



COMMENTS ON THE THEORETICAL DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC BANKING

Prof. Dr. Sava Dimov
Burgas Free University

КОМЕНТАРИИ ОТНОСНО ТЕОРЕТИЧНИТЕ РАЗЛИКИ МЕЖДУ КОНВЕНЦИОНАЛНО И ИСЛЯМСКО БАНКИРАНЕ

проф. д-р Сава Димов
Бургаски свободен университет

***Annotation:** The author makes comments on the state of the problem in part of the English-speaking scientific thought. In the beginning, he points out the main thesis and prospects for the development of conventional and Islamic banking. The main part of the comments begins with the historical aspect of the comparison. According to him, despite the differences, they are based on priority financial and human values. The benchmark review continues with “A Modern Comparison of Western Banking to Islamic Banking”, information from the Council of Islamic Financial Services, comparative analyzes of Ahmad Al-smadi, AF Hamdan and Almsafir, M., Grimarenko, I. Ye., Jamaldeen, F., Mohamad, Sh., Hassan, T. and Bader, MK, Lake, Al. and Margolin, J. and in particular „The Hundred Differences Between Islamic and Conventional Banking Systems” by Basha, S.N. After all, the author reaches two important conclusions for his research.*

***Key words:** islamic (ethical) banking, conventional (western) banking, differences, concept and principles.*

***JEL Classification:** C14, G11, G20, G21.*

***Анотация:** Авторът прави коментари за състоянието на проблема в част от англоговорящата научна мисъл. В началото той посочва главната теза и перспективите за развитие на конвенционалното и ислямското банкиране. Основната част от коментарите започват с историческия аспект на сравнението. Според него, въпреки различията, те се основават на приоритетни финансови и човешки ценности. Сравнителният преглед продължава с „Сравнение на западното банкиране и ислямското банкиране“, информацията от Съвета на ислямските финансови услуги, сравнителните анализи на Ahmad Al-smadi, A. F. Hamdan and Almsafir, M., Grimarenko, I. Ye., Jamaldeen, F., Mohamad, Sh., Hassan, T., Bader, M.K., Lake, Al. and Margolin, J. и по-специално „Сто различия между ислямските и конвенционалните банкови системи” от Basha, S.N. В крайна сметка, авторът достига до две важни заключения за своето изследване.*

***Ключови думи:** ислямско (етично) банково, конвенционално (западно) банкиране, различия, концепция и принципи.*

***JEL Класификация:** C14, G11, G20, G21.*

I. Instead of an introduction

The scientific paper attempts to compare the elements of Islamic (ethical) banking and conventional banking in Western countries. Some points of view are discussed, discussing the advantages and disadvantages of each type of banking. It emphasizes some of the key points of the various author's opinions. The peculiarities of commented viewpoints are shown.

In the Islamic world, Islamic finance is emerging as a fast growing component of the financial sector and it is not restricted to Islamic countries, but is spreading in communities where there is a substantial number of Muslims.

We defend the thesis that, despite the differences between conventional and Islamic banking, each one is based on certain financial and human values. The flexibility and resilience of financial crises will show which of the two banking systems is more promising.

II. Basic part

In order to fully appreciate the phenomenon of Islamic finance, it is necessary to understand the historical evolution of the foundations of the global banking system, i.e. historical aspect of comparison. (Grimarenko, I. Ye., 2015)

The traditional banking system originated in the Middle Ages in Europe in countries with the Christian religion. In the XVI-XVII centuries. merchant guilds of a number of cities (Venice, Amsterdam, Hamburg) created special girobanks for cashless settlements between their clients. *Therefore the activity of commercial banks in the modern sense was developed with the beginning of the industrial revolution in the West.*

But there is another type of banking model based on the religious principles of Islam. Since the advent of Islamic civilization, there have been such operations as currency exchange, money transfers and the use of checks. As a result of colonial expansion, Muslim countries assimilated the Western banking model, and Islamic banking, which emerged in the early period of Islam, ceased to exist. Significant changes occurred only in the early twentieth century.

