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ISLAMIC BANKING VS. CONVENTIONAL BANKING

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ABSTRACT

Islamic banking is a concept where in very few have ever read about. It is same as normal banking but there are certain rules and regulations laid by the Muslim law. The main difference between Islamic and Conventional banking is the treatment of risk, and how risk is shared. Whatever the profit, it is shared with depositors. If there is a loss it will also be shared. Islamic banking offers its services that lead to socio-economic development of a community, country, region, continent and the world.

Keywords: Islamic Banking, Conventional Banking, Shariah, Riba, Zakat

INTRODUCTION

Bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank links together customers that have capital deficits and customers with capital surpluses. There are various types of banks. The necessity for the variety among these banks is because each bank is specialized in their own field. Each bank has its own principles and policies. Different rates of interests are also noted among these banks.

Islamic Banking is a system based on Islamic Law (Shariah). It follows the Shariah, called Fiqh Muamalat (Islamic rules on transactions). The rules and practices of Fiqh Muamalat came from the Quran and the Sunnah, and other secondary sources of Islamic law such as opinions collectively agreed among Shariah scholars, analogy and personal reasoning.

As per the Dubai Islamic bank which is considered as the oldest IB, the definition of Islamic banking is as follows: "Islamic banking, enlightened with the guidance of Islamic Shariah principles, emerged as an alternative financial system that neither gave nor took interest, thereby introducing a fair system of social justice and equality, while fulfilling the financial needs of people and maintaining high standards of ethics, transparency and a sense of responsibility". Islamic banking depends on trade which enables to profit making instead of interest, which is prohibited by Islamic religious law.

HISTORY OF ISLAMIC BANKING

The practices of Islamic banking are usually traced back to businesspeople in the Middle East who started engaging in financial transactions with businesspeople in Europe during the medieval era. At first, businesspeople in the Middle East used the same financial principles as the Europeans. However, over time, as trading systems developed and European countries started establishing local branches of their banks in the Middle East, some of these banks adopted the local customs of the region where they were newly established, primarily no-interest financial systems that worked on a profit and loss sharing method. By adopting these practices, these European banks could also serve the needs of local business people who were Muslim.

In the beginning of 1960s, Islamic banking resurfaced in the modern world, and since 1975, many new interest-free banks have opened. While the majority of these institutions were founded in Muslim countries, Islamic banks also opened in Western Europe during the early 1980s. In addition, national interest-free banking systems have been developed by the governments of Iran, Sudan, and Pakistan.

ROLE OF ISLAMIC BANKING

It is true that individuals, government and non-government agencies have conducted many studies to understand benefits of Islamic banking and the challenges faced by Islamic banking. Since this system of banking is grounded in Islamic principles, all the undertakings of the banks follow Islamic morals. Therefore, it could be said that financial transactions within Islamic banking are a culturally distinct form of ethical investing Islamic bank, formed in 1975. Islamic banking refers to a system of banking or banking activity that is consistent with Islamic law (Shariah) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection, and payment of interest commonly called Riba. Generally, Islamic law also prohibits trading in financial risk (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses that are considered unlawful, or haram.

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PRINCIPLES OF ISLAMIC FINANCE

Islamic finance strictly complies with Shariah law. Contemporary Islamic finance is based on a number of prohibitions that are not always illegal in the countries where Islamic financial institutions are operating:

1. **Paying or charging an interest**

Islam considers lending with interest payments as an exploitative practice that favors the lender at the expense of the borrower. According to Shariah law, interest is usury (*Riba*), which is strictly prohibited.

2. **Profit And loss sharing**

It is one of the best principles of Islamic finance where the partners will share their profit and loss according to the part they played in the business. There will be no guarantee on the rate of the returns that the Muslims will play the part of a partner and not a creditor.

3. **Shared risk**

In the economic transactions, the risk sharing is promoted by the Islamic banking. When two or more parties will share the risk following the principles of Islamic banking the burden of the risk will be divided and reduced in the parties. So it will improve the economic activity of the state.

4. **Uncertainty and risk (Gharar)**

According to the Islamic finance principles, Muslims are not allowed to participate in the ambiguous and uncertain transactions. According to Islamic rules, both parties should have a proper control over the business. As well as the complete information should be shared with both parties so that the profit and loss will be equally shared.*Gharar* is observed with derivative contracts and short-selling, which are forbidden in Islamic finance.

5. **Speculation (*Maisir)***

Sharia strictly prohibits any form of speculation or gambling, which is called *Maisir*. Thus, Islamic financial institutions cannot be involved in contracts where the ownership of goods depends on an uncertain event in the future.

6. **No investment in prohibited industries**

The industries that are harmful to society or have a threat to the social responsibilities are prohibited in Islam. They include pornography, prostitution, alcohol, pork and drug.

According to the Islamic finance principles, you are not allowed to invest in such industries. You cannot even participate in the mutual funds that will help the industry to flourish.

