

DIFFERENCE BETWEEN ISLAMIC AND CONVENTIONAL BANKING

&

ISSUES RELATED TO ISLAMIC BANKING TERMS

Abstract:

This research paper discusses the conflict between Islamic banking and Conventional way of banking. In Conventional banking, profit is in the form of interest which is prohibited in Islam under the guidelines provided in the form of Quran and Shariah. This was irritating for the Muslims to make the bank transaction. To overcome this problem Islamic banking was introduced in 1976 for the first time in Indonesia. Islamic way of banking tends to follow the banking laws provided by Shariah. Islamic banking includes the terms: Morabaha, Modaraba, Musharika and Ijarah (leasing). In contrast to Conventional banking, in Islamic Banking depositors are actually sleeping partners with the bank. The bank invests the money of the depositor and shares the profit and loss with him.

Contents	
INTRODUCTION:.....	2
CONVENTIONAL BANKING:.....	2
Islamic Banking:.....	2
Literature Review:.....	3
Conventional Banking:.....	3
Interest:.....	3
Mortgages and Conventional Leases:.....	4
Islamic Banking:.....	7
MURABAHA:.....	7
Musharika:.....	8
Modaraba:.....	8
IJARAH/ISLAMIC LEASING:.....	9
Methodology:.....	10
Findings:.....	10
ISSUES IN MURABAHA:.....	10
Implementation issues:.....	11
RULES GOVERNING IJARAH.....	14
COMPARISON OF IJARA AND CONVENTIONAL LEASE:.....	14
Starting time for rental:.....	14
IJARAH AS A MODE OF FINANCING:.....	15
Conclusion:.....	16
References:.....	16

INTRODUCTION:

The main difference between Islamic and conventional banking is that Islamic teaching says that money itself has no intrinsic value, and forbids people from profiting by lending it, without accepting a level of risk – in other words, interest (known as "riba") cannot be charged.

To make money from money is prohibited – wealth can only be generated through legitimate trade and investment. Any gain relating to this trading are shared between the person providing the capital and the person providing the expertise.

CONVENTIONAL BANKING:

Banks play very important role in the economic life of a nation. The growth of the economy is dependent upon the soundness of its banking system. In Conventional banking there is fix ratio of profit and no concept of profit and loss sharing like Islamic Banking . In Conventional bank if we take any type of loan from bank than we have to pay interest on it which is also known as mark-up.

For example if we take the loan from the bank, car on lease and mortgage, we should have to pay interest on it which is not possible for us as Muslims.

Islamic Banking:

In Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (*Sharia*) and its practical application through the development of Islamic economics. Sharia prohibits the payment of fees for the renting of money (Riba) for specific terms, as well as investing in businesses that provide goods or services considered

contrary to its principles (Haraam). The Islamic financial system employs the concept of participation in the enterprise, utilizing the funds at risk on a profit-and- loss-sharing basis. The terms which are used in Islamic mode of finance are Morabaha, Musharika and Modaraba.

Literature Review:

In the process of research and analysis the literature on Islamic and conventional banking was reviewed and evaluated to find about both types of banking and terms related to Banking.

Conventional Banking:

The terms of Conventional banking are:

Interest:

Interest was defined by Rickett (1999) as "the payment made by borrower to lender for the money borrowed and is normally expressed as the rate percent per year".

From an Islamic point of view, Usmani (2000) elaborate interest definition as "a prefixed rate for use or borrowing of money". It is this 'prefixed rate', which is known as 'riba' in Islamic economics, which has been termed as 'something undesirable'.

There are two types of interest which exist:

Riba An Nasiyah; this is defined as excess, which results from predetermined interest which a lender receives over and above the principle the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. This is the main type of interest as it is directly mentioned in the Qur'an.

Riba Al Fadl; this is defined as excess compensation without any consideration resulting from sale of goods. (Usmani, 2000)

Mirakhor in(1995) defined Interest as a reward for savings: Muslim scholar responds that such payment could only be explained, from an economic position, if savings were used for investment to create additional capital and wealth. They argue that the answer to the question of whether there is an increase of wealth due to the savings depends on what he does with the money he saves. He may hoard it or use it to buy a bond without there being an increase of capital wealth created as a result of his savings. When an individual saves, his savings gives rise to creation of an asset or a debt, however, as a rule; he has no say to decide which it will be. According to the scholars, in the absence of parallel increase of new investment either a debt is created or an asset will change hands but there will be no rise to wealth. Therefore, the act of abstaining from consumption should not entitle anyone to a reward.

Mortgages and Conventional Leases:

Consumer Credit Code (2001) defines Mortgages and leases as an integral part of Conventional banking.