The first ideas for creating independent Islamic banks appeared much later in the late 40's of the 20th century. Practical steps were taken only in the early 60's with the first successful experiment to set up a financial institution working without interest through the Mit-Ghamr project. In 1963, the first local Savings Bank „Mit-Ghamr Islamic Savings Bank“ was established in the Egyptian town of Mit Ghamr on the basis of interest-free financing. *Therefore, autonomous Banking in Muslim countries is developing significantly later. The turbulent development of trade and colonialism is likely to force Muslim countries to adopt the traditional banking system.*

According to the research „*A Modern Comparison of Western Banking to Islamic Banking*“ western and islamic banks structure their financial products differently. The highlights are placed on the following elements:

(a) Shariah law prohibits charging or paying interest, called *riba* in Arabic, and also discourages investments or banking that is connected to products or industries that Islam considers sinful, or *haram*. Credit card services and any situation where interest is paid and/or charged to benefit one party and not the other are not permitted.

(b) Islamic banking resembles conventional Western banking with its overall objective of making money by lending capital. Like conventional banking, it focuses on ethical investment and non-predatory lending.



(c) Shariah-compliant finance creates its own financial products based on Islamic contracts and profit-sharing. Islamic banks offer loans based on a project's viability and contracts signed by both parties. Islamic financial products include investment accounts, portfolio management, commodity and equity-based fund management facilities and mortgages as well as investment banking and corporate finance.

(d) Islamic banking, in comparison with Western banking, conveys an intent to accomplish a moral purposes through financial services. The goal of the Institute of Islamic Banking and Insurance is „a financial system based on Islamic belief that truly embodies the concept of socio-economic justice in commercial dealings.“

(e) Companies considered to be dealing in haram, or sinful products, services or sectors include those that produce, use or deal with alcohol, pork or pork byproducts, pornography, gambling or interest-based finance.

In our opinion, the foremost stand out:

First, *Islamic Business Ethics*.

Shariah-compliant banking ideals derive directly from the Quran and from the life and statements of the Prophet Muhammad, sources that also drive Islamic law regarding diverse issues. Ethics, justice, equity and truth are mentioned frequently in the Quran. Muhammad proclaimed extensive rulings and laws regarding business ethics, trade, pricing and financial transactions, as well as admonitions to avoid debt.

Secondly, *Cross-Cultural Influence*.

Islamic banking is not limited to Muslim-owned companies. Western banks have been responding to the demands of many Muslim clients by incorporating and offering Shariah-compliant services. By the same token, Islamic banking is influenced by Western banking.

Third, *Research in Islamic banking incorporates lessons and successful components from Western financial systems*. Shariah banking organizations review and adapt Western techniques focused on business ethics and codes of conduct. For example, they use the U.S. Department of Commerce's Model Business Principles and research produced by The International Society of Business Economics and Ethics. (Lake, Al., 2017)

It is considered that, but the major twist in the story came with the advent of Islamic Banking. Before that, Capitalism and Marxism were two main Giant concepts but then a middle of the road concept came which almost astonished Western World and Encouraged Eastern World to contribute in banking industry.

Gearing up at fast pace, grabbing the market share of Conventional banking and now leadingly called as Ethical Banking in Western World, Islamic Banking has changed the shape of Industry as a whole.

The main difference between the Conventional and Islamic Financing is of Interest, called „Riba” in Islam. Conventional Financing ask lenders to charge a profit from borrowers on principal amount and this profit is termed as „Interest”. The rate of interest can be fixed or it can vary with the inflation rate (Floating rate i.e. Base Lending Rate, Karachi Interbank Offered Rate or London Interbank Offered Rate).On the other hand, Islamic Banking defines Profit on some other dimensions. Here, the borrower and lender decides on a contract where the lender purchases something on borrower’s behalf initially and then selling it back to the borrower with some amount charges as „Profit”.

Second main difference is the Payments procedure. Conventional Financing defines payments in a decided time frame in terms of installments with the decided rate of interest. In each installment, a portion carries the interest amount whereas the remaining adjusts the principal amount.

