Islamic Banks versus Conventional Banking Systems

Hussam Musa, Zdenka Musová [1]

Abstract

Over the decade, Islamic banking has experienced global growth rates of 10-15 percent per annum, and has been moving into an increasing number of conventional financial systems at such a rapid pace that Islamic financial institutions are present today in over 51 countries. Despite this consistent growth, many supervisory authorities and finance practitioners remain unfamiliar with the process by which Islamic banks are introduced into a conventional system.

Keywords

Islamic Banking and Finance, Conventional banking.

1 Introduction

Islamic banking is steadily moving into an increasing number of conventional financial systems. It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom or Japan. Similarly, countries like India, the Kyrgyz Republic, and Syria have recently granted, or are considering granting, licenses for Islamic banking activities. Since the inception of Islamic banking about three decades ago, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975 to over 300 institutions operating in more than 75 countries (El Qorchi, 2005). Islamic banks are concentrated in the Middle East and Southeast Asia, but they are also present as niche players in Europe and the United States. Total assets of Islamic banks worldwide are estimated at about $250 billion, and are expected to grow by about 15 percent a year.

2 Islamic banks

An Islamic bank is an intermediary and trustee of other people´s money like any conventional bank with the possible difference that the payoff to all its depositors is a share in profit and loss in one form or the other. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with some ownership rights inherent within it. However, in practice, Islamic banks hardly look different from its conventional counterpart in terms of organisational set-up (Dar and Presley, 2000). Islamic banking has been defined in a number of ways. General Secretariat of the OIC´s definition goes like this: „An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic *Shariah* and to the banking of the receipt and payment of interest on any of its operations“ (Ali & Sarkar, 1995).

[1] Ing. Hussam Musa, PhD., Ing. Zdenka Musová, PhD., Ekonomicka fakulta, Univerzita Mateja Bela Tajovského 10, 975 90 Banská Bystrica, e-mail: hussam.musa@umb.sk, zdenka.musova@umb.sk
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Unlike conventional banks, however, Islamic banks offer PLS (profit loss sharing) accounts, among others, which do not guarantee a fixed certain return on investment deposits. This leads to a reluctance of deposit holders, who have no representation in the organisation, to use PLS accounts. The bank faces a similar problem on the assets side when it comes to investing on PLS. The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra, 1985), it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in the Islamic order. It is simply an accepted fact that there are sufficient Muslim investors and borrowers in both Islamic and non-Islamic countries to warrant the attention of traditional banks who seek to serve such clients and capture a potentially profitable slice of a still relatively untapped market. Just as interesting and useful for non-Islamic bankers are the lessons learned from the innovation and creativity applied in meeting Islamic criteria.

Some products are more Islamic and than others. The basic principle is that interest- usury or *Riba* used interchangeably – is prohibited on the principle of no pain no gain. Chat a „pure" Islamic banking seems to be structurally very similar to venture capital finance, non-recourse project finace or ordinary equity investment. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital. It involves investing but not lending and therefore on a systemic basis is similar to the German, Japanese and Spanish banking systems rather than the Brithish or American systems.

Just as in the process of converting interest into capital gains for tax purposes, early Islamic investors were content to enter into zero-coupon bonds or discounted Treasury bills and receive the interest foregone in the form of capital gains.

Beyond the question of interest or Riba lies an ethical issue. Islamic investments exclude Tobacco, alcohol, gaming and other „undesirable" sectors. Islamic investors, by and large, are motivated in their choice of investments by much the same criteria as their Western ethical counterparts. The search for acceptable investments is balanced by natural risk-aversion. Islamic borrowers, on the other hand, also demonstrate a reluctance to give away share in the profits of their enterprise. It is not therefore surprising that most of Islamic banking takes the form of one type of mark-up or other rather than profit-sharing.

An analysis of the products suggests that Islamic banking has six key features:

- free of interest,
- trade-related and there is a perceived "genuine" need for the funds,
- in its purest form, it is equity related,
- meant to avoid exploitation – no usury,
- invests ethically,
- there are retail and wholesale applications.

