Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK

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Executive Summary

This study investigates the main problems, challenges, and opportunities facing Islamic banking in the United Kingdom. The study reports the results of interviews that were undertaken with senior officials of several key financial institutions who have had many years of experience in dealing with Islamic banking. Our interviews revealed that, although by strict definition Islamic banks do not currently exist in the UK, London is one of the major centers for Islamic banking and finance. It is apparent that the experience of previously established Islamic institutions, such as Al-Baraka, has made other institutions realize that it is possible to provide Islamic banking services in the UK under nonbanking regulations. The interviews also revealed that the main problem that Islamic banking faces in the UK is heterogeneous clients and potential clients. Moreover, regulatory hurdles, competition from conventional banks, and lack of adequately qualified and trained personnel exacerbate the situation. The study concludes by identifying opportunities such as e-banking that may have a significant impact on the future of Islamic banking in the UK. © 2004 Wiley Periodicals, Inc.

INTRODUCTION

Unlike conventional commercial banks, Islamic banks undertake their operations without paying or receiving interest. The idea of Islamic banking was first developed in the 1950s and resulted in the creation of the first generation of Islamic investment banks in Malaysia and Egypt in the early 1960s. In 1974, Dubai Islamic Bank was established as the first private interest-free bank. Since then, the idea of

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Islamic banking has become widespread. According to Kahf (1999), the number of Islamic banks around the globe now exceeds 100.

Moreover, current changes in the world economy, the revolution in information technology, and globalization, resulting in dramatic changes in world trade, placed pressure on businesses in general and banks in particular and forced them to alter their strategies to respond to these developments. More recently, the World Trade Organization (WTO) encouraged countries that signed the agreement to open up their economies to all investors. The WTO agreement has widespread implications for the banking industry. Consequently, under the WTO agreement, Islamic banks will find themselves in direct competition with the internationally well-established conventional banks, especially since many conventional banks have realized that Islamic banking provides opportunities to tap into new markets. Hence, it is not surprising to see a number of conventional banks such as Barclays, Citibank, HSBC, and ANZ offering Islamic services.

The WTO agreement has widespread implications for the banking industry.

This study, however, is based on the UK experience, since London is one of the main centers of Islamic banking. Although the United Kingdom has around 2 million Muslims living permanently on its soil, it is a place where wealthy Middle Eastern individuals prefer to invest their money. In addition, British cities have, over time, hosted thousands of Arab as well as Muslim students. Hence, one expects to see an Islamic bank that responds to the demand of these Arabs and Muslims residing in the United Kingdom. During the 1980s and up to the early 1990s, Al-Baraka Bank was the only bank adopting Islamic Shariah principles and was regulated under the Financial Services legislation. Due to a number of challenges, however, in 1993 the bank gave up its banking license and moved to investment banking. Since the bank's closure, no major attempt has been made to investigate the general difficulties confronting the Islamic banking system in the West. Thus, this study seeks to evaluate the intensity and the nature of the threats and obstacles that lie between Islamic banking and its ultimate success in the UK. The outcome of such a study is expected to assist the authorities in the West, as well as Muslim investors who may be contemplating entering the Western market by establishing Islamic banks, in formulating their decisions. The remainder of the study proceeds as follows: The second section summarizes the theoretical problems and challenges facing Islamic banking in the West. The study's methodology is discussed in the third section. The empirical evidence on the problems and challenges facing the Islamic banking system in the West is reported in the fourth section, and the conclusion is presented in the final section.

THEORETICAL PROBLEMS AND CHALLENGES

Although the idea of Islamic banking is still young, the last decade has witnessed a slowdown in the number of Islamic banks in the world in general and in the West in particular. This reality was confirmed by Ali (1981) who stated that the largest number of Islamic banks was established either in the late 1970s or in the early 1980s. Similarly, Wilson (1999) indicated that Islamic banking reached maturity only after 20 years of operations.

In general, attitude is the main problem facing the development of the Islamic banking system in the West.

Before addressing the possible reasons behind the decline in the popularity of the Islamic banking system, it is important to highlight that Islamic banks generally operate within three different types of environment: (1) those that function in countries adopting Islamic Shariah principles (e.g., Iran, Pakistan, and Sudan); (2) those that function in predominantly Muslim countries along with conventional banks (Arab and Muslim countries); (3) those that function in predominantly non-Muslim countries along with conventional banks (Western countries). In this study, the focus will be on the problems and challenges facing the Islamic banking system in the third environment.

In general, attitude is the main problem facing the development of the Islamic banking system in the West. In this context, Dixon (1992) quoted Saleh as saying "the west has failed to adopt a positive attitude towards the needs of Islamic banks." Conceptual problems of Islamic banks also pose obstacles to the Islamic banks' development in the West. In particular, the Islamic banking system faces the following problems in the Western environment.