The third major difference between both financing systems is the time frame. Where Conventional Financing defines complete installment system, interest payment and principal amount to be paid within certain time frame, Islamic Financing believes in one-time contract system. In Islamic Banking, no one party can gain benefit over the loss of another and this why it is far more superior to conventional banking system. (*Islamic Finance...*, 2019)

Therefore, of course, it is necessary:

(i) More than 75 countries have Islamic banks, of which only 45 are Muslim countries, the rest being non-Muslim nations;

(ii) Although, there are some advantages and disadvantages of both systems but it depends on the nature of the country a bank or any financial institutions are operating as well as the current position of the economy of certain Region. Conventional Banking is somewhat the pioneer of the financial World and we can simply not ignore its importance and it still imposes huge foot prints in the Financial Corporate World.

It is clear that the conclusion is that, World is moving towards this new interface and Financial World is now seeing a totally new form of Financing.

According to Jessica Margolin the major conceptual differences are:

- Islamic finance fundamentally rejects business that is considered bad for (a religious) society;
- You can't decouple risk and revenue; in other words you must share risk, rather than transfer it. (Margolin, J., 2014)

The main differences are concentrated in the following several directions:

(a) Deposit / Liabilities CASA¹ & Term Deposit.

Islamic Banks offers deposit products based on the following structures:

♦ „*Oard*” – Current accounts are offered under this contract where the risk of the funds lies with the bank and no added benefits are provided to the client solely based on this facility. However, clients may be allowed to avail those facilities which are offered across the board;

♦ „*Mudarabah*” – a type of partnership where client funds are invested in various businesses and returns are shared between the bank and client as per the agreed profit sharing ratio whereas, the loss is shared as per the investment ratio. Term Deposit and Savings Accounts are offered on the basis of Mudarabah.

Conventional banks accept deposits on the basis of loan for all types of deposit accounts including Term Deposit, Savings and Currents accounts. Interest based returns are provided for the Savings accounts and Term Deposits, whereas Current Accounts may offer free banking facilities. In addition to this, conventional bank invests the deposits in non-shariah compliant avenues and subsequently earns non-shariah compliant returns.

(b) Lending / Financing.

Islamic banks offer financing/leasing facilities to their clients to fulfil their business requirements on the basis of following contracts depending on the requirements of the client:

¹ *CASA is the acronym for Current and Savings account, which is commonly used in the banking industry across West Asia and South-East Asia. CASA deposit is the amount of money that gets deposited in the Current and Savings Accounts of bank customers. The bank pays very low or no interest for deposits in current accounts whereas the deposits in Savings Accounts receives slightly higher interest rates.*



Islamic Banks Financing Transactions Characteristics:

- ✓ Islamic bank takes the risk of the asset;
- ✓ Income is earned through sale or leasing contracts;
- ✓ Share profit & bear Loss as the case may be;
- ✓ In case of late payment or default by the client, there will be no penal charges. However, to instil a payment discipline, Bank is authorized to recover an amount at a predetermined percentage as compulsory contribution to Charity Fund constituted by the bank approved Shariah Board. This contribution to Charity Fund shall not constitute income of the bank;
- ✓ The bank will deploy the Islamic Funds in only Shariah Compliant avenues.

Conventional banks offer 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. Conventional Banking Loan Contracts Characteristics:

- ✓ No risk of underlying assets;
- ✓ Income through Interest;
- ✓ Late Payment charges on delayed payments and shall constitute bank's income.

(c) Trade Finance.

Islamic banks offer trade finance related operations under the concepts of services, guarantee and financing with the following conditions:

Islamic Banks Trade Transactions Characteristics:

- ♣ Commission based Income as per the guidelines of Shariah;
- ♣ Income through payment and documents facilitation services;
- ♣ Income through sale or lease of assets;
- ♣ Share Profit & bear Loss as the case may be;
- ♣ In case of late payment or default by the client, There will be no penal charges.

