MARKET SEGMENTATION AND THE SHARĪ‘AH COMPLIANCY PROCESS IN ISLAMIC BANKING INSTITUTIONS (IBIs)

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ABSTRACT

Sharī‘ah compliance is the unique feature of Islamic financial services (IFS) and is, therefore, a very critical process for Islamic financial institutions (IFIs). This study focuses on the compliancy process conducted in Islamic banking institutions (IBIs), as the sector is considered one of the most established IFIs. Sharī‘ah non-compliance is considered damaging to an Islamic bank’s reputation. But the main issue is whether or not consumers at large or a particular group of consumers consider Sharī‘ah compliance as critical in their purchase decision. Therefore, the main objective of this study is twofold: to explore the possible consumer segments from the managerial perspective, and to conduct a case study on the applicability of a proposed Sharī‘ah compliance framework. The analysis of interviews made with selected key market players reveals four consumer segments: Religious Conviction Group; Religious Conviction and Economic Rationality Group; Ethical Observance Group and Economic Rationality Group. Theoretically, the closest possible market segmentation basis for these groups are, values (psychographic segmentation), which also emphasises opinions and attitudes, activities and lifestyles, and benefits sought from products or product attributes. The study’s initial finding could serve as an aid to guide product/brand positioning strategies for IBIs when designing their marketing communication. The analysis of the case study conducted shows that proper Sharī‘ah governance was in place and that appropriate steps are being taken to ensure these mechanisms work as intended. In addition, the process was clearly elaborated and disclosed in the bank’s annual report. Although the detailed process is not explained, we may conclude that what is being practiced by the bank under study is in line with what we have proposed in our framework, thus validating the applicability of the proposed framework.

Keywords: Sharī‘ah-compliance process; market segmentation; Islamic banking institutions (IBIs); corporate governance; consumers.

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1. INTRODUCTION

The Islamic method of banking and financing has become a global phenomenon and has successfully developed into an established industry known as the Islamic financial services industry (IFSI). The industry has generated renewed interest among the players in the financial world amid the recent subprime crisis and the ensuing worldwide financial crisis. More importantly, IFSI has emerged as a viable alternative to the conventional interest-based financial services industry (CFSI) and has expanded rapidly over the last two decades, with diverse clientele in both Muslim and non-Muslim countries. It is attracting growing interest from global players who are playing increasingly major roles in this industry (Aslam, 2006).

The feature of Sharī‘ah compliance is unique to Islamic financial services (IFSs). Thus, it is very critical for Islamic financial institutions (IFIs) to have proper Sharī‘ah compliance procedures in place to ensure that all operations are, indeed, Sharī‘ah compliant. According to Naser and Mountinho (1997), the idea of Islamic banking and finance has grown out of an increasing desire to conduct financial activities in accordance with Sharī‘ah principles. Thus, ensuring the compliance of IFSs with the abovementioned guidelines is necessary for the services to be relevant for use by Muslims, particularly for devout Muslims, since the compliance of financial services with Sharī‘ah rules and principles is a primary concern for them in using these services (IDB et al., 2007). Islamic banking is the earliest and most established segment of the industry. The total assets of IBIs constitute more than 70% of the global Islamic financial assets (International Financial Services London, 2008; 2009). Hence, the main objective of this study is twofold:

1. Given the lack of understanding concerning market segmentation in the Islamic banking industry, the first objective is to explore the possible consumer segments and to determine whether the Sharī‘ah-compliance criterion is critical in consumers’ purchase decisions about Islamic banking services and products.
2. Given the unique feature of Islamic banking products and services, i.e., Sharī‘ah compliance, the current study aims to propose a Sharī‘ah-compliance framework for IBIs, drawing from the present requirements on corporate governance in Malaysia. A case study was conducted to examine the Sharī‘ah-compliance process in an Islamic bank.
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The remainder of this paper is organized as follows: Section Two provides a brief discussion on the IFSI. A discussion of market segmentation is presented in Section Three and followed with a discussion on risk management, Sharī‘ah compliance and governance in Section Four. The following section discusses the research methods and data collection procedures adopted in this study. Findings and discussion are presented in Section Six. The last section offers concluding remarks and suggestions for the direction of future research.

2. ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

The IFSI has witnessed a frenetic pace of growth over the last decade (Saidi, 2009; IDB et al., 2007). It is estimated that the growth rate of the industry over the last decade has been between 10 percent and 20 percent (McKinsey, 2008; Anon, 2004; Zaher and Hassan, 2001). There are over 300 IFIs worldwide across 75 countries. International Financial Services London (2008; 2009) reports that the total projected size of the global Islamic financial assets is USD729 billion, and about USD537 billion is in the form of Islamic banking assets. In terms of market share by product, Islamic commercial banks represent the majority of the global Islamic financial assets (74 percent); Islamic investment banks rank second (12 percent); and outstanding ṣukūk issued rank third (11 percent).

Various factors have fuelled the development of the industry and continue to contribute to its potential growth and, therefore, they need to be seriously considered by the key players in the industry. The increasing size of the world’s Muslim population, estimated at 1.7 billion in 2009 and expected to increase to 1.9 billion by 2015 (US Census Bureau, International Data Base, 2009), has opened up a great opportunity for the IFSI to further progress in what is a largely untapped market. IFS is an attractive alternative for those investors who, in their quest to diversify their portfolios, are looking for new asset classes, new instruments and new products with low correlation with their existing asset classes and products (Hussain, 2005). Increasing concern for green and sustainable or ethical investment, particularly in European and other Western countries, has also sparked further interest in IFS globally, as the screening criteria used in these investments largely overlap with Islamic finance principles (Saidi, 2009; Ghoul and Karam, 2007). There have even been suggestions that Islamic finance principles may be the best solution for the current global crisis (see for example Maverecon, 2009; Quinn, 2008).
According to El-Sheikh (2008), what makes an economy ‘Islamic’ is Sharī‘ah: a huge corpus of moral and legal discourses, which were intended by scholars (jurists and theologians) of the second and third Islamic centuries to guide Muslims in their pursuit of a good and virtuous life (El-Sheikh, 2008, pp. 116). Therefore, Islamic banking products and services are banking products and services that are structured in compliance with Sharī‘ah law. The basic principles in structuring these products and services are prohibition of interest; risk sharing; individual rights and duties; property rights; money as potential capital; prohibition of speculative behaviour; sanctity of contracts; and Sharī‘ah approved activities (Aslam, 2006; Zaher and Hassan, 2001; Loqman, 1999; Iqbal, 1997). Since interest is prohibited in all forms and for all purposes, IBIs have adopted various Sharī‘ah principles, as suggested by Muslim jurists and scholars, in offering products to their consumers. In summary, these principles can be broadly classified into four categories: principles based on profit-loss sharing (muḍārabah and mushārakah), principles that are based on fixed charges (murābahah, bay‘ mu‘ajjal, ijārah, and ijārah wa-iqtinā‘), principles based on free charges (qarḍ ḥasan) and, finally, principles that are applicable directly or indirectly to the operation of IBIs (wadī‘ah and rahn) (Haron, 1995).

