephone No.: 39699622/17509840

Email Address: talarabi@khcbonline.com

APPENDIX C

“Islamic Banking Sustainable Growth, Bahrain as an example”

Questionnaire

Please fill in the information below.

1. Type of your organization: Islamic _____ Non Islamic _____
2. Age: (20-30) _____ (30-40) _____ (above 40) _____
3. Gender: Male _____ Female _____
4. Educational qualification:
_____ High School Graduate _____ Diploma Graduate _____ BSc Graduate
Others (Please specify) _____.
5. Job Title: _____.
6. Years of Service: _____.
7. Banking with: _____ Islamic Bank _____ Conventional Bank.
8. Are you familiar with Islamic banks? _____ Yes _____ No.
9. Do you prefer to deal with Islamic banks? Why?

10. Do you think that Islamic banking is growing in the Kingdom of Bahrain? Why?

11. Do you believe that Islamic banks in the Kingdom of Bahrain are offering competitive and innovative products and services? Why?

12. What are the challenges facing Islamic banks in the Kingdom of Bahrain? What measures to be taken to overcome these?

13. Do you think that Islamic banks will play an important role in the economy of the Kingdom of Bahrain in future? Why?

Thank you for your cooperation.

APPENDIX D

Interview Request Letter

Dear Sir/Madam,

I am currently doing my Master of Business Administration course with The University of Hull, United Kingdom. I am doing a dissertation on **“Islamic Banking Sustainable Growth, Bahrain as an example”**, a task that I am aware could not be accomplished without the contribution of those involved in Islamic banking sector as well as others in the conventional banking.

Hence, I would like to request meeting you at your convenient time; to discuss the attached questions related to Islamic banking. Meanwhile, please be informed that our discussion will be merely used for the research and will be confidential.

I look forward for meeting you; which no doubt will enrich my study and contribute to it. Meanwhile, please feel free to contact me by telephone or e-mail in case of any enquiries.

Truly yours,

Tariq Al Arabi

Telephone No.: 39699622/17509840

Email Address: tararabi@khcbonline.com

APPENDIX E

Interview Questions

“Islamic Banking Sustainable Growth, Bahrain as an example”

1. Do you think that there is a growth of Islamic banking in the Kingdom of Bahrain? What are the factors for that? Why international banks are interested in Islamic banking? Why they choose Bahrain as destination?

2. Do you think that awareness for Islamic banking in the Kingdom of Bahrain has increased over years? What are the reasons? What are the motives for customers to deal with Islamic banks in the Kingdom of Bahrain? Do they build long term relationships with customers?

3. Do you believe that Islamic banks in the Kingdom of Bahrain are efficient in customer services? Why? Do they acknowledge the importance of workforce professional training for the industry? What should be done for them to be as efficient as conventional banks staff?

4. Do Islamic banks in the Kingdom of Bahrain offer competitive products and services? Do they copy what conventional banks offer or innovate new products? Do they use proper technology for product development and innovation?

5. Does the Government of Bahrain encourage Islamic banking? What do you think it facilitate for the same? Is the Government interested in Islamic finance for its projects?

6. Is there a need for Islamic banks in the Kingdom of Bahrain to have a unified banking code? What are the reasons? What do you think to be done to have one? Do you think that they need to standardize operations & *sharia'a* issues?

7. Do you believe that Islamic banks in the Kingdom of Bahrain face liquidity problems? What are the reasons? Do they need to have money market instruments to overcome such a problem?

8. Do you believe that *Sharia'a* boards in Islamic banks have different interpretations of Islamic banking laws? What could be the reasons for these differences? What do you believe are the solutions to eliminate these differences?

9. Do you consider that Islamic banks in the Kingdom of Bahrain lack secondary markets for their assets? What do you believe are the reasons behind this? What should be done to overcome this obstacle?

10. Do you believe that Islamic banks need to develop new products and services? What measures they should create in order to ensure successful development of new products and services?

11. Do you think that Islamic banks are capable of effectively compete with conventional banks? What actions should they take to do so?

12. Do you believe that risk management and corporate governance are challenges for Islamic banks in the Kingdom of Bahrain? Are Islamic banking transactions carrying higher level of risk than those of conventional banks? What actions to be taken by Islamic banks to effectively manage risks?

13. Do you believe that globalization and liberalization of markets will affect Islamic banks? What measures they need to consider overcoming such issues?

14. In your opinion, what are the challenges facing Islamic banks in the Kingdom of Bahrain? What measures to be addresses to solve/mitigate these challenges?

15. Do you think that Islamic banks will play an important role in the economy of the Kingdom of Bahrain in future? Why?

APPENDIX F

ISLAMIC BANKS AND FINANCIAL INSTITUTIONS IN THE KINGDOM OF BAHRAIN

No.	Name/Category	Date of Establishment
<u>Full Commercial Banks</u>		
1.	Al Baraka Islamic Commercial Bank	21-10-2001
2.	Kuwait Finance House (Bahrain)	09-12-2001
3.	Bahrain Islamic Bank	29-10-1978
4.	Shamil Bank of Bahrain	23-02-1993
5.	Khaleeji Commercial Bank	20-10-2003
6.	Al Salam Bank, Bahrain	03-05-2005
<u>Offshore Banking Units</u>		
1.	Kuwait Turkish Evkaf Finance House	13-02-2002
2.	Al Baraka Banking Group	06-01-1998
3.	Shamil Bank of Bahrain	19-01-1982
<u>Investment Banks</u>		
1.	ABC Islamic Bank	20-07-1985
2.	Al-Amin Bank	19-05-2001
3.	Al Baraka Islamic Bank	30-09-1983
4.	Capinvest	04-02-1981
5.	Al Khaleej Islamic Investment Bank	06-04-1999
6.	Arab Islamic Bank	14-12-1989
7.	Citi Islamic Investment Bank	17-03-1996
8.	Unicorn Investment Bank	06-01-2004
9.	Gulf Finance House	02-08-1999
10.	Venture Capital Bank	03-05-2005
11.	Investors Bank	03-09-1997
12.	Arcapita Bank	20-08-1996
13.	International Investment Bank	09-12-2001
14.	Liquidity Management Centre	11-06-2002
15.	Noriba Bank	04-05-2002
16.	Yazi Investment Bank	03-12-2005
<u>Representative Offices</u>		
1.	International Investment Group	09-05-1995
2.	European Islamic Investment Bank	08-04-2006

<u>Investment Business Firms</u>		
1.	Islamic Finance Consultants	25-03-1999
2.	Capital Management House	15-02-2006
3.	CIMB-Kanoo	10-05-2006
4.	Islamic Joint Venture Partners	21-07-2002

<u>Financing Companies</u>		
1.	Real Estate Finance Company-Reef	03-05-2005
2.	Sakana Holistic Housing Solutions	28-08-2005

<u>Broking Companies</u>		
1.	Global Islamic Clearing Company	04-10-2005

Source: Bahrain Monetary Agency,(2006).