Conventional banks offers trade finance related operations under the concepts of services, guarantee and lending. Conventional Banks Trade Transactions Characteristics:

- ✓ Commission based Income;
- ✓ Income through guaranteeing payments;
- ✓ Income through Interest on loan payments;
- ✓ Additional interest income on delayed payments.

According to Faleel Jamaldeen „Islam is more than a religion; it's also a code of life that deals with social, economic, and political matters. Every Muslim is expected to live according to the Islamic code, or sharia. Each issue addressed by sharia is entwined with all other issues; therefore, economic matters are related to religion, culture, ethics, and politics.”(Jamaldeen, F., 2019)

Islamic finance, then, is a financial system that operates according to sharia. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. Notwithstanding this, these entities are governed both by Islamic laws and by the finance industry rules and regulations that apply to their conventional counterparts.

The main vision of Islam is that Allah is the owner of all wealth in the world, and humans are merely its trustees. Therefore, humans need to manage wealth according to Allah's commands, which promote justice and prohibit certain activities. At the same time, Islam allows for a free-market economy where supply and demand are decided in the

market - not dictated by a government. But at the same time, Islam directs the function of the mechanism by imposing specific laws and ethics.

Consequently, *Islam and social justice are inseparable, and it's a key concept of the Islamic finance industry.*

In this regards, by reminding Muslims of their obligations, Islam seeks to promote stronger relationships between each person and Allah, between people and the earth, and among individuals.

Emphasis is placed on:

- ☞ *Requiring zakat*: To promote justice related to the distribution of wealth, Islam imposes a property tax called zakat. Every Muslim who meets certain criteria regarding the accumulation of wealth must pay zakat, which is distributed to people in need;
- ☞ *Prohibiting usury (interest)*: For the sake of social justice, Islam prohibits interest-based transactions. No individual or business entity should hoard money in order to earn interest (or riba); instead, that money should be used to support productive economic activities;
- ☞ *Encouraging shared risk*: Islam encourages risk-sharing in economic transactions. When a risk is shared among two or more parties, the burden of the risk faced by each party is reduced.

Avoiding gambling: Two Arabic words refer to transactions that involve gambling:

- ◆ „*Maysir*” – The acquisition of wealth by chance and not by effort;
- ◆ „*Qimar*” – In modern gambling, any game of chance.

Both types of transactions are prohibited because they're based on uncertainty (gharar).

So that, the Islamic prohibition against transactions that involve gambling prevents Muslims from purchasing conventional insurance products because those products are a gamble. Instead, Islamic insurance, called „takaful”, is based on a very different model of risk management that involves shared risk and mutual responsibility.

The predominant part of Islamic financial facilities is Islamic banking. From this general status quo, more accurate data is available to us from Islamic Financial Services Board in 2018, namely:

First, after two years of marginal increases, the Islamic financial services industry (IFSI) returned to strong (8.3%) growth, and its total worth slightly surpassed the USD 2 trillion dollars. The main growth drivers were „sukuk“ issuances by sovereigns and multilateral institutions. The volume of „sukuk“ outstanding grew by 25.6%, and assets of Islamic funds grew by almost 19%. Islamic banking assets grew by only 4.3%, reducing the share of Islamic banking in the total value of the IFSI to 76%;

Secondly, the market shares of Islamic banks (i.e. shares in the total domestic banking assets) increased in at least 19 jurisdictions and remained constant in seven others. Declines of market shares were reported in six jurisdictions. Islamic banking is categorised as systemically important in 12 jurisdictions where the market shares have reached 15%. Collectively, they account for 92% of the global Islamic banking assets. Apart from two jurisdictions with market shares of 100% (Iran, Sudan), the shares in most of the ten jurisdictions with dual banking systems increased, while it decreased in only one country (Qatar). Collectively, these 12 jurisdictions account for 92% of the global Islamic banking assets. The largest are Iran (34.4% of global Islamic banking assets), Saudi Arabia (20.4%), United Arab Emirates (UAE) (9.3%), Malaysia (9.1%), Kuwait (6.0%) and Qatar (6.0%). (ISLAMIC., 2018)



