A COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL BANKING SYSTEM

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Abstract - The guiding principle of Islamic Finance is to provide banking and financial services which are compliant with Islamic Law and the challenge is that to adjust historical and ancient standards with modern banking system. The philosophy of Islamic banking and finance is a set of theories and ideas related to its understanding. In this paper, the rules of Islamic law from which the very idea of Islamic banking has been drawn are explained. One of the objectives of Islamic Law is protection of wealth or property by prohibition of rate of interest as Riba. Although, both banks and customers are aware about prohibition of Riba, the customers generally think that the Islamic banks are not much different from conventional banks in the final outcome. This paper considers these two systems and their behavior and main differences are compared and clarified. The paper concludes that there is a strong reason behind prohibition of Riba, to make the financial system healthier. Increasing the share of equity and reduction of the share of debt can make the financial system more stable.

Keywords - Islamic Banking, Conventional Banking, Finance, Rate of Interest, Deposit

I. INTRODUCTION

Banking system is considered as very important for the development of an economy in all societies. Islamic banking was introduced in Islamic countries about four decades ago, and todays Islamic banking is growing in various parts of the world and has moved from a mere theoretical concept to a practical reality, therefore it is confronting some new challenges on the theory and practical issues. Islamic finance is currently practiced in more than 50 countries worldwide. In some Muslim countries, such as Bangladesh, Egypt, Indonesia, Jordan and Malaysia, Islamic banking co-exists with conventional banking and it is not limited to Islamic countries. These two finance system are operating in the same society and perform all those functions which are expected from a financial institution,however, the philosophy and operations are different, [1]. During the past four decades, however, Islamic banking has grown rapidly in terms of size and the number of players. What is Islamic banking and what are the differences between Islamic and conventional banking system? There is no standard way of defining what an Islamic bank is, but broadly speaking Islamic banking is a financial system which is consistent with principles of Islam and all its activities are according to the Islamic law. Islamic and conventional banking have many similarities and differences.

The main and critical difference between these two systems is Interest (Riba) which plays a key role in conventional banking system. From a theoretical perspective, Islamic banking is different from conventional banking because Riba is prohibited in Islam; a unique feature of Islamic banking is its profit-andloss sharing (PLS) paradigm, which is predominantly based on the mudarabah (profitsharing) and musharakah (joint venture) concepts of Islamic contracting. Under the PLS paradigm, the assets and liabilities of Islamic banks are integrated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with the depositors,[2]. After the introduction of Islamic banking system many issue were raised and discussed in this regards. Whether this system really follows the Islamic laws? Is interest free banking system better than the interest based banking system? And what are the differences and similarities between Islamic and conventional banking systems? This paper will analyze the operations and products of Islamic banking system in comparison with traditional conventional banks. The aim of this study is to address the perceptional issues by identifying the main similarities and main differences in both finance systems, figure 1 from Al Baraka Banking Group. It is shown that although Islamic banks have many products similar to those offered by conventional banks and have to face similar risk and market conditions, the two entities differ conceptually.

II. THE OVERSIGHT OF ISLAMIC LAWS

Like conventional banks, an Islamic bank is a financial intermediary that brings together the providers of capital with the users of capital but Islamic banking and conventional banking are very much dissimilar from each other, as conventional banking have interest based ideology. Unlike conventional banking system which operates based on country's banking laws and financial practices, it is done in accordance with the principles of Islam and a qualified board of Islamic scholars gives opinions on Islamic business contracts. Islamic banks and other financial institutions must comply with a variety of principles besides avoiding interest, (Riba). This system has some main rules which are accepted by all Islamic banks and institutions, such as: there must be real goods and assets, the honesty of sellers and customer, no speculation and no gambling and no

trade in activities or products which are not accepted in Islam such as alcohol and pornography. Although, all the Islamic banks and finance institutes agree with the previous issues there are several important and challenging issues available for discussion. Islamic banks are unique in that their activities are regulated by rules derived from Islamic laws and interpreting each principle is more difficult than you may think. Scholars spend their lifetimes learning all they can about the intent and past interpretation of sharia law, and they still often have differing opinions about it. One of the key differences between Islamic and conventional banking system is that Islamic banking is operating on the Islamic principles of finance. Here, the transactions are Riba free and avoid unethical practices, participate actively to achieve goals and objectives of Islamic Economy. On the other hand, conventional banks are operating on the man-made principles where the predetermined rate of interest is the core activity, [3].

III. RIBA-FREE TRANSACTIONS

In Arabic term Riba is a synonym for the term interest used in conventional banking system which is the core activity. Some Islamic banks regard seemingly use commercial rates of interest as something other than Riba and there have been many debates and attempts to discuss this issue. Some Islamic banks use interest rate as a reference point to calculate the required profit return by providing some services as long as the amount is certain, the return is fixed, the project is trade related and the bank has a genuine stake in the outcome. But, since, Islamic bank activities have to be trade based, involve actual trade, avoid prohibited practices and must be carried out with the utmost integrity and good faith, it becomes complicated. Some other Islamic Banks use Musharakah, to legitimize bank interest. Under a Musharakah one or more parties contribute to the financing and management of an Islamic project agreeing to share profits and losses at the outset. It means Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Mudarabah, Musharakah). In conventional banking system, interest is charged even in case the organization suffers losses by using bank's funds and therefore, it is not based on profit and loss sharing,[4].