The banking sector forms the largest component of the IFSI (Ibrahim, 2006). As mentioned earlier, Islamic commercial banks represent more than 70% of global Islamic financial assets (International Financial Services London, 2008; 2009). Worldwide, Islamic banks offer various kinds of products, which may be broadly classified as deposit, investment and financing products. The deposit products include current and savings accounts, normally structured under the concept of wadī‘ah yad ḍamānāh (savings with guarantee), muḍārabah (profit-loss sharing) and qarḍ (benevolent loan). The investment products comprise general and special investment accounts that use the concept of muḍārabah and qarḍ. As for the financing products, we may broadly group these into two main types, namely, personal and trade financing. Various Sharī‘ah concepts are used to structure the different products offered under the financing category. They include muḍārabah, mushārakah (joint venture), murābahah (mark-up sale), ijārah (leasing), istiṣnā‘ (manufacturing contract), bay‘ al-dayn (debt trading), wakālah (agency), kafālah (guarantee) and qarḍ.
3. MARKET SEGMENTATION

Traditionally, consumer segmentation by banks was largely limited to the broad categories of corporate and retail consumers (Machauer and Morgner, 2001). Corporate consumers are distinguished by their geographic range of activities (regional versus international) or by their sector affiliation. In personal retail banking, externally observed demographic or economic criteria such as profession, age, income or wealth (known as the ‘a priori’ approach) are often used as dimensions for segmentation (Machauer and Morgner, 2001; Harrison, 1994; Meidan, 1984). Consumers could also be segmented based on a post-hoc approach (e.g., benefit sought from products), such as service quality, location, attitudes, lifestyles and values (Machauer and Morgner, 2001; Harrison, 1994). However, is the same basis applicable in the context of the segmentation of Islamic retail banking and other IFSs?

Rusnah et al. (2009) explain that in the context of Islamic banking, religion and religiosity appear to explain the underlying motive of consumers when opting for the services, which should aid the managerial understanding concerning the type of consumers who will purchase the services. More importantly, the IFS industry needs to take action to capitalize on the current financial crisis and economic recession, as some economists have suggested that Islamic financial principles may provide an alternative solution to these problems (see for example, Maverecon, 2009; Quinn, 2008). Thus, the industry needs to carefully analyse and understand the market segments (pertinently the underlying buying motives in each segment) to appropriately design the marketing and communication strategies for promoting its products.

Not all consumers are alike and, therefore, trying to provide all things to all consumers is difficult if not impossible in a competitive marketplace. By segmenting, the consumer subgroups will be smaller and more homogenous than the overall market. Many financial institutions select a few key target markets and concentrate on trying to serve them better than their competitors (Zineldin, 1996). Islamic banks may find this strategy useful to build up their competitiveness in view of their nascent stage.

Theoretically, market segmentation is the process of dividing a market into a distinct group of individuals, who, along with organizations, share one or more similar responses to some elements of the marketing mix (Peter and Olson, 2008; Edris, 1997). Similarly, Dickson and Ginter (1987) described market segmentation as the use of information about market segments to design a programme(s) to appeal to a specific
market segment. Selecting the relevant target market is vital to developing successful marketing programmes (Peter and Olson, 2008). Accordingly, the segmentation process requires that the total market be divided into homogeneous segments, selecting the target segments, and creating separate marketing programmes to meet the needs and wants of these selected segments.

Substantial literature concerning selection criteria (or patronage) in conventional banking among individual retail consumers is already in place. Gait and Worthington (2008) summarized the following motives, namely: (1) convenience factors such as location and service quality (see for instance, Wel and Nor, 2003; Lee and Marlowe, 2003; Kaynak and Whiteley, 1999); (2) reputation (Almossawi, 2001; Kennington et al., 1996); (3) profitability factors such as low service charges and high interest rates (Kaynak and Harcar, 2005; Ta and Har, 2000; Owusu-Frimpong, 1999); (4) fast and efficient service (Kaynak and Harcar, 2005); (5) security (Gerard and Cunningham, 2001); and (6) professional advice (Devlin, 2002).

Historically, the emergence of IBIs in the financial market was propelled by the long-standing necessity of helping the members of the Muslim society (ummah) who aspire and strive to refrain from indulging in interest (ribā) while carrying out banking transactions (Rusnah et al., 2009). In recent developments, the industry has successfully established a globally diverse clientele and is attracting growing interest from global players, who are not confined to Muslims (Rusnah et al., 2009; Aslam, 2006). Thus, a broader segmentation of the individual retail consumers of IBIs has been possible on the basis of religious affiliation such as Muslim and non-Muslim segments.

A review of the extant literature reveals that past studies on Islamic banking can be categorised into two distinct groups. In light of its infancy as compared to conventional banking, a number of studies have been conducted worldwide to examine the level of awareness of Islamic banking and finance concepts as well as specific products/services among Muslim and non-Muslim consumers. Mixed results have been observed from these studies. In countries where Islam is the main religion, such as Malaysia, Jordan and Bahrain, the level of awareness concerning Islamic banking and finance products/services among consumers (particularly the Muslim consumers) is quite good. In other parts of the world where Islam is not the main religion, such as the UK, Australia and Singapore, it appears that the level of awareness of Islamic banking and finance products/services is quite low, even among the Muslim community/population currently residing in those countries. A summary of findings from various studies on the level
of awareness and understanding concerning Islamic banking and finance products/services among consumers is presented in Table 1.

<table>
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<th>Prior studies</th>
<th>Findings</th>
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<tr>
<td>Omer (1992)</td>
<td>A high level of ignorance on Islamic finance principles among the UK Muslims.</td>
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<tr>
<td>Haron et al. (1994)</td>
<td>Most Muslims and non-Muslims in Malaysia have some awareness of Islamic banking basic concepts but are unaware of specific methods and the differences between conventional and Islamic banks.</td>
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<tr>
<td>Gerrard and Cunningham (1997)</td>
<td>In Singapore, Muslims are more aware of the nature of Islamic banking than non-Muslims.</td>
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<tr>
<td>Metawa and Almossawi (1998)</td>
<td>Most Islamic banking consumers in Bahrain are aware of the fundamental Islamic terms, but are less aware of the more complex financing schemes.</td>
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<tr>
<td>Naser et al. (1999)</td>
<td>The majority of Islamic bank consumers in Jordan have a high level of awareness of at least some Islamic methods of finance.</td>
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<tr>
<td>Hamid and Nordin (2001)</td>
<td>The majority of bank consumers in Kuala Lumpur know about the existence of Islamic banks in Malaysia but more than 60 percent of respondents cannot differentiate between Islamic and conventional bank products.</td>
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<td>Ahmad and Haron (2002)</td>
<td>In a survey administered among 45 financial directors, financial managers and general managers of finance in Malaysia it was found that even though most of them are non-Muslims, most are aware of Islamic banks as an alternative to conventional banks. Most respondents have a low level of knowledge about Islamic banking products, especially the financing products, and most of them agree that Islamic banks in Malaysia need to improve on the promotion of their products and services.</td>
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The knowledge of both graduate and undergraduate students in the UAE on both Islamic and conventional finance methods is relatively low.

A focused interview was conducted with six executives across four Islamic financial institutions in London. Most respondents think that the UK Muslims are generally unaware of Islamic banking products and services.

There is a high level of awareness concerning the basic concept of Islamic finance but the level of awareness of the more complicated concepts of Islamic finance is low in Turkey.

There is a lack of awareness concerning the basic rules and principles of Islamic financing among the Muslims in Australia.

