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ANALYSIS OF THE DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL BANKING

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Abstract: *The Islamic banking sets a higher standard for investments and promotes greater accountability and risk mitigation by emphasizing the need for transactions to be supported by activities related to genuine trade and business. The end of 1970 has established several Islamic banking systems throughout the Muslim world. In 1974, the Organization of Islamic Countries (OIC) had established the first Islamic bank called the Islamic Development Bank or IDB. The basic business model of this bank was to provide financial assistance and support on profit sharing. A big step towards progression was brought by the first private commercial bank was launched in Dubai in 1975.*

Keywords: Islamic banking, Conventional banking, banking analysis.

1 INTRODUCTION

Islamic markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment. 'These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.' [Abbas, 1989].

Financial institutions have a great deal of flexibility, creativity and choice in the creation of Islamic finance products using various Islamic finance concepts such as mudharabah (profit sharing), musharakah (partnership) and ijarah (leasing). Exploring more into the concepts murabaha is the sale on the profit mutually agreed by both parties and is actually a request, which is set by the client to the Islamic bank to leverage certain services or goods for him, and in return, the bank provides a definite profit to the client over the cost of the services or goods; ijarah is the contract or the legal right against a lawful or a specified return for the effort or work and for the benefits that are about to be taken and musawamah is the regular or general sales of goods in which the price of the goods or commodity is bargained between the buyer and the seller.

This set of rules made the Islamic finance grow considerably since it first started in the 1970s. Following this set of rules it will be reaching USD750 billion and expecting to hit USD1 trillion by 2010 this showing how good this strategy is. Also according to the Asian Banker Research Group 'the world's 100 largest Islamic banks have set an annual asset growth rate of 26.7% and the global Islamic finance industry is experiencing average growth of 15-20% annually.' [Mohsin, 1987]

2 CONTRAST BETWEEN ISLAMIC AND CONVENTIONAL BANKING

Tab. 1 The following table shows the contrast between the two systems. [Archer and Karim, 2007]

Islamic Banking	Conventional Banking
• No interest and interest-based transactions. • Equity shares and ownership of real assets in investment projects. • Banks do not create or destroy money. • No asset-liability mismatch, liquid. • Money multiplier depends on the savings ratio, very low. • No speculation, no debt trading. • Profit rate determined by real economy, no price distortion. • Stable economic growth, predictable. • No systemic bankruptcies, no bailouts.	• Interest and interest-based transactions. • Deposits and loans. • Banks create and destroy money. • Asset-liability mismatch, illiquid. • Money multiplier depends on reserve ratio, very high; infinite with securitisation. • Speculation, a casino, debt trading. • Interest rate not related to real economy, high price distortion. • Highly cyclical: booms and busts, uncertainties, unpredictable growth. • Massive bankruptcies, contagion, bailouts

Islamic banks operate by respecting the society term meanings as opposed to conventional banks that are operating and perform all those functions that are expected from a financial institution. The Islamic Banks are looking to provide the type of service required to run the economy smoothly taking into consideration the philosophy and operations are different.

Any financial system is expected to assist in running the economy by providing the following services grouped in two headings.

First; Savings mobilization from savers to entrepreneurs and

Second; Provision of general utility services including transfer of funds, facilitation in international trades, consultancy services, safekeeping of valuables, and any other service for a fee.

There is no restriction on provision of such services by Islamic Banks as for the service is not against the Sharia. However there exists difference in mechanism of funds mobilization from savers to entrepreneurs as described following. Savings mobilization consists of two phases' i.e. accepting deposits and extending financing and investments.

3 BANKING PRODUCTS

As it has already been discussed in previous sections that Islamic Banking is compliant to Shariah financing, there are five principles that differentiate Islamic banking from conventional finance. They are prohibition on riba (interest or excessive interest),prohibition on gharar (risk or uncertainty, which is generally defined as speculation)prohibition on financing for illicit sectors (such as weapons, drugs, alcohol, and pork). Profit - and loss-sharing principle and the principle that all transactions have to be backed by a real economic transaction that involves a tangible asset.

While some of the products offered by Islamic banks are the same as in conventional banks (demand deposits) and others are structured in similar ways as conventional products (leasing products), there is a strong element of risk-sharing in Islamic banking.

Islamic banks have higher loan-deposit ratios, higher cost-income ratios, higher overhead costs, lower non-performing loans and higher capital-asset ratios than conventional banks. We can compare Islamic and conventional banks, while only controlling for country-year specific effects, but not for other bank-level characteristics. Islamic banks show higher intermediation efficiency, lower cost efficiency, lower non-performing loans and higher capitalization if we do not consider account differences in size and asset structure.

Conventional banks offer the facility of overdrawing from account of the customer on interest. One of them is the use of a credit card limit and overdrawing the limit set by the bank. Credit card provides dual facility to customer including financing as well as facility of plastic money whereby customer can meet his requirement without carrying cash.

As for facility of financing is concerned that is not offered by Islamic banks except in the form of Murabaha (which means IFI shall deliver the desired commodity and not the cash) however facility to shop/meet requirement is provided through debit card whereby a customer can use his card if his account carries credit balance. Under conventional banking a customer is charged with interest once the facility availed however under Murabaha only profit is due when the commodity is delivered to the customer.

Furthermore in case of default customer is charged with further interest for the extra period under conventional system however extra charging is not allowed under Murabaha. Third under conventional system customer can avail the opportunity of rescheduling by entering into a new agreement to pay interest for extended period, which is not the case under Murabaha.

Islamic Banks can claim only the original receivable amount agreed in initial contract. Another practical issue under Murabaha is how to deal with intentional defaulters. Different options are lying with Islamic Banks including to blacklist the defaulter for any further financing facility, to stipulate in the contract that in case of default all installments will be due at once, to stipulate in the contract a penalty shall be imposed but the same shall not form income of IFIs rather it will go in charity (Usmani, 2002).