Under the current interpretation of the rules governing Islamic banking, Usury and Riba are regarded as synonymous. The prohibition is on interest and not just on usurious interest. In practice, there appears to be more emphasis on the prohibition and restructuring of interest than on the potentially exploitative aspect of financing.

2.1 Features of Islamic Banking

Prohibition of Interest: Prohibiting the receipt and payment of interest is the nucleus of the system, supported by other principles of Islamic doctrine advocating risk sharing, individuals rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking, but covers capital formation, capital markets, and all types of financial intermediation. Since prohibition on transactions based on interest payments is the most important factor rand is at the heart of the Islamic financial system, it will be unjust not to provide some light on it.

The basic philosophy underlying transation of money is that the one who is offering his money to another person has to decide whether:

a) He is lending money to him as a sympathetic act or,
b) He is lending money to the borrower, so that his principal may be saved or,
c) He is advancing his money to share the profit of the borrower.

Riba	Profit
1. When money is „charged“, its imposed positive and definite result is Riba	1. When money is used in productive activity (e.g., in trading), its uncertain result is profit.
2. By definition, Riba is the premium paid by the borrower to the lender along with principal amount as a condition for the loan.	2. By definition, profit is the difference between the revenue from production and the cost of production.
3. Riba is prefixed, and hence there is no uncertainty on the part of either the givers or the takers of loans.	3. Even if a sharing ratio is agreed in advance, profit is still uncertain, as its amount is not known until the activity is completed.
4. Riba con not be negative, it can at best be very low or zero.	4. Profit can be positive, zero or even negative.
5. From Islamic Shariah point of view, i tis Haram (prohibited).	5. From Islamic Shariah point of view, it is Halal (allowed).

Table 1: Comparison between Riba and Profit

Making Money from Money is not permissible – the basic points of difference between money and commodity are highlighted to justify this. Money (of the same denomination) is not held to be the subject matter of trade, like other commodities. Its use is restricted to its basic purpose i.e. to act as a medium of exchange and a measure of value.

If money is to be exchanged for money or it is borrowed, the payment on both sides must be equal, so that it is not used for trade in money itself. In short, money is treated as "potential" capital. It becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

Muslim scholars term interest as *Riba.* Under *Shariah*, *Riba* technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity (Chapra 1985). In other words, *Riba* is the predetermined return on the use of money. In the past there has been dispute about whether *Riba* refers to interest or usury, but there is now consensus among Muslim scholars that the term covers all forms of interest and not only “excessive” interest (Khan, 1995).

The most important characteristic of *Riba* is that it is the positive and definite result of money when changed. In other words, when money begets money, without being exchanged for goods or services, or without indulging in any productive activity, it is called *Riba.* The basic characteristics of Riba are:

- It must be related to loan;
- A prefixed amount of money to be paid when due;
- A time is fixed for the repayment; and
- All these elements for repayment are taken as conditions for loan.

Since Interest or Riba has emerged as the basic alternative for Profit, a comparison is justified between the two (Table-1).