Other studies conducted on Islamic banking focused on bank patronage and selection criteria as well as the underlying motives among consumers in purchasing Islamic banking products. Various researchers have focused on individual preference factors for bank selection including both Muslim and non-Muslim consumers (for example, Zainuddin et al., 2004; Gerrard and Cunningham; 1997; Haron et al., 1994). Another category of studies discussed bank selection criteria for individual consumers without showing or giving major emphasis to any explicit classification of consumers along the lines of their religious status (see for example, Dusuki and Abdullah, 2007; Almossawi, 2001; Mettawa and Almossawi, 1998). Consumers’ age, income, education, experience and other socio-demographic characteristics have been found to have a significant impact on their buying decision. Gait and Worthington (2008) highlighted two distinct results in their analysis of past studies on the underlying motives in consumers’ preferences in selecting a particular Islamic bank. Some studies have found that religion is not the main motivation and that fast and efficient services, the bank’s reputation and image, and confidentiality are the primary motives in the decision of consumers to use Islamic banking products and services (see for instance, Hegazy, 1995; Haron et al., 1994; Erol

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Table 1: Awareness Studies in Islamic Banking and Finance
et al., 1990; Erol and El-Bdour, 1989). However, in some studies it was found that the majority of consumers in Islamic banks responded that religion was the primary motivation in the use of Islamic banking products and services (Bley and Kuehn, 2004; Al-Sultan, 1999; Metawa and Almossawi, 1998; Metwally, 1996; Omer, 1992).

Rusnah et al. (2009) offered a fresh proposal on consumers’ segmentation for the Islamic banking industry based on the segmentation of people in the Qurʾān and the segmentation of traders in kasb (earnings) literature. Based on the state of the soul, a threefold categorization of human personality can be found in the Qurʾān, namely: ammārah (coarse and crude, thoughtless and ill-mannered); lawwāmah (self-reproaching) and mutmaʾinnah (the highest level of personality, who is thoughtful, kind, polite and tender-hearted). Kasb literature divides traders into three distinct groups, known as the benevolent-ethical group (wealth is praiseworthy if and only if the wealth is used as a means for seeking salvation in the other world (al-akhirah)); the rational-moral group (wealth is good in itself and praised for its own sake) and the repugnant-amoral group (trade is an excellent means for the acquisition of wealth). Following these classifications, they subsequently propose a threefold categorization of Islamic banking consumers as given below:

1. A group that is strongly guided by religious dictates, labelled as the ‘religious conviction group’;
2. A group that may not be particularly aware or careful of religious dictates but consciously tries to uphold moral values, identified as the ‘ethical observant group’; and,
3. The last group, which is indifferent to both religious and moral dictates and is intent on deciding matters solely from the perspective of personal financial gain (or economic rationalism), is described as the ‘economic rationality group’.

In the above segmentation, the bases/groups appear to reveal that consumers are making purchase decisions based on the ascribed values, namely, religious, ethical and economic. Values constitute the deepest level of culture and are the most difficult to change (Hofstede, 1980). In Islam, akhlāq (moral and values) provide a framework that shapes the moral and ethical behaviour of Muslims in the conduct of all aspects of their lives (Ismail, 1990; Saeed et al., 2001) and are expected to have a significant impact on the behaviour of Muslims. Globally, the Islamic resurgence has resulted in an increasing emphasis on Sharīʿah (Esposito, 1991) and, thus, IBIs may uncover the profitable consumer segment that makes decisions based on religious values and
belief. A similar development has occurred in ‘ethical consumerism’, which is argued to be on the rise (Ismail and Panni, 2006; Auger et al., 2003). Various authors highlight the similarity between the evaluation criteria for ethical investment and the ideals of Islamic banking and finance (see, for example, Saidi, 2009; Ghoul and Karam, 2007; Rice, 1999; Wilson, 1997), thus supporting segmentation for IBIs consumers based on ethical values. The empirical findings on the possible market segmentation in the Islamic banking industry would benefit the industry in strategically designing the marketing plan and tools to ensure the progress and sustainability of the industry.

4. RISK MANAGEMENT, SHARĪ‘AH COMPLIANCE AND GOVERNANCE

Risk as an uncertainty of outcome is a defining characteristic of business ventures. Risk is inherent in business operations. A business organization has to undergo risk in the continuity of its activities and to manage risk as efficiently as possible for its survival and growth. Compliance with standard business practices–voluntarily delineated or officially required–can be seen as a prudent approach towards minimization, if not elimination, of harmful exposure to risks. In the banking business, risk management and compliance function are considered more important because of a bank’s fiduciary duty. Being simultaneously a receiver and a provider/user of funds, the banking business is exposed to a number of risks; traditionally, these include credit risks, market risks, liquidity risks and operational risks (Chapra and Khan, 2000).

Credit risks arise from the volatility in a bank’s net cash flow as a result of an unexpected decline in its total cash flow due to the potential defaults by counter-parties. This can give rise not only to a liquidity crunch but also adversely affect the quality of the bank’s assets. Market risks consist of interest rate risks, exchange rate risks, and commodity as well as equity price risks. Liquidity risks arise when there is an unexpected decline in a bank’s net cash flow and the bank is unable to raise resources at a reasonable cost by either selling its assets or borrowing through the issuance of new financial instruments. This situation may make the bank unable to meet its obligations as they become due, or fail to fund new opportunities for profitable business. Operational risks arise from the breakdown of internal controls and corporate governance.
Askari et al. (2009) have included reputational risk as part of operational risk and maintain that it has special relevance to financial institutions due to their fiduciary responsibilities. Reputational risk that arises from operational failures, i.e. failures to comply with relevant laws and regulations, or other sources is damaging for banks since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace. In the banking industry, any acts of non-compliance by a bank would bring serious damage to the bank as it will deliberately expose itself to the associated risks. The Basel Committee on Banking and Supervision, Compliance and the Compliance Functions in Banks (2005) defines compliance risk for banks as:

‘...the risk of legal or regulatory sanctions, financial loss or loss of reputation a bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conducts and standards of good practice (together ‘laws, rules and standards’).’

It also stresses that:

‘compliance should be part of the culture of the organization; it is not thus the responsibility of the specialist compliance staff.’

Non-compliance results in an erosion of depositors’ and investors’ confidence and deteriorates a bank’s reputation. Once a bank loses its reputation, large scale withdrawal by its depositors and investors may put its very existence at stake. This is because development and maintenance of a sound and efficient banking system presupposes an ‘atmosphere of mutual trust between the providers and the users of funds’ (Ahmad, 2010; Chapra and Khan, 2000).

The Sharī‘ah-compliance requirement is unique to Islamic banking operations. The present research views Sharī‘ah compliance of IBIs in the broader spectrum of a bank’s risk management, as non-compliance with Sharī‘ah law is considered quite damaging to the bank’s reputation. IBIs should avoid participating knowingly in transactions that transgress or bypass any Sharī‘ah regulatory requirements, in order not to be exposed to compliance risk.
Non-compliance risks may pose a greater danger for an Islamic bank than they do for a conventional bank. In a conventional banking environment, if non-compliance is followed by, or associated with, the expected returns for depositors, the bank in question may not face any problem that could arise from large-scale withdrawal by depositors. Non-compliance with Sharī’ah regulations by an Islamic bank, however, makes the bank susceptible to irreversibly loss of religiously sensitive depositors and investors—the major source of its funds. It is worth noting that the risks of non-compliance with Sharī’ah principles and regulations are not confined to this material temporal world for (top) officials of an Islamic bank. If infringement of Sharī’ah principles occurs with their cognizance and consent, this will endanger their interests in the eternal life to come.