Lack of Standardization

Interpretations of Islamic Shariah principles are left to Muslim scholars. Hence, different schools of thought have emerged in different cultures and Islamic societies. For example, there is no agreement among different schools of thought on whether *riba* and *interest* are synonymous terms. The fact that Muslim scholars disagree on such a basic issue highlights the lack of standardization of opinion in the field (El-Gamal, 1997). As a result, each Islamic bank appoints an Islamic Shariah Committee whose remit it is to assess whether its bank transactions and activities are in accordance with the Islamic Shariah. Shepherd (1996) argues that lack of standardization between these committees results in diverse interpretations and evaluations. In the opinion of Iqbal and Mirakhor (1999), lack of standardization is not only time-consuming and costly, but it also leads to confusion about what Islamic banking really encompasses and, therefore, hinders its widespread acceptance. In this context, Ainley (1997) highlighted that the biggest problem of the Islamic banking system is that people are not clear about what Islamic banking constitutes. In Ainley's view, the confusion about Islamic banking is caused by the Islamic Shariah Committees' various interpretations of what is and is not Islamic banking. This lack of standardization and clarity also makes it difficult for Western regulators to understand the idea of Islamic banking. Consequently, regulators tend to be restrictive in granting licenses for Islamic banks. Thus, standardization is expected to clarify the functions of Islamic banking and may assist in clearing the way for more coherent regulation. It may also lead to better understanding and acceptance of Islamic banking as a serious competitor to the conventional banking system. Nevertheless, it should be pointed out that because many Shariah Committees have overlapping membership, this does bring about some level of standardization. Also, the rulings of the Fiqh Academy are widely accepted.

One of the major problems facing the development of Islamic banks is the current legal structure.

On the other hand, Al-Omar and Abdel-Haq (1996) argue that the idea of Islamic banking is still relatively young, and new circumstances and issues are likely to occur that will result in further clarification. This should not be used as an excuse for the lack of standardization but it does help in understanding why standardization on particular issues does not exist. As Islamic banking further evolves, it is expected to experience an increase in the standardization of its concepts and practices.[1]

Regulation and Legislation

The long history of the conventional banking system resulted in effective regulatory and supervisory bodies. Since the Islamic banking system has only recently emerged, regulatory and supervisory techniques have not yet been developed to accommodate Islamic banks. One of the major problems facing the development of Islamic banks is the current legal structure. Lack of understanding, coupled with lack of regulation, caused tension between Islamic banks and regulators, which in turn affects the regulators' willingness to support such organizations. Regulators in Western societies are reluctant to grant a banking license to institutions that cannot guarantee customers' deposits. In this regard, Carlson (1986) indicated that the regulatory bodies in the UK tend to hold very strict policies on their banking practices. They stand firm on their definition of a bank as an institution that can guarantee deposits and provide a declared return on them. Temple (1992)

1. It is important to highlight the efforts of the Bahraini-established Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Information on the role of the AAOIFI is discussed in the "Accounting Practices" section of the article.

believes that the inability of Islamic banks to guarantee deposits or returns makes it difficult for the Bank of England to consider them as banks. Yet, Ingram (1986) questions the certainty of deposits in conventional banks, contending that any bank is subject to default.

Wilson (1999) showed that Al-Baraka was the only Islamic bank to operate in the UK as a full deposit-taking institution during the 1980s. Al-Baraka, however, no longer operates as a licensed deposit-taking institution in the UK, since pressure from the regulatory body forced it to surrender its license in 1993. Thus, no Islamic institution with a banking license resides in the UK due to the country's regulation and legislation. There are, however, a number of Islamic financial institutions registered as investment companies, as well as conventional banks that offer Islamic financing facilities.

Like other established laws in the West, the tax system developed far before the upsurge of Islamic banking as a practice.

Capital and Liquidity Requirements

Another issue related to regulation and supervision of Islamic banks is that of capital and liquidity requirements. The Basle Committee's minimum capital requirement is another strict regulatory hurdle that must be resolved if Islamic banking is to prosper. While identifying capital requirements, the Basle Committee overestimates the risk to Islamic banks' assets. Ainley (1997), however, provided an explanation for this by indicating that assets of an Islamic bank are more risky than those of conventional banks. This is because conventional banks maintain a large portion of their assets in fixed interest–bearing deposits that are relatively easy to value. In return, the value of an Islamic bank's assets, invested in long-term projects and ventures, is difficult to assess. Moreover, the Islamic bank cannot use the central bank as a safety net and take advantage of its services as a lender of last resort because of the interest that must be paid on the loan during repayment. Thus, the Islamic bank is viewed by Western regulators as maintaining a higher liquidity requirement with riskier assets than that of the conventional banks.

Tax Discrimination

Like other established laws in the West, the tax system developed far before the upsurge of Islamic banking as a practice. Carlson (1986) pointed to the difficulty that Western regulators will face when taxing an Islamic bank. Most of the tax systems that prevail seem to favor conventional banks to Islamic ones, through allowing interest to be tax-deductible, whereas profit, which is an alternative to interest under the Islamic banking system, is not tax-deductible (Temple, 1992). Most Islamic banks and financial institutions resent this extra burden and call for just regulation for both systems.

