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Islamic Finance Development in the Sultanate of Oman: Barriers and Recommendations

Hesham A. E. Magd^{a,*}, Mark P. McCoy^a

^a*University of Buraimi, Al Buraimi, Sultanate of Oman*

Abstract

This paper considers the key potential barriers that are likely to arise with the adoption of a dual financial system in the Sultanate of Oman. Despite the fact that Oman is a predominantly Muslim country, the assumption that this will equate to a significant uptake in Islamic products and services is challenged as factors such as brand recognition and insufficient product knowledge among the population may hinder market penetration. In addition the study provides some recommendations for the success of the Islamic finance development in Oman where financial institutions wishing to offer Shariah compliant services should also not neglect the importance of competing with conventional banks in terms of the quality of service offered in addition to the uniqueness of their products. The availability of a pool of indigenous labor with industry relevant knowledge shall be a vital factor in the sustainable growth and development of the sector in the Sultanate. Finally the paper concludes by highlighting the essential role of educational institutions in providing such a sustainable workforce for Islamic financial institutions through producing graduates with industry relevant knowledge and, in the more immediate term, the provision of training for conventional banking professionals that may make up the current shortfall of qualified labor.

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1. Introduction

The new Islamic banking sector that is to be introduced to the Sultanate of Oman will see newly established Islamic financial institutions competing directly with the more established conventional banks that have decided to enter the market by offering Shariah compliant products and services through what is known as

* Corresponding author: Tel: 00968-25-655-509; Fax: 00968-25-651-265
E-mail address: hmagd@uob.edu.om

a windows model. Early indications would suggest that the introduction of an Islamic financial system is indeed driven by demand with the local market expected to experience growth in line with global trends. With said there are a number of key issues that have the potential to inhibit, or at least slow, the potential growth of the industry in terms of market share that must be considered by any potential market participants which this paper seeks to consider in more detail. This paper shall begin by providing a brief background of the global Islamic finance market before examining the current environment in Oman including trends in the conventional financial sector and how the motivations behind the adoption of an Islamic financial system is likely to assist the Sultanate meet its long term strategic objectives of providing employment for the local population and reduce reliance on Oil revenues. Once a national and industry background has been provided, the authors shall highlight the key variables that are likely to impact the uptake of Shariah compliant products and services. The first factor to consider is the extent that religious motivation will influence customer behavior. It would be unwise to suggest that all Muslims will change their banking habits simply because the services are now available in the Sultanate. Despite the clear prohibition of Riba in the Noble Quran, the uptake of services is likely to be the result of a combination of factors rather than being purely down to individual levels of religious devotion. If this is accepted then it important to identify the secondary factors that may influence service uptake and in this case the authors believe that both quality of service and brand awareness will play key roles. While both these areas are applicable to CBs operating out of a windows model and dedicated IFIs alike, the extent of their impact should differ significantly which shall be discussed later in the paper. Finally the essential role of Higher Education institutions in the provision of future graduates and industry relevant training for existing participants shall be examined

2. The Islamic Finance Industry

The Islamic finance industry has come a long way in recent years. The industry potential was already being recognized in 1996 by Citi Group who branched out into the sector in the form of Citi Islamic in Bahrain. Since then the recent global financial crisis has prompted academic and industry participants alike to question the overall sustainability and ultimately the viability of the current conventional financial system (Hasan & Dridi, 2010). This has in part fuelled the recent increased interest in Islamic financial products and as a result has led to the expansion of the Islamic finance industry through the establishment of dedicated Islamic Financial Institutions (IFIs) and Conventional Banks (CBs) offering the service through a windows model. The Islamic financial industry has not been immune to the global economic downturn although the impact has been limited (Smolo & Mirakhor, 2010 and Alzalabani & Nair, 2013). It is true that the industry did manage to avoid the brunt of the financial crisis however there were periods when Islamic banks lost heavily due in part to defaults in real estate loans and to a number of sukuks defaulting with many investment companies being left shaken (Wigglesworth, 2011). It has been suggested that such defaults have damaged the reputation of the sukuk market in regions such as the Middle East where a number of high profile defaults have occurred (Majid et al, 2011). Despite this the industry has rallied and continued to grow to a significant size as illustrated below by the Financial Times writer Wigglesworth, 2011, where it was concluded that:

- Many experts are in agreement that the industry has over \$1,000 billion of assets
- The global value of Islamic bond sales reached \$15.3 billion through 60 deals by the end of August 2011
- This was up 52% on the \$10 billion raised over the same period last year

The conclusion reached by Wigglesworth, 2011 provides encouraging reading with regards to the current health and future growth opportunities in the industry and they are supported by a number of additional sources. The Organization of Islamic Cooperation (OIC) Countries in the Middle East represented 79% of the global Islamic finance assets in 2011. The GCC countries account for 40% of the \$1.1 trillion global Islamic finance industry with Islamic finance expanding at a compounded average growth rate (CAGR) of 26.4% since 2006 (see Figure 1) (OIC Outlook Series, 2012). Islamic finance remains concentrated in the Middle East, including Iran, with a share of 35.7% in total Islamic finance assets, Saudi Arabia with 13.9%, United Arab

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