A comparative study between Islamic banking system and Conventional banking system

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Abstract

This research article aims to gain a comprehensive knowledge regarding Islamic Banking and Conventional Banking system. Islamic Banking is an interest free banking based on Sharia principle. The main area for Islamic finance is on profit & loss sharing, risk management, transparency, investment fairness, equality, and social harmonywhich have attracted both Muslims and non-Muslims around the globe. Islamic banks have gained a global acceptance due to its interest free principles and practices. The products of Islamic Banking has been discussed thoroughly in this paper as well as compared with conventional banking products and services. Additionally, we tried to understand how Islamic banking system is different from conventional banking system. This article concluded that working mechanism of Islamic banking and Conventional banking is quite different in many aspects, such as interest charging perspective, product, profit and risk profile perspectives etc.

Key words: Islamic Banking, Conventional banking, Islamic product, Shariah, Riba, conventional bank product.

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Background and Introduction

Islamic Banking is an interest free banking which is based on shariah principle. Islamic finance is all about Islamic faith as it says that Islam deals with every aspect of life and dimensions of our life and finance is no different. It is derived from the Quran and the Sunnah governed by the shariah so essentially it differs from traditional banking by the word **Riba** or as translated interest… It stipulates the areas which we need to take note of when it comes to our dealings in finance. It talks about how we use money it should be a store of value and a medium of exchange but as we see it in modern financial world is that money is traded for money at a rate of interest so it's the key difference, another key difference is that Muslim mustn't be trading something prohibited by the shariah for e.g. pork, alcohol. It's also based on **Gharar** i.e., uncertainty a very simple or like when we have a contractual dealings between two parties on a commercial basis, this principal is all about is that there mustn't be any uncertainty in that contract when it comes to what is being purchased, what is the price, delivery time etc. and within that another rule comes around that is gambling or speculation is not allowed. 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. In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles. Over the last decade, this industry has experienced growth rates of 10-15 per cent per annum—a trend that is expected to continue.

Islamic Banking refers to a system of financial management that is guided by the principles of Islamic rules. Banking in Islam is a framework of saving money governed by Islamic law standards, also known as the Sharia law.

The Islamic Law or Sharia prohibits paying any fee for renting of money (called Riba) for specific periods of time. It also prohibits any sort of investment in businesses that are considered haram or against the principles of Islam. A law which is rooted deep within the principles of Quran and the Sunnah. But as there are different school of thought's in Islam there are also different versions of this law according to its principles and practices like for example, Iran has different law as compared to UAE which is far liberal as compared to Iran. Shariah has been oppressed more than any religious law in the recent times, thanks to misrepresentation, manipulation and misuse of the shariah by Islamic regimes, politicians , clerics , radicals , terrorists , they have all used the shariah to rule in the name of God.

Conventional bank offers lending facilities to their clients to fulfil their cash requirement on the basis of loan contracts where the relationship between the Bank and client is that of lender and borrower respectively.

The conventional bank borrows at lower interest from money customers and loans them to borrowers at a high interest rate. The major financial objective of conventional banking system there is to achieve maximization of the shareholder's wealth through interest differential. Although interest is not used in banking transactions, Islamic banks have products and services that are similar to conventional banks, i.e., saving and deposit accounts, loan, credit card and other financial products

Principles of Islamic Banking

As Islamic Bank is **not a non-profit organization**, it also has to fit into the existing system of full commercial organization. We take risk in everything we do in business, whether we buy an asset or trade, as in the above example Islamic Bank is acting in the middle and taking some asset.

Islamic Banking & Finance are trying to remove the loan plus interest element when we go for a conventional banking we get a loan for which we pay interest and from that loan we are buying a property and giving charge on that property if something goes wrong the bank will sell and if there is any difference the bank will come after us to pay the difference., But in the Islamic Model the banks own the property, the bank give us the property on rent or on lease so the bank takes the risk, if something goes wrong the bank is exposed to the market value.

In Islamic economic model the financial economy is meant to have a **one to one correlation with the real economy**. If a borrower or somebody who's looking to raise funds for his business than if financier says ok I'm going to give you Rs.10lakh but I want to participate in the profit or losses of your finance its halal. But if the financier says I'll charge 10% interest its not participating in the business it's merely expecting return for nothing and excess of money on money. Sometimes the cash flows look the same of both conventional and Islamic Banking but the substance is different.