Financial Instruments

In theory, the main instruments employed by Islamic banks are those that are encompassed in the profit and loss sharing (PLS) techniques; namely, Mudaraba and Musharaka. In practice, however, the use of these instruments is very limited. Kahf (1999) used the information published by the Directory of Islamic Banks to illustrate that, in practice, less than 20 percent of Islamic financing is carried out through PLS. However, we contend that this could be entirely due to the various problems associated with implementing PLS techniques. For instance, one of the biggest problems with the PLS technique is that it is long-term in nature and has a higher degree of uncertainty. According to Abdul Gafoor (1995), this requires the banks to be continuously involved in rigorous analyses, evaluations, and assessment procedures in order to determine the risk and returns involved in a given long-term investment. Furthermore, the longer the duration of an investment, the longer it takes to recover the principal and profit/loss. Hence, depositors will not be repaid for a long period of time. Thus, Islamic banks will certainly be at a disadvantage to conventional banks, which can provide returns to depositors at shorter intervals.

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Another problem associated with the financial instruments of Islamic banks is the lack of short-term instruments to meet short-term capital needs and immediate liquidity concerns (Nienhaus, 1986). The provision of short-term capital is an integral part of a conventional bank's operations. Providing this service under an interest-free regime, however, poses certain problems. These problems can be attributed to the application of PLS on short-term loans, which effectively means that risks and returns must be calculated for short periods of time. The classification of a short-term loan is typically from one day to a year. Uzair (1980) suggested that these loans should be given as interest-free loans. This, however, cannot be considered as an acceptable solution, since the Islamic bank is set out to be a business rather than a charity. Parker (1993) attributed this problem to lack of concern for research and development by Islamic financial institutions.

Accounting Practices

The accounting policies adopted by Islamic banks present another technical problem. Abdel-Magid (1981) indicated that International Accounting Standards (IASs) were set to reflect national differences and, therefore, were inapplicable to a large number of countries. Islamic banks are based on a different set of objectives, beliefs, and assumptions from conventional institutions. These assumptions lead to different types of transactions such as Zakat funds, PLS sharing accounts, and so forth, all of which must be accounted for in the books. In the light of Abdel-Magid's statement, empirical evidence on Islamic banks' financial reporting practices, it is plausible that IASs are unable to sufficiently reflect all transactions of Islamic banking in an acceptable manner. Consequently, it is reasonable to suggest that Islamic banking must develop its own intricate and detailed accounting standards.[2] Nevertheless, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is making much-needed progress in both developing and promoting financial reporting and auditing standards that specifically aim to enhance standardization across Islamic financial institutions worldwide. However, it would seem that the AAOIFI has, at present, insufficient legal backing and compliance to enforce its standards, since they are entirely voluntary (Ismail & Abdul Latiff, 2001).

Risk management is one of the most important activities of any bank.

Liquidity and Risk Management

According to Mudawi (1986), no money market for Islamic funds exists, and there is no interbank where the Islamic bank can place their funds overnight or obtain loans for short-term liquidity needs. The lack of liquidity instruments is one of the primary difficulties that Islamic financial institutions have faced. Without access to liquidity instruments, Islamic banks and financial institutions will continue to have liquidity shortages. This problem is exacerbated by the lack of support from central banks as a lender of last resort. It is obvious that without the support of the respective central banks, further development will be extremely difficult. In this respect, Dudley (1997) showed that the lack of capital markets and marketable instruments moved a significant proportion of the Middle East wealth abroad or kept part of the wealth invested in the property sector. On the other hand, some attempts have been made by the Malaysian central bank to set up an Islamic interbank and capital market systems.

Risk management is one of the most important activities of any bank. Central banks, therefore, take measures to ensure that a bank's risk does not go beyond a certain level. Al-Omar and Abdel-Haq (1996) believe that both conventional and Islamic banks are subject to similar risks such as investment risk, currency risk, and so on. Islamic banks, however, are more vulnerable to investment risk, due to the longer-term nature of their transactions. Interest-rate risk plays an important part in a conventional bank but is nonexistent for Islamic

2. A committee was established in Bahrain in the early 1990s and given the responsibility of setting accounting standards for Islamic banks and financial institutions. The fact that the committee lacks the power to enforce the stated standards plays down the importance of the standards and questions the committee's existence.

banks. It can be said that risk management is a very developed area in the conventional banking system. Unfortunately, the same level of development has yet to be achieved by the Islamic banking system. Although there has been a realization of its importance and a move toward its enhancement in recent years, there is still much more to be achieved. Ainley (1997) stated that with the absence of interest and risk management tools, a risk manager in an Islamic institution has a much more challenging task.

…the lack of professional courses and training tailored for Islamic banking has resulted in a lack of qualified staff.