Nik Norzul Thani (2007) strongly asserts that, for the industry to further progress, comprehensive and rigorous mechanisms must be put in place to ensure Sharī’ah compliance. Alvi (2005) points out that the criterion of Sharī’ah compliance is one of the distinctive features of Islamic banking products and services. Therefore, he stresses the need for proper regulation and supervision to ensure that all products are Sharī’ah-compliant at all stages of each product’s life cycle in order to maintain stakeholders’ confidence in the industry. Vicary (2005) accentuates that Sharī’ah compliance is one of the areas that Islamic banks must focus on as part of the overall corporate governance (CG). Syed Musa and Mohd Daud (2007) maintain that an effective and reliable Sharī’ah review process is extremely important in ensuring good Sharī’ah governance. In the same line of thought, Shanmugam (2005) stresses that CG within the Islamic banking environment is covered by the Sharī’ah, which has a crucial role in governing bank transactions and operations. Rahim (2008) emphasizes that due to the increasing demands from stakeholders on the assurance of Sharī’ah compliance and accountability, the Sharī’ah audit should be part of the CG mechanism in Islamic financial institutions.

The compliance process for Islamic banking products comprises two difference stages. In the first stage the product is subjected to rigorous discussion and review in terms of its Islamicity. Rahim (2008) categorizes this process as an “ex-ante” Sharī’ah audit (see also IFSB-10, 2009). He describes the “ex-ante” Sharī’ah audit as all activities performed by Islamic financial institutions to ensure that they comply with the Sharī’ah rules and guidelines during the design of the contracts and agreements, during the transaction process, i.e., the execution and conclusion of the
contract, including the implementation of the terms of the contract. In Malaysia, the “ex-ante” Sharī‘ah audit is normally conducted by the bank’s Sharī‘ah Committee as well as the BNM’s Sharī‘ah Advisory Council (SAC). The second stage of the compliancy process would be to ensure compliance in terms of operations and management of the products, which is better known as “ex-post” Sharī‘ah audit (Rahim, 2008; IFSB-10, 2009). Rahim (2008) explains that the “ex-post” Sharī‘ah audit is basically to review random samples of completed transactions to ensure that these transactions conform to the Sharī‘ah rules and guidelines. This task, according to him, may be performed by internal auditors or external auditors, and the result of the audit needs to be reported to the management. For many, the first phase of the compliancy process in the IBI is deemed to be sufficient, as the members of the responsible bodies are Islamic scholars who are proponents of Islamic banking. However, the main concern would be in the operations and management stage of these products, as these are handled by practitioners with diverse backgrounds and motives.

Hashim (2009) defines governance as ‘a combination of processes and structures conducted by the board of directors to authorize, direct and oversee management towards the achievement of the organization’s objectives’. Rezaee (2009) describes CG as ‘an ongoing process of managing, controlling, and assessing business affairs to create shareholder value and protect the interests of other stakeholders’. Cohen et al. (2004) suggest a governance mosaic that explains the interplay of corporate governance mechanism/actors: management, board of directors, audit committee, external auditor, and internal auditor, as reflected in Figure 1.
Rezaee (2009) stresses the increasing important role of the internal audit function within a business organization. According to him, the internal auditors who implement this function should have more authority and resources. They should be viewed as the eyes and ears of the audit committee, providing ‘an integral component of corporate governance as a separate value-added function’. Furthermore, it is argued that the internal audit function should be an active participant in the process of CG, as effective CG starts from inside the company (George, 2003). In George’s words, ‘The internal auditor is the most important partner in effective corporate governance...having the time to examine every financial reporting detail.’ (pp. 9). In the context of Islamic financial institutions, Rahim (2008) argues that ‘...internal auditors are generally more familiar with the record systems, policies and procedures of the institution and can provide quick responses to managers. The result could be a more detailed and exhaustive internal Sharī‘ah audit.’

In Malaysia, the increasing emphasis on the internal audit function is reflected in the mandatory requirement made by the Bursa Malaysia on all public listed companies to have the internal audit function in place starting from 2006 (Kadir, 2009). Therefore, taking off from this premise, it is proposed that the compliancy process for Islamic banking products and services be done through the internal auditing function by establishing an internal Sharī‘ah audit team as illustrated in Figure 2.
In the proposed framework, we assume that the function is under the responsibility of a distinct unit referred to as the Internal Audit Committee (IAC). It is proposed that the Internal Sharī‘ah Audit Team (ISAT) to be a special cell of the IAC which will review operations and transactions relating to Sharī‘ah matters on a regular basis. In discharging its responsibilities, the team will have bilateral functional interactions with both the IAC and the Sharī‘ah Supervisory Board (SSB). It will have discussions with the SSB and get the SSB’s opinion on Sharī‘ah non-compliance issues and the possible resolution thereof. The team will prepare a specific report on Sharī‘ah compliance issues and communicate it to the IAC. This report will then become an integral part of the internal audit report that will be communicated to the Audit Committee (AC) by the IAC. As proposed by Cohen et al. (2004), the independence of the internal auditor (in this case the internal Sharī‘ah auditor) is strengthened when it reports directly to the management.

**Figure 2: Proposed Sharī‘ah Compliance Framework**
AC and is not hampered by concerns of divulging sensitive findings as compared to when internal auditors report to the top management (pp. 125). Thus, it is through the AC that the report on Shari‘ah compliance will eventually reach the Board of Directors (BOD). It is the responsibility of the BOD to communicate the findings/resolutions on the Shari‘ah compliance processes to the management and advise the latter to take corrective actions as and when needed. A case study was conducted to examine the Shari‘ah compliancy process in an Islamic bank for the purpose of evaluating the applicability of the proposed framework.

5. RESEARCH METHOD

The methodology adopted in this study comprises two stages. To answer the first objective, that is, to explore the different consumer segments and the underlying motives, as proposed by Rusnah et al. (2009), the first stage of data collection, which is consistent with the notion of ‘a priori segmentation design’ by Wind (1978), was conducted. In order to test the proposal from Rusnah et al. (2009), data was collected from the key market players in the industry holding managerial positions. The data was collected from the managerial positions for the following reasons:

1. The current study’s objective—to explore the possible segmentation bases for consumers in IBIs—is preliminary in nature, as there has been limited research in the past to guide segmentation in this industry specifically, despite the vast segmentation research done for conventional banking consumers. The differences between conventional banking and Islamic banking in the structuring and operationalisation of products/services—that is, the element of Shari‘ah compliance—raised questions on the appropriateness of applying the segmentation bases normally adopted for conventional banking products/services.

2. The segmentation issues in the Islamic banking industry constitute a relatively new area, and research on this area is rather limited. Given the newness of these issues, the managerial perspective is considered appropriate (Peter and Olson, 2008). As highlighted earlier, in light of the infancy of the industry as compared to conventional banking, a number of studies have been conducted worldwide to examine the level of awareness of Islamic banking and finance concepts as well as specific products/services among Muslim and
non-Muslim consumers. The findings of these studies established that the awareness level about Islamic banking and finance concepts and principles as well as products and services is quite low, which means that collecting data from consumers is less appropriate at this point in time. Therefore, as an exploratory study, insights from the managerial context could help establish the initial base(s) for Islamic banking consumers.