7. Zakat

There is a property tax included in the rules of Islam that it known as Zakat, which allows the balanced distribution of wealth. According to the Islamic banking principles the fair amount of Zakat is deducted from the accounts of Muslim in the holy month of Ramadan. Islamic banks promote this social responsibility and distribute the amount among the needy.

8. Material finality of the transaction

Each transaction must be related to a real underlying economic transaction.

MODES OF ISLAMIC BANKING FINANCE

a) Murabaha

Murabaha, also referred to as cost-plus financing, is an Islamic financing structure in which the seller and buyer agree to the cost and markup of an asset. As a financing technique, it involves a request by the client to the bank to purchase certain goods for him. The bank does that for a definite profit over the cost, which is stipulated in advance.

b) Ijarah

Ijarah means lease, rent or wage. It refers to selling the benefit of use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipment such as plant, office automation, motor vehicle for a fixed period and price.

c) Istisna

It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder aggresses to produce

d) Mudarabah

A form of partnership where one party provides the funds while the other provides expertise and management. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.

e) Takaful (Islamic insurance)

Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of

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similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.

f) Musharakah (Joint venture)

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions. This is often used in investment projects, letters of credit and purchase or real estate or property.

g) Bai Salam

Bai Salam is an Islamic contract in which full payment is made in advance for specific goods to be delivered at a future date. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. It is also applied to a mode of financing adopted by Islamic banks. It is usually applied in the agricultural sector where the bank advances money for various inputs to receive a share in the crop, which the bank sells in the market.

BALANCE SHEET OF ISLAMIC FINANCIAL INSTITUTION AND CONVENTIONAL FINANCIAL INSTITUTION

Table 1

Balance Sheet of Islamic Financial Institution and Conventional Financial Institution

Balance Sheet of Islamic Financial Institution	Balance Sheet of Conventional Financial Institution
Assets	**Assets**
Cash and cash equivalents Investment in securities Sales receivables Investments in leased assets Investments in real estate Equity/ profit sharing financing Investment in subsidiaries Fixed assets Other assets	Cash and cash equivalents Investment in securities Loans and advances Statutory deposits Investment in subsidiaries Fixed assets Other assets
Liabilities	**Liabilities**

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Current accounts	Current accounts
Other liabilities	Saving and time deposits
Equity of Profit-Sharing Investment Account (PSIA)	Other liabilities
PSIA (Unrestricted)	
Profit equalization reserve	
Investment risk reserve	
Owner's equity	**Owner's equity**
PSIA (Restricted)	Off-balance sheet
Off-balance sheet [letters of credit/ guarantees]	[letters of credit/ guarantees/ derivatives]

DIFFERENCE BETWEEN CONVENTIONAL BANKING AND ISLAMIC BANKING

Table 2

Difference between Conventional Banking and Islamic Banking

Conventional Banking	**Islamic Banking**
Conventional banks are based on fully man-made principles.	Islamic banks are based on principles of Divine law.
Aims at maximizing profit with only legislative restrictions.	Aims at maximizing profit but subject to Shariah and legislative restrictions.
The relationship of the bank with its client is that of creditors and debtors.	The relationship of the bank with its client is that of partners, investors & entrepreneurs and buyer & seller.
Depositors are guaranteed a predetermined rate of return (interest).	Profits are shared between the bank and the depositors according to a pre-agreed ratio and these profits are not guaranteed.
Lending money and getting it back with interest is the fundamental function of the conventional banks	Participation in partnership business is the fundamental function of the Islamic banks
Does not deal with Zakat.	It has become one of the service oriented function of the Islamic banks to be a Zakat collection centre and they also pay out their

	Zakat.
Its scope of activities is narrower when compared with an Islamic bank.	Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multipurpose institution.
It can charge additional money (compound rate of interest) in case of defaults.	The Islamic banks have no provision to charge any extra money from the defaulters.
For interest-based commercial banks, borrowing from the money market is relatively easier.	For Islamic banks, it is comparatively difficult to borrow money from the money market.
In it very often, banks own interest becomes prominent. It makes no effort to ensure growth with equity.	It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
Conventional banks give greater emphasis on credit-worthiness of the clients.	Islamic banks, on the other hand, give greater emphasis on the viability of the projects.

CONCLUSION

Islamic banking is a very young concept in modern times yet it is emerging as one of the fastest growing areas of international finance. Islamic Banking is based on Shariah Laws. Shariah covers every aspect of our life; it provides principles how to live at individual level, in the society, legal and economic system, etc. The main difference between Islamic and conventional finance is the treatment of risk, and how risk is shared. In Islamic finance interest is prohibited. If an enterprise is financed by debt with an obligation to pay interest, the risk of the business is not being shared fairly. The relationship of the bank with its client is that of partners, investors & entrepreneurs and buyer & seller. Under *Shariah* law finance can be provided through several types of contract. Each type specifies how risk is shared between the enterprise and the supplier of finance.

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