- **Transaction including interest (RIBA) is strictly prohibited**- Interest means in excess and there are certain types of commodities as stated in the Quran and the Sunnah that we cannot have an excess of them which includes things like dates and wheat also forms of money like gold and silver. so the question is what is excess- for example If I were to give you Rs. 100 , I cannot ask for Rs. 105 back in a day or in a year. I can only ask you to give me Rs. 100 back. Clearly we cannot charge the time value of money. Holy Quran &Sunnah treats interest as an act of exploitation and injustice to the weaker sections of the society as it only favors the strong and resourceful. The objection to interest is that it is fixed and certain, if any venture fails still the vendor has to be paid the debt, which is prohibited.

- **The profit and loss sharing principle-** Profit & loss sharing is allowed which can be even specified in ratio. There's a markup value which is share at the end i.e., cost+ plus.IN SHORT, in Islamic Finance- No risk, No gain is the basic principle. So there are other ways to make a profit – trade is halal but Riba or interest in haram & there are legitimate ways to trade.
- **Transaction based on debt is not permissible**, there is no transaction based on traditional bond is Islamic Banks; but Islamic Banks have their own kind of bonds called **Sukuk** (Islamic Bonds); Sold to investors, each certificate is shared as equity based asset on rental payments; returns can be fixed or floating. Each security is prorating ownership of physical assets. Ownership in physical assets can be transferred at mutually negotiated price. Trading in secondary market is permitted.

- **Loans which are free from interest is used as a financial inclusion** further Islamic Insurance is very much like mutual insurance- which essentially is all about clubbing together, putting into a pool of money together amongst different people using that money to support those in need and that money belongs to the group of people so its cooperative or mutual structure. Even if its shariah complaint, the products and services but it should also be good for those who have a desire for something more ethical, something more value based.

- Specific sectors, like adult industry, entertainment, alcohol, and gambling are not allowed by Shariah and are prohibited for any purpose in Islamic Finance. This could be the main reason why Islamic Banks are also referred to as Ethical banking.

How Islamic Banking is different from Conventional Banking?

There are several differences between Islamic Banking and Conventional Banking that are discussed as below.

- **Interest-** Conventional bank charges interest and are based on interest related transaction i.e., it takes into account the time value of money.
  Other side Islamic Banks are based on the absence of interest-based (Riba) transaction, and works on the mechanism of profit and loss sharing principle.

- **Operational**- Conventional bank considers mainly profitable transaction. Halal is not a major Operational consideration here.
  Islamic Banks are about transactions based on Halal (legal, permitted based on Islamic rule) and profit sharing business transactions.

- **Structure Organization-**Conventional banks', are under the supervision of respective Bank Acts, Islamic Bank, is under the supervision of Bank, Islamic scholars, National Sharia Council, and Sharia supervisory Board

- **Relationship- Conventional** bank, Relationship is often defined as that of creditor-debtor in Islamic Bank, the relationship to its clients defined as partners, investors and trader, buyer and seller

- **Evaluation of the project–** Conventional bank**,** since income from the advances, it gives little attention to developing expertise in assessment of the project and evaluation. Risks are transferable at a price (and sometimes incremental)
  Islamic Bank, since it shares profit and loss, the Islamic banks pay greater attention to developing in assessment of the project and evaluations
- **Contract structure of loan between investors and entrepreneur –** Conventional bank, the investor/ lender is guaranteed of a predetermined rate of interest or returns interest. Islamic Bank, promotes risk sharing between investor and the user of funds /entrepreneur Profit and loss sharing
- **Determination of profit –**Conventional bank is Predetermined of interest rate with the assumption must be always profitable, Islamic Bank, Determine at the time of the contract with the possibility profit or loss
- **Risk ownership–** Conventional bank, customers bear all risk to loan (risk transfer)
  Islamic, risk of loss will be borne by two parties Customers bear all risk to loan (risk (risk sharing) between investor and transfer) Risk ownership entrepreneur or between lender and borrower.

Islamic Banking	Conventional Banking
Prohibits interest based transactions i.e. Riba	Interest based lending and borrowing.
Profit & Loss sharing is mandatory.	Profit & loss sharing is not mandatory.
Banks cannot create money as they are not allowed to lend money that they don't have.	Banks can create money through fractional reserve banking.
Banks cannot charge fees and penalties on late payments.	Banks can charge fees and penalties on late payment.
Banks are owned by depositors and shareholders.	Banks are owned by shareholders.
Banks can only invest in businesses which are shariah-complaint.	Banks can invest in any type of business
Credit risk is shared between the bank and the customer.	Credit risk is totally borne by the banks.
Banks act as a partner in business ventures with customers.	Bank are intermediaries that lend money to customers

4. Product of Islamic and Conventional banking

4.1 *Islamic bank product:* Islamic products need to have a distinctive value proposition based on its own identity and be bold enough to be different. As people will question that is it really authentic, is it really shariah complaint. If we see the demographic there is potential demand in all of the products of Islamic Finance, even its finding the formula to unlock that with the right product, the right education, the right messaging etc., the economics of everything is important. While for investment they pick up sectors like health or infrastructure or energy, medicine, or these type of activity which are real and economic often have positive social impact and the results are decent.