Ayman Abdal-Majeed Ahmad Al-smadi, Faizul Hamdan and Mahmoud Khalid Almsafir (Ahmad Al-smadi, Hamdan and Almsafir, 2013) highlight nine differences that include:

Islamic Banks

- ✦ The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah;
- ✦ promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur);
- ✦ It also aims at maximizing profit but subject to Shariah restrictions;
- ✦ In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a Zakat Collection Centre and they also pay out their Zakat;
- ✦ Participation in partnership business is the fundamental function of the Islamic banks. The customers' business has to be understood;
- ✦ Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion;
- ✦ It gives importance to the public interest. Its ultimate aim is to ensure growth with equity;
- ✦ The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller;
- ✦ Islamic bank can only guarantee deposits for deposit account, which is based on the principle of al-wadiah, thus the depositors are guaranteed repayment of their funds, however, if the account is based on the mudarabah concept, clients have to share. A loss if it occurs.

Conventional Banks

- ✓ The functions and operating modes of conventional banks are based on fully manmade principles;
- ✓ The investor is assured of a predetermined rate of interest;
- ✓ It aims at maximizing profit without any restriction;
- ✓ It does not deal with Zakat;
- ✓ Lending money and getting it back with compounding interest is the fundamental function of the conventional banks;
- ✓ It can charge additional money (penalty and compounded interest) in case of defaulters;
- ✓ Very often it results in the bank's own interest becoming prominent. It makes no effort to ensure growth with equity;
- ✓ The status of a conventional bank, in relation to its clients, is that of creditor and debtors;
- ✓ A conventional bank has to guarantee all its deposits.

We could highlight the following two findings:

First, Islamic banking is more humanizing than conventional banking. (Confirmed and by Shamsheer Mohamad, Taufiq Hassan and Mohamed Khaled I. Bader., 2008);

Secondly, Islamic banking provides a more human approach. It had been proven that many consumers choose Islamic banking rather than conventional.

In a more detailed and detailed scientific study „*The Hundred Differences Between Islamic and Conventional Banking Systems*” (2017) outline the concepts and principles of Islamic banking. It focuses on differences between the conventional and the Islamic banking system. (Basha, S.N., 2017)

Islamic Banking can be described as a system of banking that adheres to the principles of Sharia i.e. The Islamic Law. In other words, it can be viewed as a financial system which identifies itself with the spirit of Sharia (The Islamic Law), as laid down by the Holy Qur'an and Sunnah (the practices of Prophet Mohammed, as regards its objectives, principles, practices and operations.

There are the following differences between the differences between the conventional and the Islamic banking system, including:

- (a) Differences in the Assumptions;
- (b) Differences in the Operations;
 - Financing;
 - Long Term Loans;
 - Leasing;
 - Short Term Loans;
 - Overdraft;
 - Personal Consumption Loans;
 - Short-term Agricultural Loans;
 - Investments;
 - Investments in Central Banks and Other Banks;
 - Investment in Shares;
 - Investment in Bonds;
 - Investment in Derivatives;
 - Liquidity Management Practices;
- (c) Impact of the Banking System.

Unlike conventional banking, Islamic, also called ethical banking, is based on the following principles of its activity:

- ✓ Prohibition of receipt and payment of Interest;
- ✓ Emphasis is on profit and loss sharing;
- ✓ Prohibition of „Qimar” (gambling), „Iktinaz” (hoarding), „Ihtikar” (monopoly), „Israf” (extravagance), „Fasad” (corruption), „Mujazafah” (speculation), „Ghish” (deception), „Tadlees” (fraud), „Kathib” (lying) etc.;
- ✓ Prohibition of contracts involving „Gharar” (excessive risk);
- ✓ Prohibition of financing socially detrimental projects that deals with „Khamr” (intoxicants), „Khinzir” (Pork), and all unethical dealings such as prostitution, stealing etc.;
- ✓ Prohibition on selling what is not owned or possessed;
- ✓ Prohibition on selling fruits before they are ripe;
- ✓ Prohibition on selling debts;
- ✓ Asset Backing Principle: It is required that financial transactions should be unpinning by an identifiable and tangible underlying asset. It means financial transactions must be accompanied by an underlying productive economic activity that generates legitimate wealth.