Mortgages:

A mortgage is an agreement between a borrower (you) and a financial institution (the bank). The bank agrees to lend you money to purchase property (normally a house) and you in return promise to repay the loan, with interest. If you are unable to repay the loan the bank is permitted to sell the property to recover the debt.

- Mortgagor: This is the borrower.
- Mortgagee: This is the bank.
- The Security: The property you are borrowing funds to purchase and the thing which the bank may sell if you are unable to repay the loan.

Lease:

An agreement where an owner of property permits another person to use that property, as if they owned it, for a specified period, upon the payment of a fee (rent) and subject to any special conditions that may be imposed.

- Lessor: The person who owns the property and is permitting you to use it for a specified purpose and time.
- Lessee: the person who is permitted to use property owned by another for a specified purpose and time.
- Term: The length of time that the lessee is entitled to remain in the property.

WHAT ARE THE DIFFERENCES?

	Do you have title?	What happens to the goods if I default?	Can I be sued?
Mortgage	No, the mortgagee has legal title, but your use of it will be unaffected unless you default on payments.	If you default on repayments, the mortgagee may claim the property and then sell it provided they have given you proper notice.	If the money obtained from the sale of goods does not cover the amount you owe, the mortgagee may pursue for the remainder of the debt. If you cannot pay it, they are entitled to take legal action.
Lease	No, the lessor retains title in the goods at all times.	The lessor may be entitled to enter on your land and reclaim the goods.	The lessor must be put into the same position they would have been had you carried out the contract. So they are entitled to sue for the amount of profit they were making

Islamic Banking:

M. Ishaq Bhatti and M. Mansoor Khan(1996-2001) found out that Islamic banking is one of the latest instruments of financial management which is gaining foothold. Islamic banking refers to Shariah-compliant tools and mechanisms to replace interest-based financial intermediation with the risk-sharing and interest-free paradigm. It primarily relies on equity modes to conduct its affairs. This ensures the most efficient, ethical and equitable use of economic resources of the polity. Islamic banking relies on PLS modes, namely, *mudarabah* and *musharakah* as major, and *murabah*, *ijarah*, *bai salam*, *bai istisna* as secondary instruments to perform lending, borrowing and investment functions.

In Islamic banking, following are the terms of its conduct:

MURABAHA:

Presaly (1996) evaluated that Morabaha is a particular kind of sale where the seller (i.e. the Bank) expressly mentions the cost of the sold commodity he has incurred, and sells it to another person (i.e. Customer) by adding some profit thereon. Thus, Morabaha is not a loan given on interest; it is a sale of a commodity for cash/deferred price. In other words rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods on to the customer for a pre-agreed price. Morabaha is a mode of financing as old as Musharka. Today in Islamic banks world-over 66% of all investment transactions are through Morabaha.

Musharika:

Zia in (2008) evaluated that “Musharakah is a form of partnership between two parties where each party contributes to the capital of the partnership in equal or varying proportions, either to establish a new venture or share in an existing one”.

Musharakah literal meaning is **sharing**. The root of the word "Musharakah" in Arabic is **Shirkah**, which means being a partner. It is used in the same context as the term "shirk" meaning partner to Allah. Under Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution.

Modaraba:

Zia in (2008) evaluated that Modaraba is a partnership agreement in which the investor provide the necessary finance while the recipient of the funds (the mudarib or the manager) provides the know how towards carrying out the business enterprise.

Definition according to <http://www.scmodaraba.com/index.htm>

“The capital provider invests through an entrepreneur borrower. Profits are shared on a pre-agreed basis but losses, if any, however, are wholly suffered by the investor. This financing structure looks like non-recourse project finance. Profits can be divided in any proportion between the two contracting parties as agreed upon at the time of the contract; but losses, if any, will fall on the financier only. Modaraba can also be regarded as a form Fund Management.”

IJARAH/ISLAMIC LEASING:

Abu Ghuddah (2003) researched on ijarah and concluded on the following points

- Ijarah is a term of Islamic fiqha
- Literally, it means “to give something on rent”
- The term “Ijarah is used in two situations:
 1. It means to employ the services of a parson on wages
 2. Another type of Ijarah relates to paying rent for use of an asset or property

Khalid (2008) stated that Ijara i.e. Islamic lease is a classical concept in *Shariah* financing based on Islamic principles. Ijara has emerged as an increasingly popular financial structure in asset financing and has found its way into transportation financing. It is one of the most easily recognizable Islamic asset financing techniques which are commonly used in a singular leasing transaction and, increasingly, as a building block in larger and more complex transactions. Being one of the simplest asset-based Islamic financial instruments, Ijara has steadily gained prominence as an alternative financing tool to conventional financing structures.