Characteristics	Islamic Banking System	Conventional Banking System
Guiding principle	Guided by Quranic edicts, Hadeeth, Islamic ethics and Islamic laws.	Guided by profit motive alone, with no religious or ethical considerations.
Ethics of financing	Financing being asset-backed, and meant for productive use helps reduce the overall debt burden.	Debt burden arising out of excessive use of credit leads to bankruptcies, and waste of financial resources.
Liquidation Assets	An Investment Account Holder will have similar rights as shareholders.	Depositors are paid before the shareholders.
Involvement of risk & Equity financing	Equity financing is available to a project or venture that involves profit-and-loss sharing. Risk-sharing and profit sharing go together.	Commercial banks do not usually indulge in equity financing, only venture capital companies and investment banks do. Conventional banks carry much less risk, major part of the risks being transferred to the borrowers.
Return on Capital	Depends on productivity, idle money cannot earn any return. Money is not capital per se, only potential capital[2].	Even idle money in bank deposits earns returns.
Prohibition of Gharar (uncertainty)	The existence of uncertainty in a contract is prohibited because it requires the occurrence of an event which may not ultimately occur. "Full disclosure" by both parties is the norm in contracts. Derivatives trading e.g. options are considered as having elements of Gharar.	Trading and dealing in derivatives are widely considered as the main source of liquidity in the conventional financial, commodity and capital markets.
Profit and Loss Sharing	Most transactions are based on this variable returns, dependent on lenders' performance. Greater share of risks forces them to manage risks more professionally, to ensure better returns than conventional accounts. Depositors & investors have opportunity to earn higher returns than in conventional systems.	There is no relationship between bank performance and returns to the depositors or investors, who mostly enjoy a risk-free return. Conventional institutions mostly act as intermediaries between lenders & borrowers enjoying almost a risk-free spread.
Zakat	It has become one of the functions of the Islamic banks to collect and distribute *Zakat.*	Government Taxes perhaps serve the same purpose - mode and rate of charging are different, though.
Compounding or Interest on interest	The Islamic banks have no provision to charge any extra money from the defaulters.	It can charge additional money (compound rate of interest) in case of defaulters.
Money-Market Borrowing	For the Islamic banks, it is comparatively difficult to borrow money from the money market.	For commercial banks, borrowing from the money market is the main source of liquidity.
Developing expertise	Since it shares profit and loss, the Islamic banks pay greater attention to	Since income from the advances is fixed, it gives little importance to

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	developing project appraisal and evaluation systems.	developing expertise in project appraisal and evaluations.
Viability v/s credit-worthiness	The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.	The conventional banks give greater emphasis on credit-worthiness of the clients.
Relationship with Clients	The status of Islamic bank in relation to its clients is that of partners, investors and trader.	The status of a conventional bank, in relation to its clients, is that of creditor and debtors.
Capital Guarantee	No guarantee.	Built into the system.
Deposit insurance	None	An integral component

Table-2: Differences between Islamic & Conventional Banking

2.2 Key Islamic Financial techniques

Islamic banking and financial institutions have developed a wide rage of techniques which allow them to uphold the religious and legal principles while enabling them, at the same time, to offer viable financial products. The search is actually still going on to find newer techniques, and for variations based upon the existing ones to offer more attractive and useful instruments for the investors.

The financial vehicles of Islamic banking are numerous, but the most commonly used are those with reference to *wadi'ah* (safekeeping), *mudharabah* (profit sharing), *murabahah* (cost plus), *ijarah* (leasing), *qardh al-hassan* (benevolent loan), and *musharakah* (joint venture).

Wadi'ah (Safekeeping of funds) is of two categories: The first category is the current account which, as in conventional banking, gives no return to depositors. It is essentially an arrangement between depositors and banks which allows depositors to withdraw their money at any time but permits the banks to use depositors' money in pursuit of their banking operations. The second category is the *savings account*, which is also operated on *Wadi'ah* basis, but the bank may at its own discretion pay the depositors a positive return periodically in the form of *hiba* (gift), depending on its own profitability. In this case, the bank compensates depositors for the time-value of their money (essentially interest payment), but refers to it as *hiba* because there is no *a priori* guarantee of benefits. The Bahrain Islamic Bank, for example, offers depositors in saving accounts "an annual rate of return based on what Allah has granted in the form of profits" (www.bahisl.com).

Mudharabah (Profit sharing) can be defined as contract between at least two parties whereby one party, the financier (*sahib al-mal*), entrusts funds to another party, the entrepreneur (*mudarib*), to undertake an activity or venture. This type of contract is in contrast with musharaka. In arrangements based on *musharaks* there is also profit-sharing, but all parties have the right to participate in managerial decisions. In *mudaraba*, the financier is not allowed a role in management of the enterprise. Consequently, *mudaraba* represents a PLS (profit loss sharing) contract where the return to lenders is a specified share in the profit-loss outcome of the project in which they a stake, but no voice. In interest lending, the loan is not contingent on the profit or loss outcome, and is usually secured, so that the debtor has to repay the borrowed capital plus the fixed interest amount regardless of the resulting yield of the capital. Under *mudaraba*, the yield is not guaranteed in profit-sharing and financial losses are borne completely by the lender. The entrepreneur as such losses only the time and effort invested in the enterprise. This distribution effectivley treats human capital with equally financial capital.

