

Integrating Quality Management, Creativity and Innovation in Islamic Banks

by

Gillian Rice, Ph.D.

Thunderbird, The American Graduate School of International Management

Email riceg@t-bird.edu

And

Essam Mahmoud, Ph.D.

Independent Consultant

Email essammah@hotmail.com

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ABSTRACT

Islamic banking transactions and organizations have been growing in the last decade in response to increasing demand. Simultaneously, however, Islamic banks face challenges from non-Islamic institutions because of the mergers of several institutions, inter-organizational collaboration, introduction of new products and services, improved services, and so on. Other contemporary challenges include continuous environmental change, the speed of change, the impact of the Internet and mobile banking, and the need for an international focus. To respond effectively to these challenges, Islamic financial institutions need to establish management systems that integrate quality management, creativity, and innovation. This paper presents a framework for such a management system and discusses its implementation.

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INTRODUCTION

It is difficult to obtain exact figures on the size of the Islamic financial sector. Without doubt, it is small in comparison to the conventional financial sector but it is experiencing strong growth. Iqbal and Mirakhor (1999) report that Islamic banks grew from an asset base of \$5 billion in 1985 to a level of over \$100 billion in the late nineties. The chairman of Dubai Islamic Bank and Emirati Minister for Financial Affairs, Mohammad Khalfan bin Kharbash, recently noted that the number of Islamic banks has grown from 34 institutions in 1983 to 250 today, operating and managing assets of \$200 billion (Phillips, 2001). The annual growth rate for Islamic financial institutions varies from 15 to 40 percent annually (Hamwi and Aylward, 1999). Yet, a comparison of the assets of all Islamic banks to HSBC, just one of the world's largest banks with assets of \$569 billion in 1999 (Azzam, 2000), demonstrates how small the Islamic sector remains on the world banking stage.

Nevertheless, Islamic banking is spreading and gaining acceptance in both Muslim and non-Muslim countries. In 1999, the Middle East alone had 12 top-tiered Islamic banks with total capital of about \$1.8 billion and assets of approximately \$18 billion. Bosnia Bank International became operational in March 2001, positioned as a regional Islamic bank for the Balkan area, with wholesale and retail services in Bosnia (Carvalho, 2001). Many of the Islamic banks are gaining strength and achieving profits. For example, Al Rajhi Banking and Investment Corporation posted a net profit in 1997 of \$347 million and return on capital of 25% (Hamwi and Aylward, 1999). Bank Al-Jazira, by far the smallest bank in the Saudi Islamic banking sector, grew profits 41 percent in 2000 (MEED, 2001).

Western banks have started establishing Islamic financing products, mostly in trade and other forms of short-term finance. Competitors include: Chase Manhattan, J.P. Morgan, Goldman Sachs, Commerzbank AG, Deutsche Bank AG, HSBC, Citicorp and Bankers Trust. Many of them are establishing independent financial institutions following Islamic law or Shari'ah. Citicorp set up an independent Islamic banking unit in Bahrain in 1996. Standard Chartered Bank Malaysia Bhd aims to develop its Islamic banking division into a total money management and financial provider within two to three years (The Star, May 17, 2001). A decade ago there were less than 10 Islamic mutual funds. Now there are over 90, according to a report by Wall (2001). Islamic financial Web sites, such as Lariba.com, Islamiq.com, ii-online.com and ihilal.com have also been launched.

Islamic banks offer financial instruments that are consistent with Islamic religious beliefs. According to Islamic law, the mode of finance should emphasize profit and loss sharing and prohibit fixed-returns. An Islamic bank is much like a conventional bank in that it is a full-service financial intermediary. Most of an Islamic bank's transactions take forms such as *mudaraba* and *musharaka*, which are equity-like contracts, and the debt-like contracts of *murabaha*, *ijara*, *ijara wa iktina* and *istisna* (for further details, see El-Gamal, 2000; Hamwi and Aylward, 1999). Islamic banks are engaged in trade finance

investment, leasing projects, private banking, investment in real estate, and financial engineering (Wilson, 1999).

Islamic banks have Shari'ah Advisory Boards that advise management on all products and processes that should adhere to Islamic law (Shari'ah). Since the Shari'ah opinions on many financial transactions are not technically codified in all Muslims countries, Islamic banks have depended on their own Shari'ah experts. Each Islamic bank selects a Shari'ah board. It should be noted that Shari'ah boards of various Islamic banks very often do not see matters from the same angle, and offer advice with varying degrees of differences.