APPENDIX G

OVERVIEW OF ISLAMIC BANKING IN THE KINGDOM OF BAHRAIN

The financial system of the Kingdom of Bahrain pursues a dual banking system where Islamic banks operate along with their conventional counterparts. Bahrain as an international financial center, has led to the emergence and development of Islamic banks. The Central Bank of Bahrain (CBB) previously called Bahrain Monetary Agency; provides parallel opportunities and treats conventional banking in the same ways as Islamic banking.

The birth of Islamic banking services in Bahrain dates back to 1978 when Bahrain Islamic Bank (BIB) was established. The (BIB) provides normal Islamic commercial banking services, such as Letters of Credit, Letters of Guarantee, deposits, current and savings accounts, telex transfer, investment, etc.

Islamic banking in Bahrain gained momentum in the early 1980s, with the issue of four licenses, one of which was an offshore banking unit license, while the rest were investment-banking licenses.

The creation of an Islamic offshore bank was the first of its kind, an illustration of the innovative approach to regulation pioneered in Bahrain. The CBB (previously called Bahrain Monetary Agency), during the 1990s, issued a total of eight licenses to a diverse group of institutions to enable them to pursue Islamic banking services. As of May 2006,

the total number of Islamic banks operating in Bahrain reached 34, six of which are full commercial banks, three offshore banking units; sixteen are investment banks, with the remainder being two representative offices, four investment business firms, two financing companies, a brokerage company and an Islamic infrastructure fund (Bahrain Monetary Agency, 2006).

a. Development of Islamic Banks

Islamic banking industry in the Kingdom of Bahrain has been growing at an increasing rate. The growth of the Islamic banks has placed the Kingdom as the hub of Islamic banking in the Gulf region. Taking into consideration the strong competition posed by conventional banking, Islamic banking is proving to be successful, as shown by the number of Islamic banks that have opened in the Kingdom (Bahrain Monetary Agency, 2006).

b. Regulations of Islamic Banks

1. The Central Bank of Bahrain (CBB)

One of the responsibilities of the CBB is to ensure that Islamic banks are adequately regulated and supervised and to maintain and enhance the confidence of the stakeholders of the financial services industry, in their dealings with Islamic banks. Moreover, the CBB has developed the prudential information and regulatory framework for Islamic banks (PIRI) with the objectives to provide an Islamic banking regulatory framework and to use the information contained; to

monitor the operations of the banks, as well as to identify any signs of deterioration in banks performance. The regulatory framework is monitored through the assessment of capital adequacy, asset quality, and management of investment accounts, earnings quality, profit and loss, and liquidity management (Bahrain Monetary Agency, 2006).

2. Liquidity Management Center (LMC)

LMC was established in Bahrain in February 2002, to assist meeting the needs of Islamic financial institutions. Its main objective is to enable them to manage asset liability mismatch, to create a pool of quality assets for Islamic financial institutions, to create liquidity for conventional players, to enhance *sharia'a* credibility, and to achieve higher returns for investors and shareholders (Bahrain Monetary Agency, 2006).

c. Supporting Organizations

As the Kingdom hosts the largest share of Islamic financial institutions, it was important to have Islamic support organizations. As a result, the CBB has given permission to many supporting organizations to have their main operations offices in the Kingdom, to provide support to the Islamic financial industry. These supporting organizations are as follows:

1. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI)

It was established in 1991, when the Islamic banking industry lacked Islamic standards. The AAOIFI was established to become the main standard-setting organization. Its main objectives are:

- a) to develop and disseminate accounting, auditing governance and ethical thinking to activities of Islamic financial institutions,
- b) to harmonize accounting policies and procedures adopted by Islamic financial institutions,
- c) to improve quality, uniformity, and promote ethical practices in Islamic finance, and
- d) to approach regulatory bodies and other concerned institutions in order to enhance the implementation of standards.

The AAOIFI have now issued more than 50 standards on accounting, auditing, governance, ethical and *sharia'a* standards. It has taken significant steps to encourage the application and enforcement of its standards throughout the world which have produced high-quality standards that are internationally recognized. It is only by international recognition and consistent application of these standards that the Islamic banking industry will realize the full benefits of accurate and transparent financial reporting and accomplish the vision of a global Islamic financial architecture.

The AAOIFI standards are being implemented in leading Islamic banking and finance centers such as Bahrain, Jordan, Sudan, Malaysia, Qatar, and Saudi Arabia, where they are either mandatory or used as a guideline by the regulators (Bahrain Monetary Agency, 2006)

2. General Council for Islamic Banks and Financial Institutions (GCIBFI)

The GCIBFI which is based in Bahrain was founded in 2001 as a non-profit making organization. Its mission is to “work for the support of the Islamic banking industry with a view of promoting it through the dissemination of appropriate information and accurate data”. Its main objectives are:

- a) to enhance cooperation among members of the council and other related institutions, such as regulatory bodies, in order to achieve common objectives, and
- b) to prepare and disseminate information and data pertinent to Islamic banking practices. (Bahrain Monetary Agency, 2006)

3. Bahrain Institute of Banking and Finance (BIBF)

The institute is a non-profit organization established in 1981 to provide contemporary training and education for bankers in the areas of management and leadership, banking, Islamic banking, insurance, accounting, and information technology. The BIBF started offering training and development and specialist activities for Islamic financial institutions in the year 1990,

organizing external courses conducted by Islamic banking experts. In 1997, the BIBF established the Islamic banking learning center and recruited a full-time expert as Head of Department. The mission set for this department was “to serve Islamic banks locally, regionally, and internationally” and accordingly promote Bahrain as Islamic banking and finance center. (Bahrain Monetary Agency, 2006)

d. Islamic Banking Principles

As a religion, Islam forbids charging of interest (*riba*) but encourages the earnings of profits. In the banking system, investors are not guaranteed any pre-fixed amount of profit from the bank. Neither any pre-determined income or interest, nor repayments of the principal deposit amount are guaranteed to those who invest within the Islamic system. However, because interest (*riba*) is prohibited in the *Qur'an* (the holy book of Islam), this does not mean that Islamic finance refuses the legitimacy of risk taking. Risk taking can be rewarded, but simply earning a reward from the time value of money. The conventional banking principle, that money is traditionally worth more in the future than the present, given that it will normally earn interest, is not acceptable in Islamic banking.