Staffing and Training

Most professional and training courses in banking tend to be geared toward conventional banking rather than Islamic banking. In reality, a limited number of institutions offer training for Islamic institutions. This is, however, not surprising, since the conventional banking system is the more established of the two systems. Hence, the lack of professional courses and training tailored for Islamic banking has resulted in a lack of qualified staff. Al-Omar and Abdel-Haq (1996) believe that the absence of the required trained staff has made Islamic banks resort to the next best alternative—recruiting staff from conventional banks. With the vastly different concepts of the two systems, it is not rare to see such staff having difficulty adjusting to the Islamic banking system. The lack of trained staff, in turn, brings about an array of problems that could be related to other problems discussed earlier. Iqbal (1997) indicated that the lack of trained staff partly contributed to the slow innovation of the Islamic banks' products and instruments. In addition, Kahf (1999) thinks that the lack of trained staff affects relations with central banks due to the inability to clarify and explain various issues to them.

Marketing Islamic Banking Products and Services

It would be plausible to suggest that most of the potential customers of Islamic banks either tend to be oblivious to Islamic banking or try to avoid it. This can perhaps be observed, not only in the non-Muslim markets, but also in the Muslim markets.[3] There are two main reasons for such reactions or attitudes. First, the idea of Islamic banking is relatively young and many are unaware of it. Second, most people (Muslims or non-Muslims) have been accustomed to the conventional banking system and are not prepared to take risks with their hard-earned income. In addition, people in the industrialized world are accustomed to dealing with highly experienced conventional

3. In an Islamic and conservative country like Qatar, the total assets of the Islamic banks for the year 2001–2002 accounted for only 14% of the total assets of all commercial banks. This gives a clear indication of the extent of Muslim involvement in Islamic banking.

banks that offer a wide array of financial instruments. It is, therefore, unlikely to see them making a move to Islamic banking unless it offers them something extra. Furthermore, Islamic banks are perceived by customers as "banks," and their expectations of Islamic banks are based on their experiences with conventional ones. Having mentioned that the Islamic banking system has a relatively short history and is a much less developed field, it is unfair to classify Islamic banks with conventional banks and expect the same thoroughness or variety in their products and services. Customers, therefore, need to be educated and made aware of the difference between the two banking systems. In this context, Ainley (1997) showed that different views and interpretations about Islamic banks tend to further complicate issues and confuse the public about the reality of the Islamic banking system in the first place.[4]

Islamic banks need to be heavily involved in marketing their products and services.

With the existence of the aforementioned problems in the marketplace, it is important for Islamic banks to educate people about what they offer. Islamic banks need to be heavily involved in marketing their products and services. Al-Omar and Abdel-Haq (1996) proposed that Islamic banks can emphasize the need for a more ethical system or try to attract customers on the basis of cost-effectiveness. Whatever the Islamic banks decide to compete on, the important issue is that they realize the importance of educating their customers.

Competition from Conventional Banks

Shepherd (1996) notes that as further developments and innovations occur in Islamic banking, large amounts will be moved from conventional banks to Islamic institutions. Hence, many of the key players in conventional banking markets, such as Citibank, ANZ, and HSBC, have begun to move into the field, providing Islamic banking through Islamic windows (Cunningham, 1994). This means that many players have come into the market, and the provision of Islamic banking is no longer restricted only to Islamic institutions. In this case, it can be argued that the competition in the Islamic banking field has been greatly increased. In this respect, Nienhaus (1986) believes that it will be difficult for relatively new banking institutions to compete with the well-established conventional banks. As more players enter the field, the bigger challenge will be for the Islamic banks to survive. The counterargument, however, is that the conventional banks' move-

4. In this respect, it is important to mention that Sunni Muslims follow different schools of thought. Also, variations exist in interpretation between Sunni and Shi'ites.

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

Organization	Individual	Respondent's Occupation
A	A1	Chief Executive
	A2	Deputy Chief Executive
	A3	Manager
B	B1	Managing Director
C	C1	Manager
D	D1	Executive

ment into Islamic banking is advantageous, since its wide-scale practice will make customers more aware and diminish any apprehension toward it (Al Omar & Abdel-Haq, 1996). Similarly, Kutty (1995) contended that the two systems have much to gain by working together and cooperating with each other.

DATA COLLECTION

To provide empirical evidence on the challenges and problems facing the Islamic banking system in the UK, it was important to obtain information from those directly involved in the field. We therefore decided to collect data by undertaking a series of focused interviews. In July 2000, our search revealed that 11 institutions were involved with Islamic banking services in the UK. Consequently, these institutions were contacted via e-mail requesting an interview. The use of the e-mail secured three interviews. A formal letter backed up with telephone requests followed this. Four of the 11 organizations agreed to participate in the study.[5] Ultimately six, in four organizations, out of those contacted participated in the study. The participants included chief executives, deputy executives, and senior management who have had many years of experience in the field. All of the participants were based in London and work either for Islamic banking units within Islamic financial institutions or for Islamic units within conventional banks. A summary of the respondents who agreed to be interviewed is given in Table 1.