Islamic financial institutions are operating in an environment that is becoming increasingly sophisticated. Malaysia is developing an Islamic capital market using specially designed interest-free bonds and securities, to operate side by side with the conventional capital markets, and regulated by the Central Bank of Malaysia. Close collaboration with Bahrain, another country with considerable experience in Islamic finance, is intended to lead to the establishment of an International Islamic Money Market (The Malaysian National News Agency, May 18, 2001).

Given the dynamic and challenging environment of Islamic financial institutions, the objective of this paper is to discuss how a managerial framework that integrates quality management and innovation can be implemented. The goal is to assist these institutions to be more innovative and therefore more competitive and successful. In the next section, the importance of innovation is discussed. Then, the framework is presented and explained in depth, highlighting action steps that can be taken by executives in the Islamic finance field. The paper concludes with a discussion how innovative Islamic financial institutions can respond and are responding to some current market developments.

THE IMPORTANCE OF INNOVATION

Choi and Valikangas (2001) argue that total quality management (TQM) is an important tool, but it cannot create sustainable value unless coupled with more innovative and forward-looking strategies. Hamel and Prahalad (1994) also declared that by the year 2000, quality would no longer be a competitive differentiator; it would simply be the price of market entry. Certainly, in the Islamic finance arena, the changing external environment for organizations, characterized by strong competition especially from huge conventional banks moving into Islamic finance, technological changes such as the introduction of online services, and pressures for globalization demands a focus on creativity and innovation. Creativity is the thinking process that helps to generate ideas (Majaro, 1992). Innovation, as distinct from creativity, is concerned with the intentional and applied adoption of new ideas and therefore is focused on the practical application of ideas (Forrester, 2000). Hamel (1999) argues that innovation is the only way organizations can create new wealth. In a review of the evolution of TQM, Gehani (1993) describes innovation as the "next quality frontier" where firms focus on innovation-based value-adding activities.

Many studies have demonstrated a positive and direct relationship between innovation and performance (see for example: Damanpour et al., 1989; Khan and Manopichetwattana, 1989). In the banking industry, research on commercial banks in the USA suggests that both innovation speed and innovation magnitude have beneficial effects on an institution's financial performance (Gopalakrishnan, 2000). Innovation

speed indicates a firm's quickness to adopt a product or a process relative to its competitors within the industry (Rogers 1983). Innovation magnitude represents the number of innovations that an organization adopts from an available pool of innovations (Dewar and Dutton 1986) and therefore reflects the breadth of innovation in the firm (Gopalakrishnan, 2000).

A focus on innovation means knowledge-based competition. This implies the development of firm-specific resources and capabilities that are difficult for competitors to imitate (Chen, 1997). These resources and capabilities can be grounded in the implementation of total quality management approaches.

A FRAMEWORK TO INTEGRATE TQM AND INNOVATION

Figure One describes the components of a framework that can be used to guide managerial improvements and strategy to implement a work environment that should result in the introduction of more innovative products, services and processes. Total quality management (TQM) is based on the general principles of continuous improvement and the involvement of all employees. The involvement of employees occurs through a system of quality facilitators who work with cross-functional teams to enhance work processes in order to improve service to both the organization's internal and external customers. Top management's leadership and encouragement of the effort, based on an awareness of the benefits of TQM, is crucial. Top managers must clearly and publicly endorse TQM, must be fully committed and have an understanding of each of the phases of implementing TQM. If necessary, they must undergo training of TQM principles. Indeed, training is a key part of the process and involves all employees. Communication must be open vertically, between management and staff, and horizontally, between the different functions in an organization. Measurement of results in order to monitor and improve performance is another component of TQM, as are rewards and recognition of employees that do well.

The environment created through the implementation of TQM, as discussed in the following sections of the paper, can be further enhanced to encourage employees' creativity, and thus, organizational innovation. The speed and magnitude of innovation contributes to innovation performance. When innovation is specifically directed towards customer needs, in the context of the organization's strategic intent and competitive advantages, an increase in customer capital can result.

Stewart (1999) defines customer capital as the value of an organization's relationships with the people with whom it does business. It involves three components: (1) depth of penetration of a customer's business, which may also be referred to as "share of customer," (2) the width of coverage of customers in the market place, or "market share" of the segment in which the organization operates, and (3) the attachment or "loyalty" customers have for the organization and its brand. An organization which implements TQM is careful to gather feedback and market intelligence on the amount of customer capital it has. Customer capital is reflected in several variables that can be measured, such as the rate of customer acquisition, the rate of customer retention, the amount of cross-selling achieved, the number of complaint letters received, the number of customer referrals obtained, and customer satisfaction scores. Thus, Figure One shows feedback lines from "Customer Capital" to the box representing the "Fundamentals of TQM."