1. Mobilization of funds

Due to the prohibition of paying and receiving interest, Islamic banks cannot mobilize funds by paying interest to their depositors. Funds are mobilized on the basis of the *mudharaba* contract by which Islamic banks agree to manage the funds of customers (investment account holders) in return for receiving a

share of the profits from investing the funds and investment account holders agree to bear any losses incurred from investing their funds (Bahrain Monetary Agency, 2006).

2. Investment activities

On the “asset” side of their balance sheet, Islamic banks, unlike conventional banks, cannot lend money by charging interest but have to engage in permissible investment and trading activities. This is reflected in the structure of their assets being different from that of conventional banks.

Thus, Islamic banking cannot hold any investments or earn any income that is not in compliance with the afore-said principles. If a bank indulges in, or the regulatory regime of the bank’s country of operation requires it to invest in such activities, a disclosure of such activities is required in the financial statements. (Bahrain Monetary Agency, 2006)

e. Islamic Financial Instruments

Islamic finance is perhaps most commonly thought of as “interest-free banking.” The Islamic prohibition of interest is an important feature of Islamic finance. However, to concentrate on this is to over-simplify the rationale behind its development. Islamic finance is principally concerned with ensuring that a person who profits from another’s use of his money assumes a corresponding share of the risk from the enterprise in which his money is invested. Islamic financiers have developed certain basic types of contract which enshrine the afore-said principles. The structure of

each transaction based on these contracts will differ markedly according to its own particular facts. (Allen and Overy, 1993)

To understand Islamic *sharai'a* laws we have to define the Islamic instruments in order to grasp the principal meaning of how these instruments are in place.

The principal Islamic financial instruments are as follows:

1. ***Murabaha*** (cost plus financing)

Murabaha refers to contracts in which a financial institution purchases goods upon the request of the client, who makes deferred payments that cover costs and an agreed-upon profit margin for the financial institution. The financial institution handles payment to a supplier and the incidental expenses of delivery (against a deferred payment made by the buyer to cover delivery cost and an agreed-upon share of the buyer's markup).

Murabaha is the most widely used instrument of Islamic finance the fact that 75% of the total contracts used are *murabaha*-based. It is widely used in consumer and corporate financing as well as in subordinate or term financing. (Bahrain Monetary Agency, 2006)

2. ***Mudharaba*** (profit-sharing agreement)

A *mudharaba* is a finance process where one party, the capital owner, parts with control over a definite amount of his money and allows another person,

the *mudharib*, to invest the money in any fashion he thinks fit, subject to a share of returns (Bahrain Monetary Agency, 2006).

Contract between investors and a financial institution that, acting as a silent partner, invest deposits in a commercial activity that earns each partner an agreed-upon portion of the profits of the venture. A *mudharaba* can be entered into for a single investment or on a continuing basis, with the financial institution acting as a fiduciary. *Mudharaba* investment may be made for fixed terms and arranged through negotiable instruments, called investment deposit certificates or *mudharaba* certificates, and thus may have characteristics similar to those of shares. *Mudharaba* is a fairly used form of finance in Islamic banking and capital markets.

This instrument has mainly been developed to cover the investors that would want to invest their money and get a return. The benefit of this instrument is that it has a return on its capital, but since it has the characteristics of shares, you cannot utilize these types of shares in a secondary market nor can you exit or break the deposit before maturity (Bahrain Monetary Agency, 2006).

3. ***Musharaka*** (equity participation)

A *musharaka* is a partnership or joint venture for a specific business with a profit motive, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation (Bahrain Monetary Agency, 2006).

Musharaka is widely used by Islamic banks for the purchase of real estate, equivalent to a conventional bank mortgage, with the exception that instead of interest, the Islamic bank receives a share of the rent of the property.

In this case, the Islamic bank acts as a partner with the investor and shares the profit and losses with him. The idea of *musharaka* is to lend money against a mortgage loan, which helps the mortgage loan owner from this partnership (Bahrain Monetary Agency, 2006).

4. *Ijara muntahia bittamleek* or *Ijara wa iqtina* (leasing)

An *ijara* is a lease purchase contract in which a financial institution purchases capital equipment or property and leases it to an enterprise. The financial institution may either rent the equipment or receive a share of the profits earned through its use.

Ijara wa iqtina is the same as *ijara* except that the lessee can acquire ownership of the asset by making installment payments.

Ijara instrument is one of the most widely-used by most customers, because the property or the leased equipment goes back to them at the end of the lease agreement. (Bahrain Monetary Agency, 2006)

5. Commodity *Murabaha*

A commodity *murabaha* is an Islamically-acceptable form of a short-term inter-bank deposit or placement. These inter-bank transactions between the Islamic banks are mainly used for liquidity and cash availability to these banks which Islamic banks make more legalized as per their rules and regulations. (Bahrain Monetary Agency, 2006)

6. *Salam* (or *bai-salam*)

Salam is a sale of a commodity whose delivery will be in a future date for a cash price, which means, it is a financial transaction in which the price is advanced in cash to the seller who abides by the delivery of a commodity of determined specification on a definite due date. The deferred is the commodity sold and described (on liability) and the immediate is the price (Bahrain Monetary Agency, 2006).

7. *Istisna* and Parallel *Istisna*

Istisna is primarily a deferred delivery sale contract similar to *salam*. It is similar to the conventional work-I-progress financing for capital projects in conventional banking. In practice, it is usually used for construction and trade finance such as pre-shipment export finance (Bahrain Monetary Agency, 2006).