It deals with the following major products namely:-

- **Mudarabah**– Profit and loss sharing principle
- **Musharakah** - partnerships or Joint venture
- **Salam** – sales contract

- **Ijarah** – leasing contract
- **Qadr-e-Hasna** – interest free loans
- **Murabaha**– trade with markup

(A) Mudarabah

Mudarabah is a type of partnership in Islamic Banking and finance where one party, the investor, provides capital to another party, the mudharib, who manages the investment and bears the risk of loss. The mudharib is responsible for making investment decisions and managing the venture, while the investor provides the capital and receives a share of the profits in accordance with a pre agreed ratio. The mudharib does not receive a fixed salary, but rather a portion of the profits. Losses, if any, are borne solely by the investor. Mudarabah is a shariah-complaint alternative to traditional interest based lending.

(B) Murabaha

Murabaha is a common type of financing structure used in Islamic banking and finance. It is a cost plus financing technique where a bank or financial institution purchases a commodity, and then sells it to the customer at a marked up price that is agreed upon by both parties. The bank must disclose the cost of the commodity, and the mark up percentage, to the customer.

The customer is then able to purchase the commodity by paying the marked-up price in instalments. The key feature of Murabaha is that both the cost and the profit are known and disclosed to the customer. This differs from traditional interest based lending, where the interest rate is often not disclosed. Murabaha is considered sharia-compliant because it follows the principles of transparency and mutual consent, and it is not considered as interest (Riba) which is prohibited in Islamic Law.

(C) Musharaka

Musharaka is a type of financing used in Islamic Banking and finance. It is a partnership in which the bank and the customer jointly invest in a business venture, with the profits being shared according to a pre-agreed ratio. The customer's share is considered a return on its investment.

In Musharaka, the bank and the customer jointly own the assets and share the risks and rewards of the business venture. The customer is responsible for managing the business, and the bank provides the financing. The customer is also responsible for providing a guarantee for the loan. The bank and the customer can agree on a fixed or variable profit sharing ratio. Musharaka is a form of equity financing, as opposed to debt financing, and is considered to be a more equitable and risk-sharing form of financing than traditional interest-based loans.

It's commonly used in business and investment financing, and it's one of the most popular modes of financing in Islamic finance. Musharaka is a form of partnership in which the bank and the customer share the risks and rewards of the business venture in a pre-agreed ratio. This mode of financing than traditional interest based loans.

(D) Takaful

Takaful is very much like Mutual Insurance- which essentially is all about clubbing together, putting into a pool of money together amongst different people using that money to support those in need and that money belongs to the group of people so its cooperative or mutual in structure

Even if it Sharia complaint, the products and services should also be good for those who have a desire for something more value based.

(E) Ijarah

Ijarah, also known as leasing, is a contract used in Islamic finance that involves the transfer of the right to use an asset in exchange for a rental payment. The lessor (owner of the asset) grants the lessee (user of the asset) the right to use the asset for a specifies period of time in exchange for an agreed upon rental payment. In an Ijarah contract, the lessor retains ownership of the asset and the lessee has the right to use it for the agreed upon period. The lessee is responsible for the maintenance and upkeep of the asset during the lease period, and at the end of the lease period, the lessee has the option to purchase the asset at a pre-agreed upon price or return it to the lessor.

Ijarah is widely used in Islamic finance for a variety of transactions, such as the leasing of real estate, equipment, and vehicles. The structure of an Ijarah contract is based on the principles of justice and fairness, and the rental payments are determined based on the fair market value of the asset at the time of the contract.

(f) QardHasan

In Islamic Banking, QardHasan is a type of loan that is given without the expectation of any profit or interest. The lender only expects the return of the principal amount of the loan. The term 'Qard Hasan' translates to 'good loan" in English and it is considered a charitable act in Islam to give such a loan to those in need. This type of loan is offered to individuals or organizations that are in need of financial assistance, and it is usually given with the intention of helping the borrower to improve their financial situation. Qard Hasan loans can be used for a variety of purposes, such as business expenses, home purchase, or personal expenses. The repayment period and the conditions of the loan are agreed upon by both the lender and the borrower. The lender is not allowed to charge any additional fees or charges, and the borrower is not required to pay any interest on the loan.