Before conducting in-depth interviews, a secondary literature search was conducted to assist the researchers in formulating the interview guide. An interview guide was developed so that all interviews could be conducted in a manner that ensures consistent data collection. Several in-depth interviews were later conducted to gauge the initial dimensions from the managerial perspective to help the researchers further refine the interview guide. The refined interview guide is shown in Table 2. The sample of respondents (the key market players) was based on three different groups: (1) industry regulators, (2) Islamic banking and finance experts such as Sharî’ah scholars, consultants and lawyers, and (3) Islamic bankers. The sample of respondents includes local as well as international respondents (from some parts of the Middle East and Europe). The details of respondents are given in Table 3. The international respondents were interviewed during the sixth Islamic Financial Services Board (IFSB) summit held in Singapore in February 2009.
<table>
<thead>
<tr>
<th>Issues</th>
<th>List of Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market segmentation and positioning of Islamic banking services and</td>
<td>• What type of consumers would opt for Islamic banking services and products?</td>
</tr>
<tr>
<td>products</td>
<td>• What are the underlying motives for consumers in opting for Islamic banking services and products? Do these motives differ between Muslims and non-Muslims?</td>
</tr>
<tr>
<td></td>
<td>• Do you have a systematic approach on how you categorise your consumers? In other words, does any specific segmentation exist for your present consumers?</td>
</tr>
<tr>
<td></td>
<td>• Do you treat consumers as one group? If they are not treated as a group, how do you differentiate between them?</td>
</tr>
<tr>
<td></td>
<td>• Do you think consumer values such as religious, ethical and economic values affect the consumer’s purchase decision?</td>
</tr>
<tr>
<td></td>
<td>• How do you think Islamic banking services and products should be positioned in the global market?</td>
</tr>
<tr>
<td></td>
<td>• What message should be communicated to these different groups?</td>
</tr>
</tbody>
</table>

*Table 2: Interview Guide*
Each interview lasted between 40 and 90 minutes. All interviews were digitally recorded. The recorded interviews were then transcribed verbatim. The verbal text was then segmented based on the emergent theme in a sentence and coded with a pre-defined coding scheme (Atman and Bursic, 1998). The coding scheme was developed from a proposed consumers’ segmentation for Islamic banking customers (Rusnah et al., 2009).

The second objective of this study is to evaluate the applicability of the proposed Sharī’ah compliance framework in the Sharī’ah compliance process of an Islamic bank. In-depth interviews were conducted with the key persons in the managerial position in a selected Islamic bank to grasp their opinions on various Sharī’ah compliance issues. The details on the job profiles of the interviewees are given in Table 4. However, after a careful analysis, most of the relevant information has been gathered from our interview with the Head of the Sharī’ah Department (HSD) of the bank.

<table>
<thead>
<tr>
<th>Job Title</th>
<th>Number of Interviewees</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Manager</td>
<td>2</td>
</tr>
<tr>
<td>Assistant General Manager</td>
<td>5</td>
</tr>
<tr>
<td>Senior Manager</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>8</td>
</tr>
</tbody>
</table>

Table 4: Job Title of Interviewees
<table>
<thead>
<tr>
<th>Issues</th>
<th>List of Questions</th>
</tr>
</thead>
</table>
| Shari‘ah compliance issues | • Do you think that Shari‘ah compliance issues need to be given serious attention by the management of an Islamic bank?  
• What might be the consequences if these issues are ignored or given less than due attention?  
• Do you think that customers, while buying Islamic banking products and services, perceive Shari‘ah compliance issues as significant for them?  
• Is there any specific procedure in place to ensure Shari‘ah compliance in general? What about the procedure for specific products like home financing, credit cards, vehicle financing and personal financing?  
• Shari‘ah (non-)compliance can potentially affect a bank’s reputation? Do you think that your bank capitalizes on Shari‘ah compliance to build a distinct brand image? |
| Compliance function/process | • All publicly listed companies are required to have an internal audit function. Does the Shari‘ah Committee (SC) assume the role of an internal auditor to check Shari‘ah compliance in your bank? If it does not, who does it?  
• BNM has made Islamic banks responsible for familiarizing the SC with their operations and business. How does this familiarization take place in practice?  
• According to the Basel Committee on Banking and Supervision, compliance should be part of the culture of the organization; it is not just the responsibility of the specialist compliance staff. In line with this, banking staff need to be gradually familiar with Shari‘ah requirements vis-à-vis their operation. How does this familiarization take place in practice?  
• How do you evaluate the provision of having an industry representative on a Shari‘ah Committee as required in Pakistan? |

*Table 5: Interview guide*
The data gathering process was conducted in two different phases: in the first phase, a list of questions as given in Table 5 was emailed to the HSD, to which he provided detailed written answers to almost all questions listed; and in the second phase, we conducted a face-to-face interview at his office, asking more informal questions relating to Sharī'ah compliance issues and the practices of conducting the review process. In addition, the annual report of the bank for the year 2008 was examined to find out the formal procedures in place specifically for the Sharī'ah review process and for governance in general. The detailed discussion regarding the findings on market segmentation and the case study conducted on the Sharī'ah compliancy process are presented in the following section.

6. FINDINGS AND DISCUSSION

Market Segmentation

This section presents the findings on the qualitative enquiries conducted with the selected key market players in the Islamic banking industry on market segmentation. Specifically, the verbatim analysis of the in-depth interviews reveals four distinct market segmentations for consumers of IBIs. Rusnah et al. (2009) propose three different segments, namely, (1) the religious conviction group (guided by their religious dictates in making their purchase decisions); (2) the ethical observant group (make decisions based on ethical criterion); and (3) the economic rationality group (make decisions solely for their personal financial gain based on economic rationalism). Interestingly, the qualitative findings appear to show the existence of another group, which makes decisions based on both religious values and economic rationalism, and is properly coded as the ‘religious conviction and economic rationality group’. The next section discusses the detailed findings.

Religious Conviction Group

For this group of consumers other aspects of Islamic banking products and services, such as product options, service quality and attractive pricing, may not affect their decision or do not explain the underlying motive for opting for these products and services. As argued by Delener (1994), the more religious individuals made decisions based on their religious values. The contention is supported by the findings of various
studies on ethical decision making (see for example, Rusnah, 2009; Barhem et al., 2009; Rusnah, 2006; Rusnah and Mumin, 2006). Thus, the motive of individuals in the first group to opt for Islamic banking products and services is bounded by their religious commitment. This is reflected by the following comments made by some of the interviewees.

Malaysian Retail Banker 1:

‘The way that we profile our consumers is slightly different...particularly for people from Kelantan, Kedah or from Terengganu; the religious factor is the main motive in their decision of whether or not to opt for Islamic banking products and services.’

Foreign Investment Bank 1:

‘The principles would probably be the same. Muslim investors would opt for Islamic banking products and services because of the religious factor.’

This finding is similar to the conclusion made in prior studies, which established that the majority of Muslim consumers of Islamic banks have opted for the Islamic banking products and services primarily due to the requirement of their religion (see, for instance, Bley and Kuehn, 2004; Al-Sultan, 1999; Metawa and Almossawi, 1998; Metwally, 1996; Omer, 1992).

For this group of consumers the main concern underlying their decision in choosing financial services is whether they are Shari’ah compliant even though they have to pay higher prices, as reflected by the following interviewees.

Malaysian Retail Banker 1:

‘[T]here are situations... where people only bank with Bank A, even if they have to pay slightly higher rates....because Bank A was perceived as very strict in its Shari’ah compliance procedures.’

This is very much related to the term ‘brand fundamentalism’ coined by Ambler (2009). He explains that the brand fundamentalists are motivated by their beliefs and emotions, which to him are far more powerful than rationality. He affirms that belief is more
important than knowledge in persuading consumers, and, according to him, without inculcating belief, knowledge will not be retained. Another interviewee provided the same opinion when he said that:

Malaysian Retail Banker 2:

‘Bank A has fanatic clients. They refuse to leave Bank A. There is nothing you can do to steal them away unless you can stop Bank A...They will stay with Bank A simply because of their religious commitment, as they perceive Bank A as being more stringent in its Sharī‘ah compliance procedures.’

In segmenting consumers, the religiosity of consumers is not only applicable to Muslim consumers, as most of the basic principles of business ethics, as laid down under Sharī‘ah law, but are also applicable in other great monotheistic religions such as Judaism and Christianity (Rusnah, 2006). This is evidenced in the following interview extracts:

Foreign Retail Bank 1:

‘The level of religious commitment is very relevant in marketing Islamic banking products and services even to the non-Muslims, especially with the Jews and Christians...as their religions also prohibit interest...when my bank first introduced the housing financing product in the US, I was called by a group of devout Jews to explain the product simply because it does not have an element of interest.’