4 BORROWING

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Short term and medium term loans are provided to customer to meet working capital requirements of firm by conventional banks. Working capital is required by firms to invest in inventories and accounts receivables and meet the expenses. As for inventory investment is concerned that is provided by Islamic banks through Murabaha. As for meeting of day-to-day expenses of business is concerned financing is provided through participation term certificates where by profit of a certain period (e.g. quarter, six month, one year) is shared by IFIs on prorate basis. However financing through participation term certificates is not as easy as a short-term loan from conventional bank due to risk involved for IFIs in the transaction. Firm seeking short-term facility from IFIs has to prove the viability of the project/business to the satisfaction of investor .For meeting the working capital requirements of non-profit organizations to date there is no arrangement under Islamic financial system. Personal consumption loans are also not issued by IFIs however any individual of sound financial position can acquire anything for his personal use under Murabaha financing whereby a certain percentage of profit is added on cost by IFIs. Murabaha financing is very useful for short to medium term financial requirements of business/non-profit organizations and individuals.

Again, Medium to long-term loans are provided for purchase or building of fixed assets by firms to expand or replace the existing assets. Under Islamic financial system requirement of firms and individuals are fulfilled through Murabaha, Bai Muajjal and Istasna.

Another financing option for long-term financing is profit sharing under Musharaka and Mudaraba (discussed in appendix B). Although financing under Murabaha, Bai Muajjal and Istasna is very much look like conventional loans with the only difference of provision of asset and not cash to client however differences exist in the contracts that alter the nature of risks and returns. Financing under Musharaka and Mudaraba is challenging for Islamic Banks and firms as well. Under Sharia based financing schemes firms have to prove the viability/profitability of the project/business to the satisfaction of Islamic Banks to get the finance because risk of losing the amount is involved.

5 MANAGEMENT OF RISKS

There are distinctive natures of risks faced in Islamic Banking separates them from conventional banking. Firstly, Islamic banks are backed by assets and Islamic banks can not deal in documents. All financing provided by Islamic banks results in the creation of assets. As Islamic banking is based on an asset building nature, it results in productive economic activities and thus, it does not result in inflation. Islamic banks need to comply with both conventional regulatory standards along with Shariah standards. This dual check covers the legal risk as there is a double check on money laundering and other fraudulent activities. The Shariah Supervisory Board that has influential religious scholars ensures Shariah compliance. The referral strength of these scholars increases the acceptance of Islamic banking to general public. [Shaikh & Jalbani, 2009]

Islamic banks are not merely interest-free. This is a necessary attribute, not a sufficient one. Islamic banking transactions need to avoid other elements of fraud, deceit and uncertainty. Islamic banking transactions are gharar-free (Gharar is an element of uncertainty about the product, price and other elements in a contract). Gharar-free transactions ensure mutual benefits of both parties; also spread the risks of both parties by making each other's obligations clear at the beginning.

Clean borrowing is prohibited in Islamic banking. Islamic banks provide financing only to create assets. Islamic banks will not offer credit cards, personal loans and running finance/ overdraft like the conventional banks. Islamic banks thus can restrict themselves to asset-backed financing and cannot provide need-based loans, short term financing or debt swap finance options.

Islamic banks face risks that are complex and difficult to mitigate. Unlike the conventional banking system, given the trading-based instruments and equity financing, there are significant market risks along with credit risks in Islamic banking.

Risks intermingle and change from one kind to another at different stages of a transaction. As an example during the transaction of a 'salam' (in this types of contract, the bank pays in advance for buying specific assets that the seller will supply on a pre-agreed date) contract, the bank is exposed to credit risk and at the conclusion of the contract, it is exposed to commodity price risk. Because of rigidities and deficiencies in infrastructure, institutions and instruments, the risks faced are magnified and difficult to mitigate. For example, there are objections to use of foreign exchange futures to hedge against foreign exchange risk and there are no shariah compatible securities for liquidity risk management in most jurisdictions.

Islamic financing is working within the Sharia framework following certain restrictions including following. First Islamic Banks cannot provide finance for an activity which is prohibited by Sharia (Islamic law) irrespective of its profitability and economic viability e.g. business of liquor, pork and pornography. Second Islamic Banks cannot lend any amount in cash for interest however need is fulfilled either through supply of required asset or through profit and loss sharing. Consequently certain financial needs of some sections of the society are ignored in financing including personal loans and working capital requirements of not for profit organizations. Third under Islamic financial system when financing is provided under profit and loss sharing although profit can be shared as per agreement between the parties involved however loss must be shared according to capital contribution/ownership. Islamic banking is not as foreign to business world as it is perceived by certain quarters. It is a business very much like conventional banking within certain restrictions imposed by Islamic law. All business needs are being fulfilled by Islamic Banks in efficient ways through Murabaha, Ijara, Bai Muajjal, Bai Salam, Istasna, Musharaka and Mudaraba.

Islamic banking is not a mere copy of conventional banks as perceived by certain Muslims. It has its own way of doing business and all operations are duly certified by Sharia experts ranging from Sharia advisor to Sharia boards and finally Islamic Fiqh Academy (IFA). Islamic banks are doing business in a nonconductive environment that makes operations challenging. Islamic Banks cannot claim interest on their balances with other banks, on mandatory cash reserve maintained with central bank, cannot invest in government securities, interest based bonds, cannot claim time value of money from defaulters, bear risks in sale and lease transactions, can only invest in Sharia compliant securities and not in all available equities and finally have to compete with conventional banks in deposit servicing as well as in financing.

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6 CONCLUSION

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