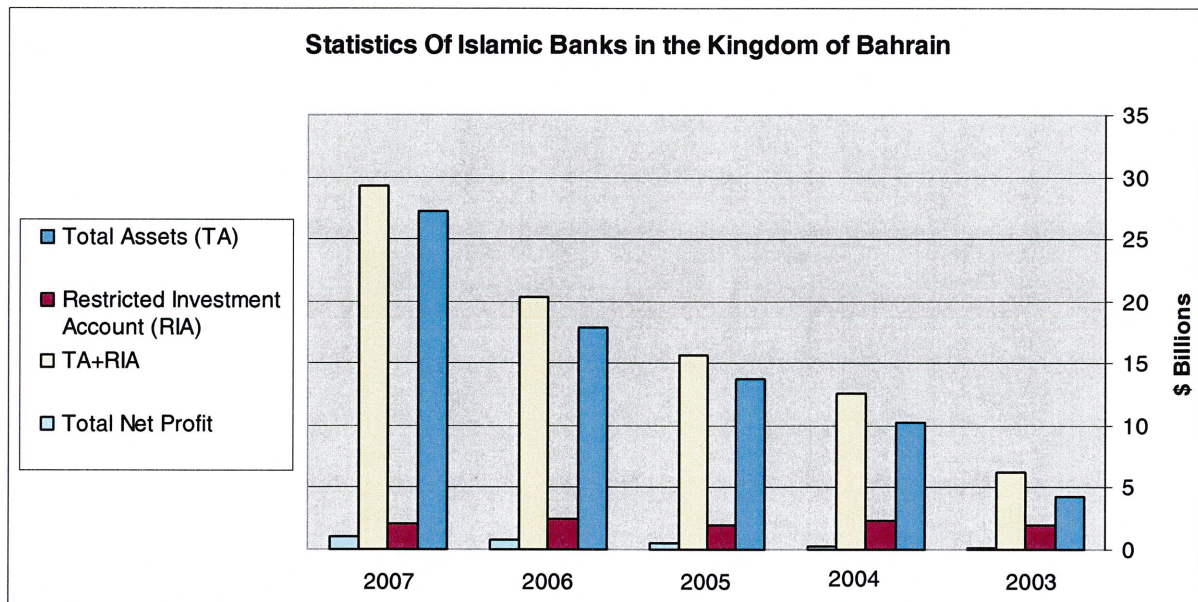
8. *Sukuk* (Islamic bonds)

Sukuk represent proportionate beneficial ownership. For a definite period, the risk and return associated with the cash flows generated from the assets belong to the *sukuk* holder. The characteristics of the *sukuk* are similar to a conventional bond with the difference being that they are asset-backed.

It is worth mentioning that the Islamic *sukuk* has been developed at an accelerated pace and over the past five years, are being used by both government and leading corporations to tap the local and regional markets for liquidity. It is also worth mentioning that this instrument is one of the most used and also the strongest Islamic banking instruments, mainly because it is dealt in a very similar way to normal bonds. Since a lot of wealthy Muslim families have been using this instrument, it has gained a very good name in the market.

On 20th July 2004, the Bahrain Monetary Agency (BMA) has launched its first Bahraini-dinar-dominated *ijara sukuk* (Islamic leasing bond) issue. Their BD40 million, fixed-rate issue will have the longest maturity period of 10 years. All commercial banks, national insurance companies, Islamic banking operation in the Kingdom of Bahrain are allowed to subscribe, including individual and institutional investors. The aim of this issue is to establish a yield curve benchmark for longer-term securities (Bahrain Monetary Agency, 2006).

APPENDIX H



Source: Central Bank of Bahrain (2008)

APPENDIX I

ISLAMIC BANKING SUSTAINABLE GROWTH, BAHRAIN AS AN EXAMPLE PRESENTATION OF FINDINGS

Responses of the 32 respondents in the questionnaires distributed and the personal interviews conducted for Islamic banking sustainable growth, Bahrain as an example, together with the factors for such growth and the challenges facing Islamic banking as well as the future prospects of the industry in Bahrain, have been collected and categorized.

The responses of the 32 respondents are referred to as superscripts ^{1, 2...} up to ³² in this part of the study for easy referencing.

A. Islamic Banking Growth Factors in the Kingdom of Bahrain

The Kingdom of Bahrain evidenced growth in Islamic banking over years which considered it as a financial centre for Islamic banking in the region by all respondents. This was clearly demonstrated by the following factors:

- 1. Regulatory Support:** The Islamic banking industry in the Kingdom of Bahrain is well supported by regulations of the Government of Bahrain and Central Bank of Bahrain which is considered as one of the main factors that donated its growth^{2,10,12,13,14,15,17,18,21,22,23,24,26,27,28,29,30,31 &32}. Meanwhile, the Government of

Bahrain is supportive of the new business model² and has made considerable efforts to raise it to advanced level^{11 & 12}. Another respondent is of the opinion that Bahrain being a financial centre for conventional banking supported by good experience; facilitated its position to become another centre for Islamic banking^{14&16}. Also, it is a result of low cost factor in setting up business opportunities in Bahrain¹⁵. Meanwhile, Bahrain has been a pioneer in this industry while Central Bank of Bahrain as a regulator has been very supportive as well as having the reputation as a strong and transparent regulator²¹. Thus, international and regional banks have been encouraged to show interest to establish Islamic banks and Islamic windows in the Kingdom of Bahrain due to the fact that it has good supportive regulations and legislations for Islamic banking over years^{21, 22, 23,24,25,26, 27, 28, 29&30}.

2. **Increased Awareness:** Many respondents believed that increased awareness among the public has contributed to the growth of Islamic banks in the Kingdom of Bahrain^{1, 3, 4, 5, 11, 13, 21, 22, 23, 24, 25, 26, 27&28}. Meanwhile, many Muslims have become more conscious of doing banking for religious reasons which have increased the awareness as well^{6, 7, 9, 10, 15, 17, 19&20}. In addition, other respondents referred increased awareness to increasing numbers, visibility and marketing campaigns of Islamic banks and promotion of Islamic banking by agencies such as Central Bank of Bahrain and Economic Development Board (EDB) in the Kingdom of Bahrain²¹. Also, Internet and media played a role in increasing the awareness of the people in Bahrain to deal with Islamic banks^{21, 27 & 30} as well as international conferences of Islamic banking held in the kingdom, was an added

value to its growth^{23, 27, 28 &29}. Nevertheless, awareness for Islamic banks has increased because of the phenomenal success enjoyed by almost all institutions within this sector during recent years^{22, 23, 25, 26, 27 &31}.

3. Availability of Local Expertise: This factor has supported greatly the success of Islamic banks in the Kingdom of Bahrain^{1, 2, 3, 9, 15, 28&29}. Meanwhile, the Bahraini skilled bankers are representing almost 70% of the banking workforce in the financial sector in Kingdom of Bahrain²⁷ which with no doubt has contributed to this growth of Islamic banking. These workforces are well educated^{16&22} and well trained^{18&21}. Many Bahrainis had the opportunity to be Chief Executive Officers of many Islamic banks³²; in fact all Islamic commercial banks are headed by Bahrainis^{26, 29&32}. Nevertheless, Bahrainis within the Islamic banking sector succeeded to hold many other senior positions such as Assistant General Managers, Heads of Corporate Banking, Heads of Credit & Risk Management and Directors of Financial Control^{27 &29}. Meanwhile, Bahrain had other expertise in banking field which supported its position^{20&26}.