We may conclude that for the religious conviction group, the main motives in purchasing the products and services among consumers is Sharī‘ah compliance, and the term Sharī‘ah compliant should be clearly described. Accordingly, all these features and benefits should be conveyed effectively to consumers to persuade them to purchase IBIs’ products and services and thus create consumer loyalty.

**Religious Conviction and Economic Rationality Group**

Interestingly, some of the bankers highlighted that in recent years a new group of consumers has emerged. These consumers combine both religious and economic criteria in their purchase decision. It is suggested that this consumer group has better
access to education, has high income and resides in urban areas. For this group, which is bounded by religious as well as economic performance, Shari‘ah credibility and the reputation of the bank and quality of the services, as well as pricing and returns may be important motives for them to opt for Islamic banking products and services. This is reflected in the following interview extracts:

Malaysian Retail Banker 1:

‘The second criterion besides Shari‘ah compliance… is the economic value; this is what I think is applicable for the central region, Kuala Lumpur and other parts of the Klang Valley. Consumers are looking more at the economic values instead of the addition in other benefits.’

Malaysian Retail Banker 2:

‘That is why when we in Bank B started, we decided to concentrate on the Shari‘ah credibility and the technological advancement and innovation, as in our opinion, both are equally important for some consumers.’

Foreign Retail Banker 1:

‘For moderate Muslims, besides Shari‘ah compliance, they also look for the returns. They will switch to Islamic banks if they can obtain the same benefits as those offered by conventional banks because at the same time they can observe the requirements of their religion.’

The overlapping of both values, religious and economic rationality, is interesting and provides consumer insight to marketers when designing and tailoring their marketing messages. This is akin to the second kind of personality ‘lawwāmah’, as described in the Qur‘ān (75:2), where the angelic element encourages a person to follow in totality the will of God but such a state appears to contain at the same time the evil element that persuades an individual to be selfish and decide things based purely on self-interest. Apparently, this combination or overlapping of values highlights the notion put forward by Wind (1978), who asserts that clustering consumer segments does not necessarily mean that consumers should be classified in only one cluster (or one segment). He argued that ‘conceptually, there are a number of situations in which a consumer can belong to more than a single segment, especially if one considers multiple brand usage, different usage occasion, multiple benefit sought, etc.’ (Wind, 1978, pp. 331).
Furthermore, in the context of Islamic banking, Haron et al. (1994, pp. 34) explain that, ‘consumers view Islamic banks just like any other commercial bank; thus, the service quality and products and services offered must be compatible with those offered by the commercial banks’.

For this newly emerged group, both the religious and economic criteria are relevant in their decision to opt for IBIs’ products and services, thus providing an indication to these institutions that while Sharī‘ah compliance is critical, other aspects such as quality of services and economic performance should also be emphasised in their marketing messages to consumers.

**Ethical Values Group**

Another interesting motive that emerged from our qualitative findings is that consumers or investors may consider opting for Islamic banking products and services, as this meets the requirements of their ethical beliefs. This is described in the following responses:

Foreign Investment Bank 1:

‘For non-Muslim investors, they are looking to be ethical and honest. I do not think they really care whether it is Sharī‘ah compliant or not….the most fundamental aspect is that we only invest in ethical investments, and that is not just a religious point of view.’

Foreign Investment Bank 2:

‘Islamic products are not just for Muslims, we have non-Muslims buying Islamic products. Therefore, to me it is not purely a religious factor….One of the drivers is the principles of Islamic finance, which make it appealing to fund managers who want to invest in sustainable or green funds.’

Foreign Retail Banker 1:

‘In European/Western countries, where ethical/social responsibility funds are emerging and upcoming, Islamic financial products may be
attractive to this group of investors since the basic principle of Islamic finance is in line with their investing criteria.’

Fund Manager based in Italy and London:

‘I believe that promoting Islamic financial products should start through the ethical channel, I am very much involved in ethical investing. The Pope is very much in favour of Islamic finance, as published in the daily official newspaper, L’Osservatore Romano. To market Islamic finance in Western countries, for example, the right thing to do is to portray Islamic finance as an integral part of an ethical approach to finance.’

Various authors point out that the evaluation criteria for ethical investment is parallel with the ideals of Islamic banking and finance (see for example, Saidi, 2009; Rice, 1999; Wilson, 1997). Some even went a step further and commended that Islamic banking and finance principles may be the best solution for the current global crisis (see, for example, Farooq, 2009; Maverecon, 2009; Quinn, 2008). A report at AMEinfor.com states, ‘As the global economy creates a new financial architecture, incorporating lessons from the global financial crisis, Islamic banking could emerge as a role model because of its focus on ethical investments’. This was one of the key messages that emerged from a panel discussion on Islamic finance in a forum organized by the Dubai Islamic Financial Centre (DIFC) in 2008. Therefore, IBIs can promote and market their products as one of the alternative choices for ethical investors, and the specific features of their products that meet the criteria evaluation for ethical/green/sustainable/socially responsible investment should be clearly outlined and effectively communicated to this potential group of consumers.

Economic Rationality Group

For some individuals, Muslims or non-Muslims, the main motive underlying their purchase decision is made purely on the economic rationale of minimizing loss and risk and maximizing profit. If investment in Islamic banks can provide good returns, and their financing facilities are offered to consumers at a competitive rate, and they are able to provide quality services, then this group of consumers may decide to opt for Islamic banking products and services, as highlighted by one of the interviewees below:
Malaysian Retail Banker 1:

‘The bottom line is what is good for their pocket.’

Diversification strategy is another reason that consumers in this group are opting for Islamic banking products and services (Hussain, 2005), as the performance of IFS is promising and is argued to be more resilient to economic shocks. One of the interviewees mentioned this reason as the motive for consumers in their decision to opt for IFS.

Foreign Investment Bank 1:

‘[T]he non-Muslim investors would probably opt for it because it is an alternative….They see Islamic banking products and services as an arbitrage for the conventional banking products…to minimise risk….By investing in both, they manage to diversify the credit risk.’

The ability to provide efficient and innovative products/services that can successfully compete with other available financial products in the market will be necessary to capture the demand from this group of consumers. As stressed by IDB et al. (2007), the Islamic financial services industry can possibly capture the demand beyond the Muslim population through the provision of innovative and high-quality financial services.

The results of this study indicate that, in general, the practitioners do not have any organised segmentation bases as yet, which may be due to the newness of the issues in the industry. Several bases may exist, such as geographic (based on regions), socio-cultural (based on religion) and behavioural (based on values). Therefore, we conclude that the most appropriate segmentation, as has emerged in this study, could be based on the value dimensions as follows:

1. Religious conviction;
2. Religious conviction and economic rationality;
3. Ethical observance;

It is critical for the marketers of an Islamic bank to understand the market segments that it is serving, which may focus on any or a combination of the motives described in the preceding section, so as to design marketing communication strategies and messages effectively. The next section discusses the findings of a case study conducted on a compliance process in an Islamic bank.
Shari‘ah Compliance Review Process

This section discusses the findings of a case study conducted to evaluate the applicability of the proposed Shari‘ah compliance framework in the Shari‘ah compliancy process of an Islamic bank. As highlighted earlier in the section on research methods, most of the discussion in this section is extracted from email interviews and face-to-face in-depth interviews with the HSD of the bank.