It is a concept of providing financial assistance to individuals or organizations in need, such as low-income families or small businesses, with the expectation of receiving a lower rate of return or no return at all. This is based on the Islamic principle of social justice and the belief that wealth should be distributed in a fair and equitable manner.

(G) Halal

In Islamic Banking and finance, the term “Halal”, refers to transactions or financial products that are permissible according to Islamic law (Sharia). These transactions or products are considered morally and ethically acceptable, and they do not involve any activities that are considered haram, or forbidden, by Islamic finance law which prohibits the charging or paying of interest (Riba), gambling and speculative activities (Maysir), and the financing of businesses involved in alcohol, tobacco, gambling, pork-related products, and other activities that are considered haram.

It’s important to note that the concept of halal in Islamic finance is based on sharia laws and it may vary depending on the interpretation of different Islamic scholars and institutions.

In order for a financial activity or transaction to be considered halal, it must adhere to the principles of risk sharing and not involve any form of gambling or excessive uncertainty. This means that the returns on investments should be tied to the performance of the underlying assets and not guaranteed. Overall, the goal of halal finance is to promote financial practices that are fair, transparent, and aligned with the principles of social justice, while avoiding activities that are deemed harmful or exploitative.

(H) Sukuk

In Islamic banking and finance, Sukuk refers to a type of financial instrument that is similar to bonds in conventional finance. Sukuk represents an undivided ownership in a tangible asset, a pool of assets or project, or a company’s cash flows. They are generally used to raise capital for infrastructure projects, real estate developments, and other investments.

Sukuk holders are considered to be co-owners of the assets or projects underlying the sukuk and are entitled to a share of the income generated by these assets or projects. The income receives by sukuk holders is not considered interest but rather a share of the profits generated by the underlying assets or projects.

Sukuk is typically issued by a special purpose vehicle (SPV) on behalf of the issuing company or government, and are sold to investors in the form of certificates. The certificates may be traded on a secondary market, just like bonds.

Sukuk are considered to be shariah-compliant alternative to conventional bonds, as they comply with the Islamic prohibition on interest-based transactions. They are widely used in the Middle east and Southeast Asia, and have been increasingly popular in recent years as a tool for raising capital for infrastructure projects, real estate developments, and other investments.

(I)Wadiah

Wadiah in Islamic banking and finance refers to a type of deposit account where the depositor entrusts their money to the bank for safekeeping. The bank, in turn, guarantees the safekeeping of the depositor's funds and promises to return the deposited amount to the depositor upon request. Unlike traditional deposit accounts, the bank is not allowed to use the deposited funds for investment or lending purposes, and the depositors do not earn any interest on their deposited funds. Wadiah accounts are considered safe and secure form of savings and are often used by individuals who want to save money for specific purposes, such as education or retirement. The bank may use the deposited funds for charitable or other Islamic-complaint purposes, such as funding investments in halal industries. The bank is also obligated to return the depositor's funds in full in the event of any loss or damage.

(J) Salam

Salam in Islamic banking and finance refers to a type of contract in which a buyer pays a portion of the price of an asset upfront and the remaining balance at a later date. The asset is typically a commodity such as agricultural produce, and the sale is based on the principle of deferred payment. The buyer and the seller must agree on the price and the delivery date of the asset in advance. The seller is obligated to provide the asset on the agreed –upon date, and the buyer is obligated to pay the remaining balance at that time. The key feature of salam is that it is a contract for the future delivery of goods, and it is not permissible to sell something that does not exist yet. It is considered a form of Islamic finance because it is based on the principles of risk sharing and prohibits interest.

The key difference between salam and conventional forward contracts is that in salam, the buyer pays the full purchase price upfront, while the seller commits to delivering the goods at a later date. This differs from conventional forward contract where payments are made at the time of the delivery.

Salam is considered permissible under Islamic Law because it is based on a real underlying asset and the contract is executed with the intention of actual delivery of goods at a future date. It is used in agriculture, construction, manufacturing and trading sectors. Furthermore, Salam is a risk sharing contract as the goods may not be delivered as promised and the buyer may lose the money paid, while the seller may fails to deliver goods and lose the opportunity to sell them in the future.