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

5. For the purpose of anonymity, names of individuals and their respective organizations have not been revealed.

RESULTS AND ANALYSIS

Early Experience of Islamic Banking in the UK

As mentioned earlier, London is viewed as the financial capital of Europe and might therefore be expected to attract different types of financial disciplines. Islamic banking is no exception. Hence, several Islamic financial institutions have resided in the UK. For instance, during the 1980s and early 1990s, Al-Baraka managed to maintain its status as the only Islamic bank to operate under the UK Financial Services Act. London also attracted the attention of many Islamic banking units, as well as Islamic finance and trade institutions, regulated by the Financial Services Act (FAS) and Department of Trade and Industry (DTI). For example, Dallah Al-Baraka (Ltd.) UK is currently supervised by the UK DTI.

At the start, Al-Baraka was set up in the UK as a small finance institution.

At the start, Al-Baraka was set up in the UK as a small finance institution. During 1982, however, it took over a local institution called Hargrave Securities, a registered deposit-taking institution in the UK. It was this takeover that gave Al-Baraka the opportunity to function as a fully fledged bank under UK banking regulations. In 1983, the Bank of England, the supervisory body, found no problem with Al-Baraka and issued a banking license. Once the bank was formally established, its name was changed to International Bank Ltd, which functioned as a bank for eight years before problems began to emerge. It was the collapse of the Bank of Credit and Commerce International (BCCI) in 1991 that triggered problems between the International Bank and the Bank of England. According to the managing director of organization B, after the collapse of BCCI, "Al-Baraka and any bank from the Middle East became questionable in the UK." The British authorities scrutinized the system and found that Al-Baraka did not have a banking license in Saudi Arabia, which posed a question of how it could operate in the UK without support from its home country. Apparently, Al-Baraka was unable to answer this question. In order to save the bank, however, Al-Baraka offered possible solutions such as bringing in the Islamic Development Bank (IDB) as a partner, which, to Al-Baraka's dismay, was rejected. Consequently, in 1993, Al-Baraka surrendered its license, and now operates under the supervision of the DTI and engages in trade finance, investments, and structured finance. Respondent A2 found the outcome inevitable since, in his opinion, Al-Baraka was not involved in banking. He added:

> They were not really doing much banking. They were merely doing a lot of financing and deposit taking, but it was not

> banking; it was something else. Now they have a different kind of operation and they are perhaps more successful than when they were a bank. I think Al-Baraka has come to understand that for what they want to do here, a banking license is the wrong instrument. Why have that? Go for some finance house. It is like saying, I want to go fishing so I apply for a license to dig the street.

A number of Islamic financial institutions operate under the UK Financial Services Act (FSA) or other regulations.

In fact, respondent A1 made clear that the bank could not operate in the UK market unless it provides a "defined predetermined return called interest." As a consequence, it can be said that Islamic banks cannot exist under the UK definition of banking and cannot be regulated by the UK Banking Act. A number of Islamic financial institutions, however, operate under the UK Financial Services Act (FSA) or other regulations. These institutions are of two types. The first are purely Islamic institutions such as Dallah Al-Baraka, and the second are specialized Islamic units/windows provided by conventional banks offered by Citibank, HSBC, ANZ, and others. In this respect, respondent C1 revealed that "the largest Islamic wholesale market is found in London." Most of their transactions emanate in Muslim countries, predominantly from the Arabian Gulf, as indicated by all respondents.

The responses generated by our focused interviews indicate that the bank must provide a predetermined return (interest) under the UK banking regulations. Islamic banks cannot comply with such regulation. Instead, they can apply for other licenses under which the regulations would be more suited to their nature, so that problems with the authorities can be minimized.

Current Experience of Islamic Banking in the UK

The respondents were asked to comment on the current experience of Islamic banking in the UK. This is because the Al-Baraka experience may be considered unique, since it operated a pure Islamic bank under the UK Financial Services Act. Other established conventional banks, however, have also moved out of the Islamic banking market. A senior individual in organization B said that "Dresdner is gone, Goldman Sachs is gone, and I think there is one other that is gone too."

It is important to note, on the other hand, that many new players, such as the Arab Banking Corporation (ABC) and HSBC, have recently entered the field. The sheer movement of players in and out of the market indicates that the market faces numerous opportunities and threats.

Difficulties in Establishing Islamic Banks in the UK

The vast majority of the respondents who took part in the focused interviews suggested that there would be regulatory hurdles to overcome while trying to set up an Islamic bank in the UK. Respondent D1 believed that this is "because the Islamic bank would have to comply with regulations set up for conventional banks." Two of the respondents, however, confirmed that it is easier to set up a financial institution in the UK than anywhere else. According to a senior individual in organization A:

> One thing that London has got is a history of being capable of embarking on most types of financial disciplines. The chief of FSA said to me nine or ten months ago that the reason why we do not have an Islamic bank in this country is that nobody has put a proposal for one. There is no technical reason why there should not be an Islamic bank in this country as long as it fits in with the rules. So, I sense that, in a way, they want to tease out what the real problems are by having a real example. I sense that the regulators do have the desire to do something.