Conventional banking is governed by all the man made principles and no divine guidance has been followed by these banks. Conventional banking is supported by the capitalist economy which allows all type of transactions for the purpose of earning of higher profit, it may be riba, hording, gambling, dealing in unlawful goods and services, short sales in short all the speculative transactions can be deal in this banking system. The purpose of the conventional banking is to maximize profit only.



As per capitalist theory, the capital and enterprise are factors of production, capital gains fixed returns in the shape of interest and the enterprise receives its return in the shape of profit or loss as the case may be. In the conventional banking system only the guidelines or rules are followed which are made for the purpose of earning profit.

Therefore, conventional banking system provide loans to every business and earns profit, i.e business model of the conventional banking system is to receive money from the people who have in access and lend the same to the people who need money for the establishment and enhancement of their businesses.

III. Conclusion

From the comments presented, the following more important conclusions can be made:

First, Conventional banking system considers economic methods of wealth creation but ignores social, ethical and moral methods. Islamic banking system gives first priority to social, ethical and moral methods of wealth creation; economic attractiveness of business is the next priority. Islamic banking is not a mere copy of conventional banks. It has its own way of doing business and all operations are duly certified by Sharia experts Islamic Fiqh academy (IFA).

Secondly, In conventional financing, lenders lend to borrowers to make a profit from interest charged on the principal amount. At the other pole - at the very heart of Islamic Finance is the prohibition of collection and issuance of interest/riba. The ban on interest in all economic activities is so explicitly define and remains non-compromising in Islamic literature as it is divinely forbidden by Allah. The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah. In other words, it can be viewed as a financial system which identifies itself with the spirit of Sharia (The Islamic Law), as laid down by the Holy Qur'an and Sunnah.

References:

- 1) Ahmad Al-smadi, A. F. Hamdan and Almsafir, M. (2013) *Journal of Islamic and Human Advanced Research*. Vol. 3, ISSN: 2231-8968, Issue 1, January 2013, 27-40
- 2) Basha, S.N. (2017) The Hundred Differences between Islamic and Conventional Banking Systems. *International Journal of Scientific Research and Management (IJSRM)*. Volume 5, Issue 09, Pages 7093-7106
- 3) Grimarenko, I. Ye. (2015) *Comparative Analysis of Islamic and Traditional Western Banking Models*. Available from: <https://cyberleninka.ru/article/v/sravnitelnyy-analiz-islamskoy-i-traditsionnoy-zapadnoy-bankovskih-modeley> [Accessed 14th July 2019]
- 4) *ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2018*. Published by: Islamic Financial Services Board. ISBN 978-967-5687-63-1, p.3
- 5) *Islamic Finance vs. Conventional Finance in UAE*. Available from: <http://www.loansuae.com/islamic-vs-conventional-finance-uae/> [Accessed 10th July 2019]
- 6) Jamaldeen, F. *How Is Islamic Finance Different from Conventional Finance?* Available from: <https://www.dummies.com/personal-finance/islamic-finance/how-is-islamic-finance-different-from-conventional-finance/> [Accessed 11th July 2019]
- 7) Mohamad, Sh., Hassan, T. and Bader, M.K. (2008) Efficiency of Conventional versus Islamic Banks: International Evidence using the Stochastic Frontier Approach (SFA). *Journal of Islamic Economics, Banking and Finance*. January 2008, 107-130
- 8) Lake, Al. (2017) *A Modern Comparison of Western Banking to Islamic Banking*. Available from: <https://classroom.synonym.com/a-modern-comparison-of-western-banking-to-islamic-banking-12086596.html> [Accessed 12th July 2019]
- 9) Margolin, J. (2014) *What is the difference between Conventional finance and Islamic - interest free - finance?* Available from: <https://www.quora.com/What-is-the-difference-between-Conventional-finance-and-Islamic-interest-free-finance> [Accessed 14th July 2019]