In the following sections, this integrated framework is discussed in the context of Islamic financial institutions and specific recommendations are provided for executives.

TOP MANAGEMENT, QUALITY FACILITATORS, AND INNOVATION

In an environment where TQM is implemented and the goal is to become more innovative, top managers should adopt a consultative style. This style is an interactive type of leadership where the manager gets opinions before deciding on the plan presented (Flamholtz, 1990). This is in contrast to a coercive style of management that is characterized by an authoritative manner and little input is permitted from subordinates. In organizations characterized by coercive management, a high level of negative energy grows. People use their creativity to work against autocratic leaders or in spite of them; they refuse to contribute positively to the organization (Wheatley, 1999). A consultative management approach, however, creates a work environment where sharing knowledge is truly valued. This can operate through the quality facilitators who are the links between management, staff and other employees, and who often represent cross-functional work teams.

Thus, to achieve an environment that can nurture the creativity and originality so vital for success in the Islamic finance sector, senior executives should consult with others in the organization. They should do this at various levels and in various functions, explain why change is occurring, and obtain input on ways their particular firm could achieve a more innovative environment. Two-way communication is crucial. Atif Abdulmalik, the chief executive of Bahrain's First Islamic Investment Bank, emphasizes the importance of participatory management approaches in Islamic banks (New Horizon 2000).

The Shari'ah advisory board plays a unique role in the management of Islamic financial institutions. Within the context of TQM, it is important for Shari'ah boards to play an integral role in the banks which they advise. The relationship should not merely be an arm's length advisory role, but one where genuine education of employees and exchange of ideas occurs in order to stimulate innovation in an Islamically acceptable context. Close interaction between Shari'ah experts and the management team will mean that both groups will be more familiar with suitable innovative strategies for the Islamic financial marketplace. Innovative financial product solutions cannot be developed by staff who have inadequate knowledge of Islamic principles. Collaboration and alliances among the Shari'ah boards of several Islamic banks can also be helpful in furthering the expansion of new products for the Islamic sector. For example, in Saudi Arabia, there is the prospect of mortgage products being launched for the first time and government and banking officials are considering exactly how mortgages might be structured to comply with Islamic law (MEED, 2001b).

In order to grow and share knowledge, Islamic financial institutions also need to develop trust-based environments. When team or organizational members trust one another, this facilitates their working toward team or organizational goals rather than toward narrow, individual or functional goals or agendas (Madhavan and Grover, 1998).

To nurture a trust-based environment, top management should first build fairness into its organizational practices. Unfortunately, in many organizations, nepotism is still common and fosters a lack of trust. In the Arabian Gulf region in particular, executives should consider how guest workers from numerous countries can be fully integrated into a work environment characterized by trust. Management should try to close the trust gap

between the national employees and guest workers through careful mentoring and leadership. Shaw et al. (2000) studied a commercial bank in Dubai to investigate the job satisfaction of the bank's employees and their frustration and their intention to quit. The results demonstrated the different conditions under which guest workers and national personnel work. The researchers illustrated the importance of the role that management should play in order to manage their workforces better. Managers need a clear understanding of the role that personality plays in how individuals approach work, behave in the workplace, and react to different situations in the employment relationship. Cultural barriers and differences are also important in this context.

COMMUNICATION AND INNOVATION

Johnson et al. (2001) illustrated that the communication and participation of individuals are critical factors in innovation. In particular, enhanced communication quality results in a broader awareness of the implications of an innovation, and as a result, facilitates further involvement by employees. In a meta-analysis of 782 studies, Damanpour (1991) found a positive association between internal communication (the extent of cross-functional communication and coordination) and organizational innovativeness. Mechanisms for sharing and integrating ideas are frequent meetings, face-to-face contact in both horizontal and vertical relationships and units or departments sharing decisions (Han et al., 1998). Madhavan and Grover (1998) refer to these mechanisms as the "richness of personal interaction."

McDermott (1999) emphasizes that it is important to develop existing knowledge communities within an organization without formalizing them. The organization should nurture and support communities that already share knowledge about key topics. Wenger and Snyder (2000) define "communities of practice" as groups of people informally bound together by shared expertise and passion for a joint enterprise. They often emerge of their own accord when people find themselves drawn together by a force that is both social and professional (Stewart, 1999). If groupings are too formalized, learning communities can become bureaucratic structures and ideas are stifled in the documentation and approval processes. Unlike project groups and teams, communities of practice have no specific deliverable such as a report or a new product. Thus, informal approaches may be better than formal ones in inducing innovation because of the opportunity for serendipity.