...all respondents acknowledged some form of operational difficulties related to tight regulation.

This view was also shared by a senior executive of organization B1 who stated:

> Authorities in the UK have never understood Islamic banking. So far as the UK law was concerned, we were never dealing with Islamic banking. As far as the UK law was concerned, we were doing banking.

On the other hand, when the issue of operating an Islamic bank in the UK was addressed, all respondents acknowledged some form of operational difficulties related to tight regulation. The managing director of organization B1 also highlighted these difficulties. He revealed:

> There were attempts by some local banks to get into the field in various forms, and they have all retreated because they have discovered that it is a very difficult market. United Bank of Kuwait tried to do some housing but the local laws do not support it in terms of stamp duties. If there were people who wanted to keep their money on a PLS basis, local laws do not allow this, because they say that as far as the law is concerned, if you have taken money from depositors you have to return it back to the principal. Suppose that you were very keen to take Islamic investment and your money is going to go out to finance a shop in the neighborhood. If the shop sustained losses, I cannot pass the loss to you because the law does not allow it.

Another problem facing a bank operating in the UK market is that a percentage of the bank's funds must be deposited with the Central

Bank in the form of treasury bonds earning interest. This requirement violates Islamic Shariah principles. The senior manager of organization C1 also referred to the tax issue as another problem that an Islamic bank would face when functioning in the UK market. The chief executive of organization A1, however, suggested the following solution to this problem:

…problems have arisen because the UK banking authorities were not aware of what Islamic banking involved.

> I talked to the Shariah advisors to one particular large Islamic bank. I said there is a tax issue and profit is the economic equivalent of interest but not interest. They took a very sensible view, which was, if it is not interest, why do we care what they call it? Let them call it interest; it is not interest.

However, this respondent agreed that while this was not an ideal solution, it was the best solution at the present moment.

When respondents were asked about the issue of liquidity requirements and capital adequacy ratio, respondent A1 argued that the UK banking authorities do not place Islamic banks at a disadvantageous position in comparison to conventional banks by requesting higher capital adequacy ratios. He added, "The issue at hand is that the authorities would be skeptical to start with, but they would do this with any new bank."

Overall, it would seem that problems have arisen because the UK banking authorities were not aware of what Islamic banking involved. The Islamic bank, however, does not have to be regulated under the Banking Act to carry out its activities. Also, it is obvious that the Islamic bank operating in the UK will be at a disadvantage compared to conventional ones when regulatory issues are concerned. These circumstances, however, come about not because the UK authorities do not want Islamic banking to prosper but because Islamic banking is trying to fit into a long-established system that has not been developed to accommodate it.

Support for Islamic Banking in the UK

When attention is turned specifically to support for Islamic banking in the UK, the respondents revealed that the UK government does not provide any form of support or encouragement, as indicated by the managing director of organization B1, who was rather scathing and commented:

> The Central Bank or the FSA periodically give their speeches, 'Yes, we are very supportive of Islamic banking and we would love to have it but we do not understand it and we need some more

> research.' I have been hearing this for more than ten years and I think I'll hear it for another twenty years.

Respondents C1 and D1 also made it clear that they do not believe that the UK government provided encouragement for Islamic banking and they did not wish to elaborate further. A completely different and positive view, however, was signalled by respondent A1, who strongly believes that the government did provide support. His response to the question of whether the government provides any support was:

> I think they do. They provide speakers at conferences, they do engage in debates, they are trying to understand more. People here are very conservative; they don't like change and they don't like new things. It takes them a while to understand what is going on.

There is no doubt that changes are taking place in the UK market but at a slow pace.

Respondent A1 supported his argument with the following statement:

> Ijara, Murabaha, and some Musharaka contracts have been recently approved as being banking instruments by the Federal Reserve. Therefore, changes are taking place.

Although what respondent B1 said might be correct, it can be looked at in a more optimistic perspective, as viewed by respondent A1. Respondent B1 himself had suggested that "the first thing that needs to be done is to propagate," and, according to respondent A1, his organization is engaged in debates and conferences, which could be a form of propagating. The chief executive of organization A also provided support to the government but he argued that the authorities have the responsibility to:

> Educate people in financial matters, to encourage providers of financial services to be more inclusive of different people with different needs. So, are they doing anything? Well, yes, in a general socially inclusive sense.

There is no doubt that changes are taking place in the UK market but at a slow pace. The senior individual in organization B believes that the achievement of the authorities over the last 20 years was very limited. In order to accelerate the process, pressure should come from the customers who demand such financial services.

Customers

All our respondents revealed that the vast majority of the customers of Islamic banking services present in the UK tend to be either institutional investors or high net worth individuals from the Gulf region. According to the majority of the respondents, the UK does not have a sufficient market for Islamic banking. Respondent B1 argued:

> From the one-and-a-half million Muslims you have here, most of them are very poor. There are very few that are rich, and the ones who are rich now have so many other choices and their banking needs are so much more complex. Unless you have an institution that is large enough to accommodate the needs it is not a viable option.