4. Economic Growth: The boom in economies in the Gulf region being experienced during recent years; had its role in the growth of Islamic banking in the Kingdom of Bahrain^{2, 8, 10,11&21}. Excess liquidity generated from the increased prices of oil exports had supported the growth of Islamic banks^{13,15,18, 21, 27 & 32} as these funds were available for investment and needs to be employed to generate more profits for investors^{14,19 &24}. Meanwhile, the economy of the Kingdom of Bahrain is stable and developing over years, which enabled the

Islamic banking sector to grow and as such contributed to its success^{2 &22}. In addition, economic stability has encouraged international banks who are tracing new business opportunities; to open branches and Islamic windows in the Kingdom of Bahrain to benefit from the future trend in the banking industry^{4, 8, 23&31}.

5. Better Investment Returns: Innovation and product development by Islamic banks have encouraged many customers to deal with them^{4, 9, 14, & 25}. However, only recently Islamic banks were able to develop their own products and services^{5, 10 &12} as they were copying conventional banks products and services and amending them to be in accordance with *sharia'a*^{6,9 &22}. On the other hand, product innovation especially in the investment side has enabled Islamic banks to have a competitive edge over conventional banks by providing better returns to investors^{1, 6, 7, 8, 12, 14, 21&31} and they have been able to diversify such investments to mitigate associated risks in order to generate higher yields to investors^{2, 25 &26}.

6. Other factors: The growth of Islamic banks in the Kingdom of Bahrain has been associated with other factors than those explained above. The availability of supporting organizations in the Kingdom of Bahrain has facilitated the emergence of Bahrain as a financial centre for Islamic banking backed by it being a financial centre for conventional banking in the Gulf region^{1, 2, 10, 21& 23}. In addition, the state of art telecommunication services infrastructure available in the country has played a role in the growth of Islamic banks^{7, 11&30}. Besides,

social life and working environment for expatriate has been another feature to develop Islamic banking in the kingdom of Bahrain as many expatriate professionals have been working for Islamic banks over many years with comfortable corporate and social cultures^{10, 15 &24}.

B. Challenges of Growth for Islamic Banks in the Kingdom of Bahrain

The main challenges facing Islamic banks in the Kingdom of Bahrain and the reasons for these challenges are as follows:

- 1. Lack of Human Resources:** This is one of the most significant challenges facing Islamic banking nowadays. Some respondents are of the feeling that attracting , recruiting and retaining high caliber employees who are qualified and trained in both finance and *sharia'a* is not an easy task for Islamic banks^{2,3,6,10,21,23,24,27,28,29,30&31}. They believe that Islamic banking is growing at a higher pace than development of individuals working within the industry^{23, 24 &29}. However, others are against this idea as they claim that Islamic banking is maintaining good quality of employees that are able to provide efficient services and capable of delivering results^{5, 8,14,22,25 &32}. Furthermore, Islamic banks are recruiting expatriate employees who are not familiar with *sharia'a*, although they are professionals, which can complicate issues especially with customers of these Islamic banks⁵. Nevertheless, currently most Islamic banks are hiring employees and professionals from conventional banks who maintain high standards of performance and familiarize them with the *sharia'a* requirements in order to provide them the basis of Islamic banking^{3, 10, 21&22}.

In addition, Islamic banks are members of the Bahrain Institute of Banking and Finance (BIBF) which include Islamic Studies section, to provide proper training for their staff members³ & ²². Apart from that, BIBF has launched Islamic Banking Diploma Program to qualify those working for Islamic banks to have such professional qualification^{3&26}. Meanwhile, Islamic banks in the Kingdom of Bahrain in coordination with the Central Bank of Bahrain; have established a training fund called *Al Waqf Fund* to support qualifying individual's career development such as *sharia'a* auditors and risk management professionals²⁷.

2. ***Sharia'a* Issues:** Over years, Islamic banks had this challenge which could not be solved till date. The limited number of *sharia'a* scholars in the Kingdom of Bahrain forced Islamic banks to have small number of scholars in their *sharia'a* boards, compared to other Islamic banks in the region and usually are having busy schedules^{2, 5, 16, 21, 23 & 27}. Usually, those who study *sharia'a* may not be able to understand the business environment which represents another shortage in the market^{6&26}. Meanwhile, *sharia'a* scholars having economic or business backgrounds are difficult to be found which puts another burden on Islamic banks^{22, 24, 26 & 29}. However, some *sharia'a* scholars are studying business in order to enrich their background to mitigate any shortfalls they have²⁸. Nevertheless, some Islamic banks have started to hire internal *sharia'a* auditors to overcome such shortages so that they can run their daily work^{25, 30 & 31}.

Also, Islamic banks were dependent on scholars to develop products and services that were initially one of their tasks^{5&21}, yet those scholars have no time to participate in this process and they prefer to be provided with a ready presentation of products to verify its compliance with *sharia'a*. They will modify them to be religiously accepted^{1, 24&31}. On the other hand, disputes among *sharia'a* scholars themselves are another issue as they follow different *sharia'a* schools within the Islamic religion^{5, 24 &26}. One respondent stated that Islamic banks might lose creditability due to these disagreements which will affect their future business opportunities²⁵. Yet, some believe that such disagreements among scholars are in favor of the industry; as customers can have different available choices to conduct their transactions with different banks^{27 &28}.

- 3. Competition by Local and International Banks:** It is another challenge for Islamic banks in the Kingdom of Bahrain. They are facing competition from different sources. They have internal and external competition^{22&23}. Internal competition is from local conventional banks who are trying to provide products and services of the same nature of Islamic banks^{4, 8&25} as well as Islamic windows to attract those customers who are willing to have Islamic products and services for religious purposes^{1,6,12,24,27&29}.