Therefore, management should facilitate the emergence of communities of practice within Islamic financial institutions. Such communities could be permitted the usage of organizational facilities and resources for their activities. They may focus on learning about Islamic Shari'ah with respect to financial issues, Islamic economics, the role of Islamic financial institutions in economic development and other socio-economic activities and outreach, or on specific customer sectors like trade, retail, construction, or venture capital.

Senior managers should strive to develop an organization that engenders healthy relationships among its employees: relationships where people listen and speak honestly to one another, work well with diverse members, are trusted with information and honor collaborative efforts. In such an environment, the positive energy that flows through the organization results in increases in productivity, personal satisfaction and creativity (Wheatley, 1999).

TRAINING AND INNOVATION

Knowledge, an essential basis for innovation, is created only by individuals. An organization cannot create knowledge by itself. An organization learns by the learning of its members and by ingesting new members who have knowledge the organization previously did not have (Simon, 1991). A problem exists in Islamic banks because of insufficient training of their personnel (Kahf, 1999). The growth of Islamic banks has happened too rapidly to allow time for adequate personnel training. Also, many Islamic banks recruit their employees from conventional banks, and these employees have sometimes experienced problems in understanding Shari'ah rulings, implementing the new modes of financing, and in advising bank customers on the characteristics of different types of Islamic transactions and services. This problem has negative effects on the creativity of Islamic banks. Although Islamic banks have been able to grow quickly in the last three decades, their growth has been accompanied by few innovations in the banking services offered to their customers. The lack of knowledge has also contributed to a weak relationship, in most instances, between Islamic banks and their central banks. This is partly due to the inability of the newly appointed personnel of Islamic banks to explain adequately the special characteristics of their transactions to central bank staff.

Von Krogh (1998) defines two types of responsibilities that are important: (1) the responsibility to acquire expertise (implying that innovation would follow) and (2) the responsibility to help those who need it as one's expertise grows (that is, the sharing of ideas by mentoring others in the organization). Therefore, what the organization can do is support creative individuals or provide contexts for them to create knowledge (Takeuchi, 1997). Indeed, the training of employees is a fundamental principle of TQM. Training can take many forms and the quality facilitators should adopt leadership roles with respect to training activities. One example is in-organizational training in the form of regular seminars or workshops designed to meet the specific needs of an institution. Particular attention should be paid to cultural adaptation to the workforce and to an Islamic perspective. Employees should learn about Islamic principles and ethics. Other examples of training approaches include supporting, through financial incentives or time-release, the continuing education of employees at colleges and universities. Senior managers should encourage employee initiative and develop programs where the employees choose what to learn and when to learn. This self-directed approach has been successful at the Canadian Imperial Bank of Commerce (Stewart, 1999). Mentoring programs and employee rotation also expand skills and sharing of knowledge.

MEASUREMENT, REWARDS AND RECOGNITION, AND INNOVATION

Von Krogh (1998) proposes that an incentive system should reward the contribution to knowledge creation in the organization, including participation in mentoring programs. An incentive system depends on measurement that in turn should be based on internal and external benchmarks. Internal benchmarks are based on the institution's historical performance and future plans with respect to innovative activity (for example, the speed and magnitude of innovation) and external benchmarks are based on competitors' achievements. Objectives should be provided for each employee and/or employee team.

A culturally-adapted rewards and recognition system should be implemented that motivates and encourages employees but also challenges them.

Gopalakrishnan (2000) suggests that one way of creating a culture of innovativeness is to adopt an extensive number of innovations. His research results implied that this would be most appropriate if return on assets and short-term profitability were not of immediate concern, and if the organization had access to abundant resources. An organization that implements such a strategy will find that its employees are increasingly confident about the firm's ability to adapt to changing circumstances, which in turn will lead these managers to initiate innovations quickly - thus improving the bottom line.

INNOVATION THEMES AND EXAMPLES

Based on their research study of over 200 business strategies over a 20 year time period, Choi and Valikangas (2001) identified ten innovation themes that have proven useful over time and across industries. Some of these innovation themes are especially relevant to Islamic financial institutions. Examples are consolidation, digital delivery, deep connections with customers, and mass marketing.