According to the majority of the respondents, the UK does not have a sufficient market for Islamic banking.

A further problem echoed was that the UK Muslim community was not concentrated in one place but scattered throughout the UK, resulting in an increase in distribution costs. It could also be suggested that the Muslim community is not in a unified position to demand Islamic banking. Respondent A1, however, stated:

> There is initially a big market of 1.6 or 1.7 million Muslims in UK and that's a big market. It can be said that half of them are not so desperately attractive customers, but they'll buy some services and also as their economic lot improves, they would be more economically active.

This might explain what respondent B1 meant when he revealed, "There is a difference between saying the words and doing the deeds." Most Muslims would be excited to see Islamic banking prosper, but when asked to deposit money into a PLS account, very few would be willing to take the risk.

Most respondents agree with B1's response that there is a "tremendous lack of understanding of what Islamic banking is." In addition, respondent D1 notes that "one of their bigger problems is to educate clients as to what Islamic finance is." A lack of awareness is also portrayed when customers tend to view Islamic banking as "dressing up" of interest. "In fact, this is totally erroneous; there are many different ways to make profit and interest is only one of them," states respondent A1. He also notes that it is not difficult to understand why a lot of people think this way, saying, "It is embedded in their beliefs." In contrast, respondent C1's response did not indicate any problem of a lack of customer base or awareness.

It can be said that the interest and the willingness of the community are a big issue. This has been acknowledged by almost all respondents and therefore can be addressed as one of the first issues that needs to be remedied if Islamic banking is to prosper in the UK. As noted in the previous section, the first step would be to make the community aware of the necessity and benefits of Islamic banking.

Conventional Banks

It would seem evident from the earlier discussion that the involvement of the conventional banks in Islamic banking activities would prove to be beneficial in the long run. All our interviewees strongly believed this to be the case. One of these, the chief executive of organization A1, commented:

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

…it can be argued that conventional banks may misuse Islamic banking to make profit for their institutions.

On the other hand, respondent A1 states:

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

In his assessment of the conventional banks offering Islamic banking services, respondent A1 commented:

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

Staffing and Training

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

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

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

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

Half of the respondents believe that there are problems related to customers and the Islamic community in the UK.

In terms of licensing Islamic banks, the respondent further argued:

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

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

Challenges Facing Islamic Banks

The respondents provided a variety of answers to the question about challenges facing Islamic banking. Each of the respondents seems to have his own concept of what the biggest problem is. Half of the respondents, however, believe that there are problems related to customers and the Islamic community in the UK. The managing director of organization B made clear that the "customers are not taking a risk with their money." The deputy chief executive of organization A thinks the biggest problem for Islamic banking is lack of awareness by the Muslim community. Respondent A1 also addresses the same issue and argues that the problem is not as much related to awareness or not wanting to take risks, but it is due to the *inertia* in the community. That is, in order to bring about change, the consumers need to take certain action. But there is no one to take the initiative. He stated:

> The inertia factor is something that has to be understood and identified, and can be overcome by proper branding and marketing, which takes some time. I am not just telling you this because I just thought about it. I spent a lot of money, running focus groups and surveying the market in the UK and the USA.

Respondent C1, on the other hand, indicates that technical issues relating to instruments are the main problem for them. An executive at organization D believes that the biggest problem for them is educating customers about Islamic banking and their products. Respondent A3, however, considered regulatory issues as the major threat. He added:

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

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

The answers to questions about developments and opportunities for the Islamic banks in the UK market ranged from completely negative to extremely positive.

DEVELOPMENTS AND OPPORTUNITIES FOR UK ISLAMIC BANKING

The answers to questions about developments and opportunities for the Islamic banks in the UK market ranged from completely negative to extremely positive. The managing director of organization B was the one with the most negative answer. He stated, "It is only a myth. The concept of Islamic banking here does not and will not exist." Other respondents were optimistic about the future of Islamic banking in the UK. In relation to the long-term future, respondent D1 commented:

> I will expect to see it very much in the retail side. Although regulations for retail banking are difficult, we will work on that.

Interestingly, two respondents strongly believed that the future of Islamic banking would be in electronic banking. Respondent A1 remarked:

> I think the biggest single change to the current Islamic banking status quo is going to be through technology, since statistics show that half of the Muslims in this country are under the age of 21.

The financial consumers of tomorrow are expected to be well equipped to deal with electronic banking. Expressing similar views to those of respondent A1, respondent A2 suggested that technology might also overcome the problems of costly distribution to Muslims concentrated in different areas. Respondent A3 indicated that there will be many improvements in the products offered and more options available to investors in the future. About the expected growth in the future, respondent A3 commented:

> Sometimes there is a little bit of a slow growth and then it becomes a little bit logarithmic and then suddenly the whole thing explodes. Within the space of five or ten years, it could really be something quite significant.