The International Review of Business Research Papers states that the Islamic finance industry in Pakistan has grown tremendously in the past few years. This growth of the industry coincides with the economic developments of the country, mainly triggered by the persistent economic policies, privatization, stable political situation and many other factors. The economic growth has created huge investment opportunities and therefore the number of financial institutions has increased considerably.

Methodology:

In this research paper, the comparison between Conventional banking style and conduct of Islamic banking system reveal a lot of differences. In the compilation process of information, I have used various sources. I visit various banks and get through internet. The interview of the account holders of different banks give me the impression that both banking systems are alike and the only difference is in terms and terminologies. Then I have used the brochures of different banks for the sake of correct and accurate informatory data.

Findings:

ISSUES IN MURABAHA:

Following are some of the issues in Murabaha financing:

Securities against Murabaha:

Payments coming from the sale are a receivable and for this the client may be asked to furnish a security. It can be in the form of a mortgage or hypothecation or some kind of lien or charge.

Penalty of default:

Another issue with Morabaha is that if the client defaults in payment of the price at the due date, the price cannot be changed nor can penalty fees be charged.

In order to deal with dishonest clients who default in payment deliberately they should be made liable to pay compensation to the Islamic Bank for the loss suffered on account of default.

However these should be made subject to the following conditions:

- a) The defaulter should be given a grace period of at-least one-month.
- b) If it is proved beyond doubt that the client is defaulting without valid excuse then compensation can be demanded.

Calculation of cost in Morabaha:

The Morabaha can only be affected when the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained then Morabaha cannot take place. In this case the sale will take place as musawamah i.e. sale without reference to cost.

Implementation issues:

This is a tall order but is an absolute necessity if we are to create a truly *riba*-free. The implementation of this system lacks the cultivation of new attitudes on the part of all the participants' economy. It requires more from each participant, but it also offers more both to the individual and to the society as a whole. From the investor it requires the full understanding that he/she/it may incur loss and that he will have to wait longer to know the results, but it promises a truly *riba*-free income and possibly better profits. From the entrepreneur it requires complete and accurate bookkeeping and full disclosure of all his/her/its accounts and the sharing of his bounty with his financiers, but it provides him with capital without collateral and the guarantee that in case there is a loss he will not be required to make it up, provided he had been honest in his dealings and his books will substantiate it. The intermediary is both a banker and an entrepreneur. As an entrepreneur, he too is required to be honest in his dealings, and accurate and transparent as to his bookkeeping and accounts.

Bankers are trained to be very cautious, because their first concern is to guarantee the safety of the funds deposited with them. But in this system they are relieved of that concern because the investors have agreed to take the risk, and therefore if they persist with the banker's attitude they will miss many opportunities at the investors' expense. On the other hand, too much adventurism can bring about low profits or even loss, and that may lead to the loss of customers. They must have an entrepreneur's natural talent to spot profitable projects and to avoid bad ones, and should develop it into a professional tool. The intermediary's staff will have to be carefully picked and trained to bring out inherent entrepreneurial talent. Such intermediaries will have ample reward, as they will share in the profits. It requires a new culture, a culture of entrepreneur-financiers and of professionally run partnership companies.

The system is heavily dependent on proper and accurate bookkeeping, accounting and auditing. That requires the availability of trained bookkeepers and their wide use, as well as professionally responsible and well-trained accountants and auditors. They are the bedrock of the system. The system requires a high level of integrity from these personnel, and it is in the interest of all the participants in the system to respect it. Substantial investment is necessary in the training of such personnel, and legal protection is necessary to safeguard the independence of the auditors.

The comprehensive system presented in the four books groups the entire spectrum of business activities into three broad categories: at one end is the one-man-owned-and-operated small enterprises, including the ones financed or supported by loans and advances from commercial banks, and at the other end are the large enterprises financed entirely by shareholders and managed by professionals. In between are the proposed participatory-financed enterprises. The size of the enterprise is an important factor in this categorization, and the type of financing and the type of organization must generally match the size.

The *mudaraba* principle is applicable to a range of situations, from a simple local two-person partnership to a multiparty international corporation. A shareholder company works essentially on the *mudaraba* principle. But the participatory financing scheme envisaged in this article aims at the middle section of this range. It brings in the intermediary, and provides the investors with a unit trust type of investment opportunity. The scheme is ideally suited to medium scale *new* enterprises. However, it is possible to modify it slightly and bring in some of the *running businesses* too into the participatory financing system. This will help expedite bringing about the even distribution mentioned earlier.