Consolidation of various competitors into a bigger, more powerful organization could help purely Islamic institutions achieve the scale necessary to compete globally against the Islamic divisions of conventional banks. The Islamic mode of finance is a relatively recent innovation in the world's banking industry and is beginning to receive widespread recognition. According to Ahmad Tajudin, managing director of Bank Islam Malaysia Bhd., cooperation among Islamic banking institutions worldwide should be closer so that the sector's operations and transaction systems would be internationally recognized (The Malaysian National News Agency, May 30, 2001). At the time of writing, discussions are proceeding regarding a merger between The International Investor (a Kuwaiti institution) and Saudi Arabia's Dallah al-Baraka group to create one of the largest Islamic banks in the Arab world (Reuters English News Service, 2001). Abu Dhabi Islamic Bank, Islamic Development Bank, Dubai Islamic Bank and Bank Islam Malaysia Bhd. are all partners in Bosnia Bank International.

An alternative to consolidation is to focus on niche segments and to do so by developing deep connections with customers. When banks innovate to provide new products, these are easily and quickly copied by competitors. For example, in March 2001, HSBC Bank Malaysia Bhd launched Malaysia's first Islamic charge card, through which transactions are done according to Islamic principles: no interest will be charged but late payments would attract a flat fee (The Star, March 6, 2001). In May 2001, Bahrain's ABC Islamic Bank announced that it will launch a credit card conforming to Islamic Shari'ah; this product will apply the classic murabaha practice, under which a borrower has to pay an extra amount agreed in advance. Undoubtedly, these products will soon be imitated.

Therefore, the quality of service is often the differentiating factor between competing banks, Islamic or otherwise (Tang and Zairi 1998). Innovations should also focus on the customer experience to search for ways to create deep connections between the institution and the customer. This means encouraging emotional attachments to the institution's services, people and brands that go beyond the mere functional value of financial products. Service quality improvements are often part of TQM initiatives. A TQM perspective means that all employees are trained to focus on the customer. A team of

employees led by a quality facilitator could be responsible for diagramming and studying each of a customer's contact points (experiences) with the institution and considering how each contact point could be improved in some way. Thus, the institution could gain a competitive advantage based on superior customer relationships. This would build the customer capital referred to in Figure One. Such customer contact point innovations might occur in the areas of employee-customer protocols, customization, methods of information delivery, speed of information delivery, or the development of a breakthrough notion that revolutionizes a customer's experience with the organization.

Digital delivery is another innovation theme. Online banking is expected to grow apace and for the Islamic financial sector there is no exception. Although the penetration of the Internet is lower in most Muslim countries than in the West, it will become an indispensable platform for banking (MEED, 2001a).

Online banking is a tool to distribute Islamic financial services to the mass retail market. The move from an elite market to a mass market is another of Choi and Valikangas' (2001) innovation themes. iHilal, based in Dubai, targets millions of Muslims living in Europe and North America who previously had no access to a "one-stop shop" where they could compare Islamic financial products. There is a growing demand for Islamic investment services from middle-income Muslims in the West, according to Hasnita Hashim, a founder of Islamiq.com (Wall, 2001). To date, Islamic banks have been slow to respond to the needs of mainstream Muslim investors; international banks such as BNP Paribas, HSBC and Citicorp have specifically targeted the Middle East's high net worth individuals with Islamic private banking products (Dean, 2001). Bank regulation in the West can be a hurdle; nevertheless, the agreement between Freddie Mac (a corporation to support home ownership) and American Finance House - Lariba in the USA demonstrates that barriers can be overcome (PR Newswire, 2001; for details of American Finance House, see Abdul Rahman, 1994). Markets can be expanded even further to include non-Muslims. In Malaysia, 60 percent of the clients of the Islamic banking system are non-Muslims (The Malaysian National News Agency, 2001). In the USA, Islamic financing might be perceived as an innovative community-based banking approach (Abdul Rahman, 1994).

CONCLUSIONS

The framework proposed for the integration of TQM, creativity and innovation should be tested in selected Islamic financial institutions. This could be done using a case study approach. Every organizational environment is different, even within one culture. Therefore, a contingency approach is best (Lawler, 1994). A preliminary step is to understand the firm's particular environment through employee interviews, focus group surveys and observation. An evaluation of the external environment should also be conducted. This process will identify the most relevant challenges and possible barriers to change. Using the suggested framework as a basis, solutions tailored to the organization can be implemented. It should be noted that an important key to the growth of customer capital in the Islamic financial industry is knowledge-based management as well as a focus on the innovation of services and customer-related processes that are less easily imitated.

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