…it would be reasonable to suggest that the possibilities for Islamic banking in the retail commercial banking sector appear to be limited.

Taking into account the regulatory hurdles and the inertia factor of the Muslim community, it would be reasonable to suggest that the possibilities for Islamic banking in the retail commercial banking sector appear to be limited. Technology, however, seems to offer immense opportunities. Islamic bankers need to be aware of this and develop the necessary competencies to take advantage of such opportunities.

In the previous discussion, it was generally felt that Islamic banking had not been given the opportunity to prosper sufficiently because of a number of obstacles. Respondent A1 highlighted this when he said:

> These obstacles are not capable of easy technical explanations because you are dealing with some possible cultural and possibly historical obstacles, which don't have their basis in logic. They probably have their basis in misunderstanding.

With time, the aforementioned problems are expected to be solved and the options that technology brings about would provide increased opportunities for Islamic banking.

CONCLUSION AND RECOMMENDATIONS

The main purpose of this study is to provide empirical evidence on problems facing the Islamic banking in the West, with the UK being a case study. To serve this purpose, a number of specialists in Islamic banking and financial investments were interviewed in London and asked to identify challenges facing Islamic banking in the UK. The result of our focused interview effort revealed that Islamic banking faces numerous problems, which are probably the reasons behind the absence of any Islamic banks in the UK. The absence of Islamic banks is not only due to regulation, which does not accommodate Islamic banking, but also due to Islamic banking's failure to adapt to regulation. The UK banking regulations have been set to accommodate conventional banks long before the creation of Islamic banks. Hence, hasty changes in the UK banking regulations to accommodate Islamic banking might have detrimental effects on the functioning of other economic units. This is, therefore, an issue that needs more time and research. Islamic banking representatives and UK officials, however, need to sit together and openly discuss the matter to work out practical solutions. A possible solution within current circumstances, as highlighted in our findings, is to function effectively under different yet comprehensive regulations. It must be remembered that regulators do not make the rules; people's representatives make the rules. Unless the UK Islamic community stands united in demanding their rights for financial services, making an attempt to change regulations, things will remain the same.

It must be remembered that regulators do not make the rules; people's representatives make the rules.

Strangely, it would also appear that the Islamic community resident in the UK poses a major difficulty. It is evident that they suffer from a possible lack of customer base or awareness of Islamic banking. The results, however, pointed to a lack of unity within the Muslim community as the main problem in developing Islamic banking. A united community is necessary to bring about sufficient demand for Islamic financial services that comply with their beliefs. Moreover, the UK Islamic community should perhaps take action to change conditions.

However, the fact that conventional banks increasingly engage in Islamic banking activities must indicate a possible future market. This would also provide increased exposure for Islamic banking, promising a better future for it. By providing Islamic banking by means of conventional banks, a significant proportion of the non-Muslim population may also be made aware of Islamic banking and its virtues, which may lead to a larger market share in future years. On the other hand, some researchers claim that as conventional banks start offering Islamic banking services, the expansion and spread of Islamic banks may be hindered (Nienhaus, 1986). Our interviewees, however, opposed this school of thought. In all cases, it is fair to say that some conventional banks may enter the field of Islamic banking without fully understanding its principles. It may then give rise to situations where the practice of Islamic banking is merely disguising interest. This might discourage many customers who think Islamic banking is "dressing up" interest, and who thus avoid it completely.

Another problem facing Islamic banking in the UK is recruiting professional staff. Staff is expected to have not only the required technical expertise of banking, but also awareness of the basic principles and the ultimate goals of Islamic banking. It is, therefore, important for an organization to provide such knowledge and training to those who want to participate in Islamic banking.

The overall conclusion, therefore, is that Islamic banks do face major problems and challenges in the twenty-first century. The respondents who took part in the interviews provided overwhelming support and were definite about the challenges facing UK Islamic banks. However, they were far from clear about whether Islamic banking has any major opportunities. A diverse set of opportunities emerged from the focused interviews. Two (out of the six) respondents, however, believed that electronic banking and technology would have a positive impact on Islamic banking. In this respect, statistics in the UK show almost half of the UK Muslim population to be below the age of 21. This would suggest that the future customers of Islamic banking are more technologically adept than the older generation. The use of electronic Islamic banking can be extremely beneficial, since it would allow Islamic banking units to reach a widely dispersed Muslim population. Without making use of this technology, reaching scattered Muslim populations would be difficult due to the large distribution costs involved. Nevertheless, it would be useful to carry out a comprehensive survey to identify how technologically capable the Muslim community is before contemplating such a service.

It is, of course, accepted that this study does not provide conclusive evidence of the problems and challenges facing the Islamic banking system in the West, since the focused interviews were undertaken in only 4 out of the 11 institutions currently residing in London. Obviously, a more thorough analysis is needed that would incorporate the views of individuals working in all Islamic financial institutions in the UK. In the meantime, it is contended that the perceptions of the senior executives that are reported in this study highlight some major thoughts and concerns on the challenges that face Islamic banking in the UK.

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