This product of Salam is mostly used in agricultural schemes which are basically interest free; the banks invest the money in the respective sector and get a share of final products which is sold by the banks to gain a profit from this overall investment.

(K) Waqf

Waqf in Islamic finance refers to a charitable endowment in which a person dedicates a portion of their wealth, property, or assets for a specific religious, educational, or charitable purpose. The property, or assets are transferred to the ownership of God and are managed by a waqf board or trust. The income generated from the property or assets is used to support the charitable purpose, such as funding a mosque, school, or hospital. The property or assets themselves cannot be sold or transferred to another party, and the waqf continues in perpetuity. Waqf is considered a form of Zakat, one of the Five pillars of Islam, and is considered a way for Muslims to fullfill their religious duty of giving to charity and helping the less fortunate.

It means the donation made by customers voluntarily through his hard earned money and wealth accumulated. It's a donation made by Muslim's under the Islamic Law to fund a manager who is responsible for generating profits.

Other than all these products and services it includes fairness, equality, transparency and social harmony. In the end of the day Islam basically follows certain principles that Muslims should follow when it comes to finance and their business there been a lot of criticism of the industry, a lot of pouring cold water over it but in reality we have to provide real solution which are authentic according to the Islamic principles.

Conventional bank have a power that Islamic Bank doesn't so maybe that's where it has failed to achieve its economic power as it is run by people who may have different ideology or thoughts.

Islamic Banking and Finance is about the real economy, about creating real wealth and real prosperity for people and it's not about addressing something up but in terms of money upon money or artificial transaction so all to do is a real thing.

It's a young industry, it's growing its changing but its ideology is something that we can feel better about our self and be able to sleep for.

4.2 *Conventional banking products:* There are several conventional bank products, discussed below.

(A) Credit card

A credit card issued by a conventional bank is a payment card that allows the cardholder to borrow funds from the bank up to a certain limit in order to make purchases or withdraw cash. The bank sets a credit limit for the cardholder, and the cardholder is responsible for repaying the borrowed funds, along with interest, on a monthly basis. Some credit cards also offer rewards or cash back for certain type of purchases.

(B). Certificates of deposits (CDs) : CDs are a type of savings account where customers deposit money for a fixed period of time at a higher rate than a traditional savings account.

(C). Mortgages: These are loans used to purchase or refinance a home. A mortgage is a type of loan that is secured by the property being purchased.

(D). Wealth Management Services: These include investment products, retirement planning, and trust services for customers with significant assets.

(E). Online Banking and Mobile Banking: Most of the conventional banks now provide online banking and mobile banking services for their customers to access account information, pay bills, and manage their accounts remotely.

(F) Running finance

Conventional financial instruments (CFIs) are mere paper assets. The value of such assets are based on their intrinsic value usually determined by the availability of information, issuers performance and ratings, targeted returns and the extent of trade-ability of a given instruments.

(G) Car/house loans and long-term loan facility

Conventional banks are providing car loan, house loan even long-term loan and other.

(H). Investment Products: Banks offer a variety of investment products to its customers such as bonds, stocks and Mutual funds.

There are other products of conventional banks which are not mentioned here as the main focus of the paper is on Islamic Banks.

Conclusion

Islamic banking and conventional banking both have their own unique characteristics and differ in certain principles, such as the prohibition of interest in Islamic banking and the integration of religious principles in the decision-making process. However both types of banking aim to provide financial services to customers and contribute to the overall development of the economy. Islamic bank if implemented will be beneficial for both Muslim & Non-Muslim's by financial inclusion, economic growth, innovation, diversification, even attracting investments. It's worth noting that India's Central bank, i.e. Reserve Bank of India (RBI) has not yet issued any regulations specifically for Islamic Banking. Islamic banking is a growing industry in India, with a number of Islamic finance institutions and products being introduces in recent years. However, there are still challenges to be addressed, such as the lack of understanding and awareness of Islamic Finance among the general population, and the need for more regulations and guidelines to govern the industry. Despite these challenges, the potential for Islamic Banking in India is significant, as it could provide an alternative form of finance for the country's large Muslims population, as well as for other communities looking for ethical and socially responsible financial options.

After going through the comprehensive study, it is concluded that there are quite differences between Islamic banking and conventional banking system. On the one side conventional banking is working based on interest system, however, Islamic banking system is against the charging of any interest. Additionally, Conventional banking system is differed from Islamic banking in many angles such as operational perspective, structural perspective, determination of profit, risk and product profile perspective.

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