Meanwhile, those conventional banks considered large; started to have Islamic branches in the Kingdom of Bahrain to offer such products and services^{7,10,13&28} for example HSBC Amanah Bank and Citi Islamic Bank^{15 &32}. Another addition to these challenges is the globalization and liberalization of the world financial

system which will have an effect on Islamic banks. The Islamic banking industry is still considered small when compared to international banking as most Islamic banks capital are below \$100 million ²⁷, although there are only three Islamic banks having their capital over \$500 million. This supports the argument that Islamic banks are still not able to compete in international markets due to capital and assets size^{2, 21&30}. On the other hand, it is believed that Islamic banks are expanding in terms of capital and assets size where most have increased their capital base and as such assets size has increased as well during recent years, although not to the international level but it is an attempt towards it^{22&29}. Moreover, the market of the Kingdom of Bahrain being liberal for many years, allowed international and regional banks to have operations in the country and participated in the competition among banks, as such many are of the opinion that globalization, liberalization and World Trade will not have a significant impact on the competition within the Islamic banking sector in Bahrain^{1, 21, 27&28}. In addition, Bahrain is considered as a small market when compared to others, which will not be the focus of many international banks; they will approach bigger markets such as Saudi Arabia and United Arab Emirates^{2, 7, 14, 24&32}. On the contrary, they believe that these international policies will force Islamic banks to provide quality products and services. Nevertheless, others are of the opinion that Islamic banks will be affected by these policies and some banks might terminate their operations once competition is rigorous^{5 &30}.

4. Innovation and Product Development: Additional challenge for Islamic banks is innovation and product development. Islamic banks offer limited products and services contrary to conventional banks who offer many^{13&15}. Some are convinced that Islamic banks follow conventional banks and they copy what they offer; however they modify them to be *sharia* 'a compliant^{4, 7, 15&17}. Islamic banks are still offering limited products and they lack innovation^{5&20} which is an important factor for the success of financial institutions²². Initially, Islamic banks were dependent on scholars to provide products such as *Mudharaba*, *Murabaha* and others which were famous transactions during the old centuries and concentrated on these²⁵. However, currently development is relatively done and information technology has added to this process^{11, 18&32}. Another cause of limitation of product development is the interference of *sharia* 'a boards in all the transactions to conform them to the requirement of the religion^{2&9}. Expansion or development of new products can't be done without the approval of the *sharia* 'a board which lays another burden on product development by Islamic banks and it is a time consuming issue^{1, 13, 15&23}.

Moreover, Islamic banks were not able to develop new products for long time until recently when *Ijara* and *Istisna* were developed^{4&25}. Although the later is not widely used, the former has been extensively used for financing large transactions such as projects. *Ijara* has been developed to have many types such as *Ijara wa iqtina* and *Ijara muntahia bittamleek* as well as others²⁴. Meanwhile, there are many products offered by conventional banks that need to be developed for Islamic banks for example credit cards, although there are certain types in the

Islamic banking market, yet they are relatively inconvenient due to complications of its process⁴. Another example is *tawaruq* which simply means financing customers by providing them with cash. This process is still of disagreement among *sharia*'a scholars as some accept it while others do not. Islamic banks need to address such relatively small issues which prevent them from innovation and product development^{9, 22&24}.

A different element of innovation challenge is how to differentiate Islamic banks products and services from those of conventional banks and make them acceptable to the public⁷. Information technology is not efficiently used by Islamic banks for product innovation¹¹, yet recently some initiatives have been made to overcome this subject of concern. However, others are of the feeling that Islamic banks are offering alternatives to conventional products and services for those who are demanding *sharia*'a compliant products and services^{8, 12&26}. Similarly, others assert that Islamic banks are offering their own products and services and they do not copy conventional products and services^{9, 12, 14, 22, 23&31}. Islamic products and services are totally different from other conventional banking products for instance; capital guaranteed investments are not acceptable in Islamic banking as well as current accounts overdraft facilities^{19, 20&30}. On the other hand, some investment products offered currently by Islamic banks are not available in the conventional market such as restricted investment accounts and income generating investments backed by real assets^{13, 31&32}, which persuades that Islamic banks do not copy what is offered by conventional banks. Currently, many Islamic banks are innovating and developing their own products.

5. Customer Services Enhancement: A vital challenge for Islamic banks is the enhancement of customer services. They need to catch up with what conventional banks provide^{2&15}. Services offered by Islamic banks are not up to expectations and needs lot of improvement which resulted in bad reputation^{7&18}. Meanwhile, Islamic banks do not build long term relationships with customers especially retail customers^{13&27}. Alternatively they build long term relationships with sophisticated investment customers and willing to provide better services to them^{8&12}. However, others of the opinion that Islamic banks are improving in terms of customer services as they started to acquire those qualified personnel from conventional banks to defeat such a problem^{3&5}. Another issue is that proper training is not done for those employees in customer services, some of them are there to get their salaries only and they don't bother to provide good services nor they are there for religious purposes^{28 &32}. Various employees of Islamic banks are not to the standard of conventional banks employees and they lack such skills of providing excellent services to customers¹⁴.

However, others are against this argument and they believe that Islamic banks have developed over years and started to provide good customer services which have resulted in increasing the awareness among the public^{9, 12, 25 &29}. This case is supported by the debate that most of Islamic banking employees are recruited from conventional banks having experience and had good training^{1, 3&21}. Nevertheless, new Islamic banks in the Kingdom of Bahrain managed to recruit many skilled professionals to deliver results as well as to change people's

perceptions about Islamic banking^{3, 10, 21, 23&27}. Furthermore, with the global development of information technology; Islamic banks need to cater for the same and needs to incorporate these in their strategies and objectives in order to enhance customer services²⁸.

6. Unified Banking Code: A further challenge is the lack of unified banking policies among Islamic banks. Previously, several banks in the Kingdom of Bahrain have tried to unify the Islamic banking policies, yet they found it difficult to achieve^{1, 5 &21}. Islamic banking have been in presence for the last thirty years when compared to conventional banking with a history of more than three hundred years, makes it difficult for them to have a unified code². Moreover, Islamic banking is considered in the growth phase and needs more market experience to develop such a code while it has been significantly developing at a higher rate than expected^{9, 22, 23&26}. Another reason for the absence of a unified code is the disagreements among *sharia'a* scholars where a product is approved in certain boards while it is rejected in others due to different schools of *sharia'a*^{10, 13, 17&32}. However, some of the opinion that these disagreements are in favor of the banks and customers together as they will provide competitive advantages for the former and different alternatives to the later^{28&30}.

Because Islamic banks did not reach the sophistication level, non-uniformity of its operations has led to irregularities and unpredictability in Islamic banking as many transactions can not be accepted without referral to the *sharia'a* boards for

approval, to the contrary of conventional banks who can determine whether transactions are doable or not initially^{1,22&24}.

However, there are many activities that are agreed up on by Islamic banks yet it is interpreted differently. These are normal banking practices that would be daily transactions such as current and savings accounts. Meanwhile, the Central Bank of Bahrain is working on having at least a unified banking code for deposits and financing activities²⁷.