TYPES OF MODARABA:

There are 2 types of Modaraba

- Restricted Modaraba
- Unrestricted Modaraba

RESTRICTED MODARABA:

- Rub-ul-mal may specify a particular business for the mudarib
- Mudarib can invest the money in that particular business only

UNRESTRICTED MUDARABA:

- Rub-ul-mal gives full freedom to mudarib to undertake whatever business he deems fit.

DISTRIBUTION OF PROFIT:

It is necessary for the validity of Modaraba that the parties agree at the time of entering into the contract on the ratio in which the actual profit will be shared.

DISTRIBUTION OF LOSS:

- Loss is bear only by rub-ul-mal because the mudarib doesn't invest anything.
- Mudarib's loss is considered to be wasted effort.

RULES GOVERNING IJARAH

Rules governing Ijarah are similar to the rules governing sale in both the cases something is transferred from one person to another.

The only difference is:

- In case of sale, title of property is transferred to buyer
- In case of Ijarah, title remain with the lessor
- Only the use of the property is transferred to lessee

COMPARISON OF IJARA AND CONVENTIONAL LEASE:

Starting time for rental:

Ijara: In Ijara the rental starts from the day the asset is handed over to the “*Mustajir*” so that he is able to make productive use of that property or machinery.

Conventional lease: In conventional lease the rentals start from the day the lessee makes payment for the asset/machinery/property.

Penalty of Late Payment of rent:

Ijara: The bank or financial institution is not allowed to charge the customer an additional amount in case of delays in payment of the rentals since it is considered Riba. Islamic scholars have found a solution customer could be asked to pay a certain amount to charity.

Conventional lease: The bank charges an extra amount if rent is not paid on time. This extra amount is taken by the leasing institute in to their income.

Insurance of the asset:

Ijara:

Asset is insured through Takaful (Islamic product of insurance). Takaful should be at the expense of the lessor. However the lessor may increase with the consent of the lessee, the lease rent to recover the Takaful. The Islamic bank bears the risk of Takaful claim settlements.

Conventional lease:

In conventional lease the asset is insured through insurance companies. Insurance is independent of lease contract and insurance expense is borne directly by the lessee.

IJARAH AS A MODE OF FINANCING:

- Leasing is an acceptable transaction under shariah
- The difference between conventional lease & Ijarah lies in the nature of the contract
- Several characteristics of conventional agreements may not conform to Shariah thus making the transaction un-Islamic & thereby invoking a prohibition
- In order to use leasing as a mode of finance changes need to be made to the lease agreement.
- Some basic parameters of the agreement have to be changed to reflect the change in the nature of the transaction

Conclusion:

After analyzing both banking systems and the reviews of banking experts, I found that according to Islamic laws Islamic banking is the best alternative for our Muslim society. Even the Islamic banking system make people bear a loss and there is no concept of consistent profit while in Conventional banking fixed profit ratio eliminates any chance of loss, the first one is likely to be implemented in Muslim society because it excludes any transaction related to interests, etc.

References:

➤ Websites:

- ◆ <http://www.aaofii.com>
- ◆ <http://www.bankislami.com.pk>
- ◆ <http://www.darululoomkhi.edu.pk>
- ◆ <http://www.financeinislam.com>
- ◆ <http://www.google.com>
- ◆ www.ijaraloans.com
- ◆ <http://www.isra.my>
- ◆ www.meezanbank.com
- ◆ <http://www.nzibo.com>
- ◆ <http://staff.uob.bh>
- ◆ <http://www.sbp.org.pk>
- ◆ <http://www.wikipedia.org>

➤ **Research papers and articles:**

- ◆ Andereno Rickett, *Business and Regional Enterprise* .Research Paper No.71 Interest in Banking *University of South Australia, Mount Gambier, Australia* (1999)
- ◆ Abu-Matar ul Usmani, Write an article on Interest in (2000)
- ◆ Consumer Credit Code ,(2001), Mortgage in Conventional Banking
- ◆ M. Mansoor Khan (Centre for Regional Engagement, University of South Australia, Mount Gambier, Australia) and M. Ishaq Bhatti (Department of Economics and Finance, School of Business, La Trobe University, Melbourne, Australia and International Centre for Education in Islamic Finance (INCEIF), Kuala Lumpur, Malaysia) Development in Islamic banking: a financial risk-allocation approach
- ◆ Humayon A. Dar and John R. Presley Economic Research Paper No. 00/24 Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances , Loughborough University(1996-1998)
- ◆ Syed Muhammad Zia Executive Manager of Meezan Bank Write a Research Paper on Islamic Banking (2008)
- ◆ Dr.Abdul Sattar Abu Ghuddah Secretary General, Unified Shariah Panel Dallah Al-Barakah Group Department of Research & Development Dallah Al-Barakah Group (ABG) **(1999-2003)**