Murabahah (Cost plus) is the Islamic verion of a just or equal profit where no one is hurt nor damaged during business transactions. It is one of the alternatives for a just monetary system. Murabahah is a cost-plus contract in which a client, wishing to purchase equipment or goods, requests the Islamic bank to purchase the Items and sell them to him at a cost plus declared profit. By this technique a party needing finance to purchase ceratain goods gets the necessary finance on a deferred payment basis. The finance provider does the purchasing of the required goods and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods even though the goods can delivered immediately. The need for finance of the one in need is thus met.

This financing technique is sometimes considred to be the same as interest, however, in theory, the mark-up is not in the nuture of a compensation for the time or deferred payment, even though the entire cost had to be incurred because the needy person did nt have at hand to make the purchase he wanted. Rather, the mark-up is for the service that the finance owner provides, namely, seeking out and locating and purchasing the required goods at the best price.

Ijara (Leasing), also known as *ijara waqtina* (lease and purchase), is a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the bank) bears all risks associated with ownership. The asset can be sold at a negotiated market price, effectively resulting in the sale of the *ijara* contract. The *ijara* contract can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life. Such contracts are also common in real estate transactions in the United States (El Qorchi, 2005). This system is disadvantageous for the buyer, who is unable to refinance a property he lives in at more favorable terms because it is registered in the name of the bank. Such a restriction if applied to the U.S. real estate market would have enormously negative economic consequences for the entire real estate sector.

Qardh al-hassan (Benevolent Loan) **-** This is a loan extended on a goodwill basis, wherein the debtor is required to repay only the amount borrowed. However, the debtor may, at his discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. Muslims consider this type of loan to be the only type that does not violate the prohibition on *riba* because none is promised or paid.

Musharakah (Joint Venture) is a form of an equity participation contract under which a bank and its client contribute jointly to finance a project. It is done through the issuance of "Participation Securities," commonly referred to as *sukuk* or Islamic bonds. The *sukuk* is becoming so lucrative that many banks are rushing to set up *shari'a*-compliant operation. With abundant oil-windfall revenues and with many mega infrastructure projects which are either underway or on the drawing board, the Gulf is fast becoming the logical choice of new and established players alike to set up shop.

3 Conclusion

Islamic banking has been making headway into an increasing number of Western countries. This is indeed a trend that is likely to carry on, as oil-exporting nations continue to accumulate wealth, GCC (Gulf Cooperation Council) and South East Asian Islamic financial markets develop further, and companies in Western nations keep on competing to attract international investors.

Nonetheless, despite the rapid growth of Islamic finance in the last few years, many supervisory authorities and practitioners are unfamiliar with the process by which Islamic banks are introduced into a conventional system. This paper has attempted to shed some light in this area, by identifying the main traits in the process, and by flagging some of the main challenges that countries will face as Islamic banking develops alongside conventional institutions.

As Islamic finance keeps expanding, the supervisory authorities will have to ensure that these new institutions become fully integrated with the rest of the financial system. The integration process will not only entail allowing Islamic institutions to operate, but also providing a comprehensive regulatory framework, as developing a supportive financial infrastructure.

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Summary

Islamské banky verzus tradičné bankové systémy

Príspevok sa zaoberá islamským bankovníctvom, ktoré v našich podmienkach nie je v povedomí verejnosti bežné. Pritom islamské banky v súčasnosti prudko prenikajú do európskeho (aj amerického) priestoru a ponúkajú klientom svoje špecifické produkty. Aj pre významné európske konvenčné finančné domy je islamské bankovníctvo veľkou výzvou. V silnom konkurenčnom prostredí si nemôžu dovoliť prehliadať stále sa rozširujúcu skupinu potencionálnych klientov, ktorí o služby islamského bankovníctva prejavujú záujem, otvárajú pre nich svoje pobočky fungujúce na princípoch islamského bankovníctva a snažia sa prenikať aj na príťažlivé trhy islamských krajín. V príspevku sú stručne uvedené základné princípy islamského bankovníctva, rozdiely medzi islamským a tradičným bankovníctvom, ako aj ním využívané vybrané finančné techniky.