7. Risk Management and Corporate Governance: Islamic banks face similar risk issues as conventional banks, if not more^{2, 5&24}. Yet Islamic banks are exposed to higher risk - financial risk management - based on the *sharia*'a major principle of owning the assets prior to selling or leasing them to customers in case of *Musharakah, Murabaha or Ijara*^{22&26}. Moreover, in case of *Murabaha*; Islamic banks can not charge extra profit for default of repayment in case the customer becomes past due, unlike conventional banks which usually charges extra interest by number of days in case of any past due^{14&30}.

However, other respondents are of the opinion that Islamic banks transactions do not carry high level of risk as they are usually real transactions and based on real assets^{1, 8, 10&27}. It is well known that Islamic banks deal in tangible assets and contracts are always specific to certain transactions; to be conducted by the customer and the bank²⁸. These contracts are always transaction related and very specific to include all its details^{22, 25, 28, 29 &30}. Meanwhile, the presence of

sharia'a boards in Islamic banks furnish another risk mitigation as by reviewing each transaction, they filter the flow of transactions and prevent the bank from entering non *sharia'a* compliant transactions which provides another comfort for risk issues^{2,16,21,27, 30 &31}. Besides, Islamic banks have their own credit & risk departments who do risk assessments same as conventional banks and usually financing is done against collateral^{1, 2 &22}.

On the other hand, corporate governance within Islamic banks is believed to have the same issues of conventional banks. Their employees are as well, exposed to certain pressures and demands that might lead them to unethical behavior^{4&5}. Besides, Islamic banks need to address Basel II requirements which they are still not ready for; although the Central Bank of Bahrain is trying to find solutions to comply these with Islamic banks^{2, 21&27}. In deed, Islamic banks in general being relatively new are still in process of setting up the required infrastructure for risk management and corporate governance. Lack of academic research in this area is also a major hindrance for Islamic banks trying to develop practices that are different from conventional banks^{2&21}. Moreover, some Islamic banks need to widen their acceptance of corporate governance and accept the adoption of the concepts of delegation²². Furthermore, better risk management and corporate governance is mainly a product of: sound approval process in terms of business, risk and executive management; timely supervision and management of the transactions and accountability²³. Nevertheless, others are in conflict to this impression and they believe that Islamic banks are in better position than conventional counterparts due to the availability of *sharia'a* boards that impose

certain restrictions on the transactions being conducted by Islamic banks. They have the responsibility of reviewing the business transactions of Islamic banks to verify its compliance with the *sharia*'a^{5, 21, 26, 27, 28, 30 &31}. Islamic banks are doing their business on ethical standards as the *sharia*'a imposes; and usually their employees are aware of this substantial requirement during the course of their employment due to the uniqueness of Islamic banks^{3, 10, 28&29}. Meanwhile, Islamic banks need to develop their Information Technology systems - for customers and internally- to cater to the uniqueness of Islamic banking and to accommodate with the global developments and requirements; to overcome any future shortfalls in operational risks^{4, 11&30}.

8. Absence of Secondary Markets: It is another challenge for Islamic banks as without secondary markets; their assets are less liquid and not easy to sell in case of any crisis which constraints their ability to mobilize funds^{2, 5, 24&29}. The solution is in long term for the market to develop. The regulators and the government have to support this by launching initiatives and also trying to develop at least a regional market for these assets²¹. Meanwhile, secondary markets are lacking for a number of Islamic assets and products though this is largely due to a “buy and hold” strategy as well as the fact that the number of market participants has yet to reach critical mass²³. Islamic banks need to find solutions to this challenge as overtime they may face liquidity problems²⁷. Currently Islamic banks do not face liquidity shortage problems^{1, 2, 9, 13, 21, 23, 24, 26, 27, 31&32}; actually they have excess liquidity that needs to be employed to generate more income for the banks^{10, 16, 22, 29&30}.

C. Measures to Overcome these Challenges

To overcome these challenges of growth for Islamic banks in the Kingdom of Bahrain, the respondents have proposed the following:

- 1. Developing Human Resources:** Islamic banks need to consider this measure as vital and should include it within their objectives and strategies^{3, 17, 22&28}. They should take the initiative to increase the awareness among students in the community in order to encourage them to study *sharia'a* and Islamic banking in universities as well as preparing back ups for scholars who are limited²⁸. They should provide sponsorships to students to develop new era for Islamic banking with the benefit of current practices and growth of Islamic banking³⁰. This emerging industry is in need to have many qualified human resources to serve customers and to develop the industry further²⁷. As a result, Islamic banks in the Kingdom of Bahrain have established "*Al Waqf Fund*" to support the human resources requirement and to narrow the gap for this important growth factor by sponsoring individuals to study some specialty fields of Islamic banking^{10&24}. In addition, The Bahrain based; Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is one of the official bodies that is willing to standardize the accounting and auditing issues for Islamic banks, is playing a good role in this regard as it conducts many seminars and conferences to increase the awareness among stakeholders of the Islamic banking industry. Also, it provides many industry related courses to develop and assist Islamic banks to

improve the quality of their staff^{21, 28&30}. Moreover, Islamic banks in coordination with the Government of Bahrain need to increase the supporting learning centres other than Bahrain Institute for Banking and Finance (BIBF), to request universities to have Islamic banking as a major subject¹ as well as having a research centre for the same³⁰. Additionally, Islamic banks should allocate percentage of their yearly profits to support training and sponsorship programs^{3&30}.

2. Unified Set of Banking Policies: In order to mitigate this challenge, Islamic banks should realize its importance for their business. Following standard *sharia'a* rulings and setting up unified practices should be one of the main objectives of Islamic banks^{1, 2&22}. They should take the initiative to meet together to have a unified code of business. *Sharia'a* scholars need to meet regularly to standardize unresolved issues as the public is more concerned to deal with Islamic banks that have standard policies and regulations^{21, 23, 29&30}. Although *sharia'a* standards are difficult to standardize because scholars are following different *sharia'a* schools, however some conformity should exist to provide sort of unified policies²⁸. The AAOIFI and Central Bank of Bahrain are required to play better role in coordination with Islamic banks to have these issues solved and put standards for all aspects of Islamic banking, not only accounting and auditing standards^{5, 10, 26&31}.