Shari‘ah Compliance Issues

It is widely accepted that Shari‘ah compliance is the distinctive/unique criteria of IBIs (see for example, Grais and Pellegrini, 2006; Haniffa and Hudaib, 2007; IDB et al., 2007; IFSB et al., 2010; Ahmad, 2010). However, our main concern is whether the management of IBIs is committed to ensuring that a rigorous Shari‘ah compliance mechanism is in place in their institutions; and whether stakeholders are seriously concerned about this issue. Legally and morally, as well as from an Islamic point of view, the board of directors (BOD) and the management of an IBI is fully responsible to ensure that the operations of the institution are Shari‘ah compliant. The following extracts illustrate this point:

HSD:

‘It is a fiduciary duty of the Bank’s BOD and Management towards its stakeholders to ensure the operations of the Bank are in line with the Shari‘ah requirement.’

General Manager 1:

‘...so you must ensure that all banking operations are really conducted in accordance with the requirement of Shari‘ah, and not just merely claim it to be Shari‘ah compliant.’

HSD:

‘From my experience in the industry, the Shari‘ah compliance issues are subject to the willingness of the management and the BOD of the bank. So the question here is whether Shari‘ah compliance issues are a mere rubber stamp from the Shari‘ah Committee at the end of the financial year, or is Shari‘ah compliance governance taken seriously by the management in the operation of a particular Islamic bank by putting a specific control mechanism to ensure Shari‘ah compliance is observed throughout the organisation? It depends totally on them.’
It may be concluded that the commitment of the top management and BOD is the most important aspect in determining whether good Shari’ah governance is in place and working effectively; it is the tone at the top that can ensure the mechanism is fully working.

In the banking industry, any noncompliant acts by a bank would cause serious damage to the bank, as it will deliberately expose itself to compliance risk (Basel Committee, 2005). As for Islamic banks, Shari’ah non-compliant acts can cause serious confidence problems and deposit withdrawals (Ahmad, 2010). In this regards, one of the interviewees has deliberated in detail the consequences of Shari’ah non-compliance acts committed by an Islamic bank, as reflected in the following extracts:

HSD:

The consequences of committing Shari’ah non-compliant acts can be divided into two, namely: 1) Non-financial impact: i) Against the Commands of Allah SWT. Any non-compliance with Shari’ah is against the Commands of Allah; ii) Impediment of Allah’s SWT Blessing or Barakah. Any non-compliance with Shari’ah would deprive the Bank and/or staff from Allah SWT’s blessing or barakah. Thus, the banking activities would be meaningless (not considered as part of ibādah) before Allah; iii) Contravention of the Provision of Islamic Banking Act 1983. Any non-compliance with the Shari’ah would contravene the provisions of Section 3 (5) (a) and Section 4, Islamic Banking Act 1983, and upon conviction, the perpetrator would be liable to a fine and subjected to revocation of license; and iv) Business Reputation. Any non-compliance with the Shari’ah would jeopardise or affect the Bank’s reputation as an Islamic bank. 2) Financial impact: i) Invalidation of Contract (Aqd). Any non-compliance with Shari’ah with regard to the ’aqd, its documentations and execution would render the contract between the Bank and the customer, under the perspective of Shari’ah null and void (bāțil). Therefore, any profit gained from this contract would be considered as non-halāl; ii) Non-Halal Income. Income generated from Shari’ah non-compliant transactiona shall not be recognized as the Bank’s eligible incomes. In this case, the Shari’ah Supervisory Council (SSC) is to decide on the proper treatment of the non-halāl income. In the event that the Bank receives non-halāl income unintentionally,
the SSC should be advised and such income shall be channelled to the Bank’s Tabung Ehsan; and iii) Capital Adequacy Ratio (CAR) Impact. Sharī‘ah non-compliance can lead to non-recognition of income and erosion of capital. Therefore, in the event of non-compliance, BNM may impose a higher capital charge, as they deem fit to cater for the Sharī‘ah non-compliance risk of any particular Bank.’

Are stakeholders really concerned whether or not the banking operations and products and services of an Islamic bank are fully Sharī‘ah compliant? The findings from the preceding section reveal that for the religious-conviction consumer segment, Sharī‘ah compliance is the only criterion considered in their purchasing decision. But do they really evaluate the Sharī‘ah compliance process implemented by a particular Islamic bank. Generally, the majority of Muslims has limited knowledge of fiqh mu‘āmalāt; thus, they mainly rely on the endorsement made by the Sharī‘ah Supervisory Council (SSC) of a bank. The following extracts describe the reliance on SSC regarding the certification of Sharī‘ah compliance for Islamic banking products and services:

HSD

‘Yes. However, the majority of consumers rely on the endorsement made by the Sharī‘ah Committee of the Bank in terms of the Sharī‘ah compliance process because, in my opinion, they have no knowledge on the matter. For those with knowledge on Islamic commercial laws (fiqh al-mu‘āmalāt), maybe they question certain structures that are not acceptable under the fiqh jurisdiction e.g. bay‘ al-‘īnah, ‘īnah-like, and bay‘ al-dayn.’

He further adds that the bank is guided by a specific framework in ensuring the operations of the bank are fully complying with the requirements of Sharī‘ah:

‘Yes. In Bank A, we are guided by the Sharī‘ah Compliance Risk Management (SCRM) framework, which serves as guiding principles in managing Sharī‘ah compliance risk throughout the organization. The framework is supported by the SCRM Policy and more than 10 Sharī‘ah contract guidelines as well as the Handling and Reporting of Sharī‘ah Non-Compliances Guideline. Procedure-wise, we are governed by the Sharī‘ah Compliance Manual developed by the Bank in compliance with the BNM GPSI.’
We may conclude that more efforts are needed to expose and educate various stakeholders on the Sharī‘ah compliance issues, as that awareness is considered still very low amongst stakeholders and the public in general. This fact is stressed by the HSD, as reflected in the following interview extract:

HSD:

‘...normally, most of the Sharī‘ah non-compliance (SNC) is operational in nature, and that is not made known to all stakeholders. In addition, Sharī‘ah compliance awareness is still low among the public, and the Bank organized several programs and participated in programs organized by others to uphold the Islamic teachings, especially on Islamic commercial law.’

The understanding of Sharī‘ah compliance issues is particularly critical amongst the employees of Islamic banks, as they are the drivers in ensuring the procedures are implemented effectively in their institutions. This is a prerequisite in an Islamic bank, as the HSD stresses:

‘Awareness, communication and ongoing training on Sharī‘ah requirements and on events/scenarios that lead to breaches and their negative impacts are pivotal components in managing Sharī‘ah compliance risk. In order to enhance the Sharī‘ah compliance risk awareness amongst all staff, the Bank developed a comprehensive awareness and communication program which includes training, briefing, workshops, seminars, newsletters and other communication channels.’

In conclusion, the onus in ensuring Sharī‘ah compliance procedures are effectively implemented lies with the management and BOD of a particular Islamic bank since it is the bank’s fiduciary duty to ensure compliance with all regulations/requirements. The management, overseen by the BOD, should take the necessary steps to establish the proper mechanisms in their bank to ensure all products and services are Sharī‘ah compliant at all stages (i.e. from the designing and structuring as well as the implementation stages).
Compliance Function/Process

In the proposed framework, we assume that the Sharī‘ah compliance review process is made the responsibility of a distinct unit, referred to as the Internal Audit Committee (IAC). It is proposed that the Internal Sharī‘ah Audit Team (ISAT) be a special cell of IAC that will review operations and transactions relating to Sharī‘ah matters on a regular basis. In evaluating the Sharī‘ah compliance review practices in the bank under study, we found that:

‘Technically, there is no specific requirement for the SSC to assume such a role, except under the Governance Standards issued by AAOIFI. In Bank A, the role is assumed by the Sharī‘ah Audit Unit of the Internal Audit Division, and the report is submitted to the SSC for deliberation and decision.’