IV. LIABILITY AND BUSINESS RISK

The concept of risk sharing is common to all Islamic finance transactions, whether equity, trade, or lease based. A few additional conditions make Islamic finance transactions even more equitable in many cases; such as the ruling that silent partners receive profit no more than is proportionate to their investment, while they may receive less; and that working partners may enjoy more pre-agreed profit than is proportionate to their investment, reflecting an emphasis on reward for work rather than reward for merely possessing capital, [5]. In Islamic banking this principle concerns the overarching concept of fairness, the idea that all parties concerned should both share in the risk and profit of any endeavor. To be entitled to a return, a provider of finance must either accept business risk or provide some service such as supplying an asset and from Islamic point of view, profit comes with liability. What this means is that one becomes entitled to profit only when one bears the liability, or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.

V. DEPOSITS

Fixed deposits (FDs) continue to be a banking staple for the financial industry. Conventional FDs are an extremely popular way to save and grow your money with as little risk as is possible. In conventional banking system, a Fixed Deposit (FD) is a special type of savings account that pays a certain amount of interest for a specific sum of money invested over a predetermined period of time. Though, a Fixed Deposit pays a significantly higher interest rate, thus allowing account holders the opportunity to earn more interest revenue.

The depositors from conventional banks receive profit from their investments in the form of predetermined interest rates irrespective of bank's performance. In Islamic banking, on the other hand, bank depositors receive their returns depending solely on the bank's performance. Unlike conventional banks, an Islamic bank acts as an intermediary between the depositor and the entrepreneur. Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development. Money received from depositors is invested by the Islamic banks in any Islamic based project to earn profit.

This profit is shared with the depositor in a predetermined ratio. In case of loss the depositor has to bear that, too. In other words, Islamic banks don't provide a guaranteed return as in case of conventional banks. As such, Islamic banks declare their profits on a monthly basis as part of their risk sharing scheme. Profits are shared on a predetermined profit sharing ratio that is agreed between the depositors and bank while losses are shared equally between all the participated parties.

This means that depositor's profit/loss will vary from month to month directly depending on how the bank performs. Thus any "Interest rates" that you might have seen on Islamic bank websites are actually reference rates based on the performance of the bank in previous periods, [6].

VI. FINANCING, LOANS AND INVESTMENTS

Although many products offered by Islamic banks are similar to those offered by conventional banks such as deposits, equity, etc. but the two entities differ conceptually and both have different business models. The major difference is that conventional banks cannot exist without dealing in interest and it plays a key role in conventional banks and some level of speculation takes place. Islamic banks prohibit interest-based dealings and Islamic finance is based on four core principles: prohibiting usury, avoiding speculation, avoiding gambling and investing ethically. Both types of institutions are providing financing to productive channels for reward. The difference lies in financing agreement. Conventional commercial banks give loans on a certain percentage interest as their return, they accept deposits and give out fixed percentage of compounded interest to depositors and invest the deposited money or give out loans, they offer credit cards and so on. Islamic banks earn their money from profit and loss sharing, trading, leasing, charging fees for services, etc. which are guided by the principles of Islamic law. They can charge profit on investments but not interest on loans. Conventional banks are offering loan for a fixed reward while Islamic banks cannot do that because they cannot charge interest. In conventional banking three types of loans are issued to clients including short term loans, overdrafts and long-term loans. Islamic banks cannot issue loans except interest free loans (Qarz e Hasna) for any requirement however they can do business by providing the required asset to client. In conventional banking system while disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods and services is made. In Islamic banking system, in the other hand, the execution of agreements for the exchange of goods and services is a must, while disbursing funds under Mudarabah or Salam contracts.

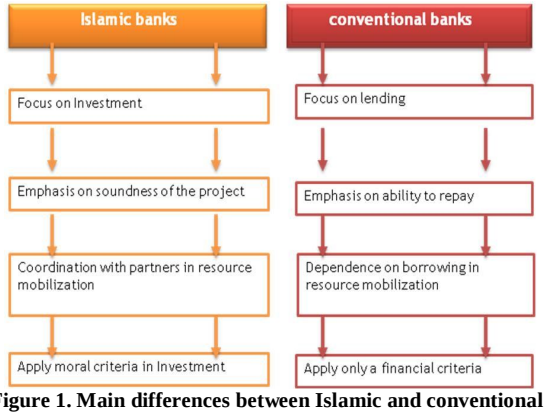


Figure 1. Main differences between Islamic and conventional banking Systems

CONCLUSION

The basic purpose for establishing an Islamic bank is to promote and encourage Islamic principles. It means, Islamic financing is working within the Islamic laws frame work following certain restrictions. First Islamic banks cannot provide finance for an activity which is prohibited by Islamic law, irrespective of its profitability and economic viability. Conventional banks, in the other hand, are profit-making organizations that generally aren't based on religious principles.Although the similarities between Islamic banking and conventional banking far outnumber the dissimilarities, because the basic principles of finance remain the same, but the two entities differ conceptually and both have different business models. One of the major differences is that conventional banks earn their money by charging interest and fees for services. It is based on a pure financial intermediation model, whereby banks mainly borrow from savers and then lend to enterprises or individuals. They make their profit from the margin between the borrowing and lending rates of interest. Islamic banks, in the other hand, earn their money by profit and loss sharing, trading, leasing, charging fees for services rendered, and using other Islamic contracts of exchange.

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