3. Being Competitive: Although Islamic banking is there for the last thirty years, it is still considered in its early stage. It has not reached its ability to compete with

conventional banks especially international banks². Hence, to have a competitive advantage, Islamic banks should target new markets for their products through active marketing strategies such as participating in international transactions and geographical expansion^{1, 2, 21&24}. In addition, Islamic banks need to have Research and Development departments to do necessary assessments of the markets and innovating new products and services to be offered to customers in order to increase their market share^{4, 10&29}. Nevertheless, standardization of product specification is another factor to be competitive as well as benchmarking them to improve and Islamic banks should encourage *sharia'a* boards to be involved in product development and innovation^{7&18}. Additionally, Islamic banks need to meet together frequently to overcome unresolved Islamic banking issues in order to have added value over conventional counterparts³⁰. Besides, development of strategic plans and objectives over short to medium terms should be an essential task for Executive Managements of Islamic banks²⁴. Furthermore, they should diversify their portfolios and customers base apart from real estate; to include granting facilities to support healthcare, education and manufacturing as well as infrastructure projects^{2, 28&29}.

4. **Customer Services Enhancement:** To gain higher market share and to increase their customer base, Islamic banks are required to improve their customer services as it is a fundamental factor for growth^{8, 9&25}. By hiring the skillful and competent employees who can provide better customer services, Islamic banks will gain good reputation in the market¹². Apart from attending Islamic banking conferences and forums, regular on job and workshops trainings; are vital for the

development of staff and to increase their professionalism as well as their knowledge¹⁰. Meanwhile, Islamic banks should encourage the programs and seminars that educate and expand the awareness of people for Islamic banking by participating and sponsoring such programs which will in turn increase their customer base as well as better understanding of Islamic banks products and services by the public^{15,17,19,28&32}.

5. Information Technology Development: Islamic banks should develop their own systems since tailor made systems are rare in the market¹¹. Information technology companies just take conventional banks system and they modify them to suit Islamic banks although many deficiencies are there²⁰. It should be one of the main concerns for the management of Islamic banks and they need to use state of art technology to sustain growth by providing best information technology solutions to customers^{6&23}. By consistently updating their systems, Islamic banks will progress in this field and will have added value over conventional counterparts; ultimately contributing to the sustainable growth of Islamic banking^{11, 24&31}.

6. Be large Enough: Globalization will no doubt have an effect on Islamic banking. With its current growth rate; it will provide a fruitful opportunity for international banks to enter this emerging industry, taking into consideration that Islamic banks are still considered small when compared to those international banks²¹. As such, Islamic banks should strengthen their resources to grow in size²³. Over time, mergers and acquisitions will certainly be one of Islamic banks

main alternatives in order to survive in the global market. Alternatively, they will opt to increase their capital which might be available nowadays due to increased wealth as a result of cash flows generated from oil exports^{27, 28&30}. Moreover, Islamic banks are required to take the lead to initiate large transactions especially those Islamic related transactions; as they are currently done by international banks with Islamic windows or branches^{2, 22&29}.

- 7. Managing Risks:** Islamic banks are concerned with risks associated with transactions being in default by obligors. They should resolve this issue by imposing penalties to defaulters and it should be incorporated in the lawful agreements between the bank and the customer². Meanwhile, *sharia'a* boards should recognize that having defaulted accounts affects the bank in different ways such as making provision for doubtful debts as well as grading of its financing portfolio¹. However, some *sharia'a* boards have found a way to deal with this issue by incorporating the default clause in the financing agreement with a penalty to be paid by the obligor to the banks but the bank must pay it later to charities. It should not be part of the bank's profits^{22&24}. Furthermore, scholars should be aware that they are there to help Islamic banks to grow and expand, which ultimately requires them to provide support to these banks^{1, 21&31}. Moreover, Islamic banks in coordination with their *sharia'a* boards should find ways to reduce the risk associated with financing transactions where the bank should own the asset and then sell or lease it to the customer. They can do so by imposing a clause in the financing agreements that the customer is forced to buy the asset from the bank, although some scholars may not agree^{5, 8&32}.

8. Developing Secondary Markets: Islamic banks are in their early development and it will require sometime for them to develop secondary markets. However, they should develop secondary markets which are helpful tools for liquidity problems^{2&21}. *Sukuk* (Islamic bonds) is the only tradable instruments at the present time, though it has limited secondary market. Consequently, Liquidity Management Centre in the Kingdom of Bahrain is extending good efforts in this regard to effectively trade these instruments and to provide secondary market option^{22, 23 &26}.

On the other hand, Islamic banking needs more transparency as information is not available in the market which would be considered as a good base to establish such markets^{6, 13&30}. Specialized agencies do not have such information and they need to gather information by themselves in order to provide some statistics. For example, there is no accurate figure on the size of Islamic banking industry in the world, yet mostly are estimates^{24&31}.

D. Future Prospects of Islamic Banking in the Kingdom of Bahrain

Banking industry is currently playing a crucial role in the economy of the Kingdom of Bahrain and eventually Islamic banking is part of it. It has contributed to the growth of the economy which has increased its Gross Domestic Product (GDP). Banking is considered as one of largest source of income for the Kingdom after the oil industry^{21&27}. Meanwhile, Islamic banks have provided customers with different

investment alternatives yielding higher returns which have increased their customer base. Also, Islamic banks have led the major financial projects in the Kingdom of Bahrain such as the Bahrain Financial Harbour and World Trade Centre apart from other major tourism projects^{1, 9, 10, 14, 18, 22, 26, 27&28}. They have established new business opportunities in the economy for both retail and corporations². Moreover, Islamic banks have contributed much to the welfare of the society by offering better job opportunities to the Bahrainis and by donations made to the social activities as well as sponsoring some society functions^{20&23}. In addition, Islamic banks have increased the awareness of the public for the Islamic religion to the effect that it is part of their welfare and business life²⁸. However, Islamic banks are considered as a reason for the real estate boom in Bahrain which negatively affected the lower income population in the country^{5&32}.

Furthermore, Islamic banking in the Kingdom of Bahrain has been another success story by the support of the Government of Bahrain and the Central Bank of Bahrain through providing necessary legislations and regulations which has facilitated Bahrain's role to be the hub of Islamic banking in the Gulf region^{26, 27&30}. It substantiated the reputation of the financial system in the Kingdom of Bahrain, thus attracting many international banks to have their Islamic branches in the country^{21&22}. The growth of Islamic banking in the Kingdom of Bahrain will continue to increase and surplus liquidity available in the region will no doubt contribute to this effect^{1&21}. Meanwhile, most economic sectors will benefit from this growth as it is the case during recent years^{22, 28&31}.

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