We also proposed that in discharging its responsibilities the team should have bilateral functional interactions with both the IAC and both Sharī‘ah Supervisory Board (SSB). Any Sharī‘ah noncompliance issues should be discussed with SSB to seek the possible resolution thereafter. In the bank under study, these issues are being handled as explained below:

‘In our Bank, we have established several functions to manage Sharī‘ah Compliance Risk Management (SCRM), e.g., the Sharī‘ah Department, and Sharī‘ah audit function under the ambit of Internal Audit Division. A management level committee, Sharī‘ah Compliance Risk Working Group (SCRWG) was established to deliberate to track Sharī‘ah non-compliance (SNC) and to ensure that there are adequate controls to ensure Sharī‘ah compliance throughout the organization. The Head of the Sharī‘ah Department has been appointed as a member to most of the Bank’s management level committees.’

In our framework, we have suggested that the ISAT should be responsible for preparing a specific report on Sharī‘ah compliance issues and communicate it to the IAC. This report will then become an integral part of the internal audit report, which will be communicated to the Audit Committee (AC) by the IAC. In the bank under study, the compliance function is assumed by both the Sharī‘ah Department and Sharī‘ah audit unit, as mentioned above, and the report on SNC is then submitted to the top management for deliberation, as stated below:
'The reports are escalated to the management level namely the Operational Risk Control Committee and SSC for deliberation and notification.'

The HSD illustrated a situation where a specific action was taken in the case of SNC, as noted in the following extract:

'For instance, in our bank when such Sharī‘ah compliance procedure is not complied with, we will instruct the original contract to be repeated all over again...terminating the original arrangement, which is not Sharī‘ah compliant, and executing the new one. However, if the bank fails to do that we will trace the account in the system, and any income arising from that particular transaction will not be recognised as revenue for the bank.'

To ensure that members are equipped with sufficient knowledge on banking operations and business so that they are able to carry out their roles more effectively, the bank has taken various initiatives:

'Several initiatives have been taken by the Bank to familiarize the SSC with banking operations and business, namely, cross attendance between the Board Risk Committee members and SSC members; appointment of Chief Internal Auditor and Chief Risk Officer as permanent invitees to the SSC meetings; sending SSC members to training programs organized by training providers, e.g., IBFIM, CERT and regulators; and organizing briefings on business activities by subject matter experts for the SSC members.'

According to the Basel Committee on Banking and Supervision, compliance should be part of the culture of the organization; it is not just the responsibility of the specialist compliance staff. In line with this, all staff of an Islamic bank need to be gradually familiarized with Sharī‘ah requirements vis-à-vis their operation. To ensure this familiarization actually take place in practice, the bank under study has taken the following initiatives:

'In order to enhance Sharī‘ah compliance risk awareness amongst all staff, the Bank had developed a comprehensive awareness and
communication program, which includes training, briefings, workshops, seminars, newsletters and other communication channels. In addition, the Shari’ah requirements are embedded into the product operational manuals.’

Ideally, the SSC itself should conduct the review process, as recommended by the said HSD:

‘For me, the SSC itself must perform the review of the Shari’ah compliance process because they are going to issue the report. How could they issue such a report without doing the review?’

The HSD mentioned that the annual report of the bank is reviewed to check that disclosures made are in line with the actual practices. The process was explained under the “Shari’ah Compliance Risk” section, as part of the bank’s Risk Management Structure.

In summary, we can conclude that Shari’ah governance is taken seriously by the management of the bank, and proper mechanisms are in place to ensure the bank’s operation are conducted in line with the Shari’ah requirements.

7. CONCLUSION AND DIRECTION FOR FUTURE RESEARCH

The findings reveal that there are four distinct consumer segments from the perspective of key market players, namely the religious conviction group; religious conviction and economic rationality group; ethical observance group and economic rationality group. Theoretically, the current study identifies that the closest possible market segmentation basis for these groups are: (1) values (psychographic segmentation), which emphasises values, opinions and attitudes, activities and lifestyles (Peter and Olson, 2008; Keller, 2000), and (2) benefit sought from product or product attributes. These groups bear a resemblance to either one or more of the suggested groups, as proposed by Rusnah et al. (2009).

Thus, although the study’s data was collected from a management context, the findings provide an interesting theoretical insight into consumer segmentation for IBIs as compared to the segmentation in conventional banking. Unlike the criticism
that surrounds the traditional or conventional banking segmentation, which was based upon a single indicator or ‘a priori’ approach, the current study suggests that the initial dimensions of consumer segmentation for IBIs could be based upon a combination of approaches: values (a priori: religion/religiosity) and benefit sought (post-hoc).

As for the managerial implication, the study’s initial finding could serve as an aid to guide product/brand positioning strategies for IBIs when designing their marketing communication. For example, if the target group is ‘religious conviction’, then the message that should be emphasised is the Sharī’ah credibility of the services provider in ensuring the Sharī’ah compliance of services and products. In the case of the ‘religious conviction and economic rationality’ group, both the Sharī’ah compliance and economic criteria (such as pricing, returns and services quality) are relevant in their purchasing decision and, thus, should be conveyed to them. Ethical issues, such as fairness and justice for all, socially responsible behaviour, accountability and transparency, are among the criteria that may be considered by the ‘ethical observance’ group in deciding whether to purchase Islamic banking products and services and, therefore, these issues should be highlighted to this group of consumers. For the ‘economic rationality’ group, the only motive in purchasing Islamic banking products and services lies in the economic criteria (such as pricing, returns and services quality), and these attributes should be well communicated to this target group. Furthermore, the overlapping dimension of religious conviction and economic rationality is interesting, as conceptually these overlaps are common in segmentation (Wind, 1978) and to be expected, particularly in the IBIs (Haron et al., 1994). The findings give marketers some insights into the potential of what may be a profitable segment within the industry.

The current study examines issues on the market segmentation of IBI consumers from the perspective of key market players. In future, studies may be conducted to examine these issues from the consumers’ perspective so that there will be an alignment between what is perceived by the providers of Islamic banking products and services and the consumers. The present study is exploratory in nature and, thus, a larger sample using robust quantitative analysis could be adopted in future studies to verify/strengthen these findings and for the purpose of generalisation.

Evaluating the actual practices adopted in the Sharī’ah compliance review process, we may conclude that proper Sharī’ah governance was in place and appropriate steps are being taken to ensure that these mechanisms work as intended. In addition,
the process was clearly elaborated and disclosed in the annual report of the bank. Although, the detailed process is not explained, we may conclude that what is being practiced by the bank under study is in line with what we have proposed in our framework.

The willingness and serious commitment from the top management are very critical in ensuring that an effective Sharī‘ah compliance review process takes place in a particular Islamic bank. In addition, it is vital for all parties in the industry, such as institutions offering Islamic financial services, the regulatory authorities, the relevant educational entities and the government to continue taking initiatives to improve the level of awareness amongst stakeholders and the public on the issue of Sharī‘ah compliance, as the awareness level is considered very low at present.

The present study adopted a case study examining the Sharī‘ah compliance process in an Islamic bank to evaluate the practicality of our proposed Sharī‘ah compliance framework. In future, focus group studies considering the relevant actors in Sharī‘ah governance mechanisms may be used to gauge better understanding of the compliancy process and the applicability and appropriateness of the proposed framework.
REFERENCES


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