Conventional VS Islamic Banking System

SUMMARY:

An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a Mudarabah or Wakalah (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank. and which are guaranteed. On the assets side, it advances funds on a profit-and–loss sharing or a debt-creating basis, in accordance with the principles of the Sharīah. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank.

Before we define what an Islamic bank is like, it is better to give a short description of conventional banking. Conventional banking does not follow one pattern. In Anglo-Saxon countries, commercial banking dominates, while in Germany, Switzerland, the Netherlands, and Japan, universal banking is the rule. Naturally, then, a comparison between banking patterns becomes inevitable

Commercial banking is based on a pure financial intermediation model, whereby banks mainly borrow from savers and then lend to enterprises or individuals. They make their profit from the margin between the borrowing and lending rates of interest. They also provide banking services, like letters of credit and guarantees. A proportion of their profit comes from the low-cost funds that they obtain through demand deposits. Commercial banks are prohibited from trading and their shareholding is severely restricted to a small proportion of their net worth.

Because of the fractional reserve system, they produce derivative deposits, which allow them to multiply their low-cost resources. The process of bank lending is, however, subject to some problems that can make it inefficient. Borrowers usually know more about their own operations than lenders. Acting as lenders, banks face this information asymmetry. Because borrowers are in a position to hold back

information from banks, they can use the loans they obtain for purposes other than those specified in the loan agreement exposing banks to unknown risks. They can also misreport their cash flows or declare bankruptcy fraudulently. Such problems are known as moral hazard. The ability of banks to secure repayment depends a great deal on whether the loan is effectively used for its purpose to produce enough returns for debt servicing. Even at government level, several countries have borrowed billions of dollars, used them unproductively for other purposes and ended up with serious debt problems. Banks can ascertain the proper use of loans through monitoring but it is either discouraged by clients or is too costly and, hence, not commercially feasible. Hence, why the purpose for which the loan is given plays a minimal role in commercial banking. It is the credit rating of the borrower that plays a more important role.

By contrast, universal banks are allowed to hold equity and also carry out operations like trading and insurance, which usually lie beyond the sphere of commercial banking. Universal banks are better equipped to deal with information asymmetry than their commercial counterparts. They finance their business customers through a combination of shareholding and lending. Shareholding allows universal banks to sit on the boards of directors of their business customers, which enables them to monitor the use of their funds at a low cost. The reduction of the monitoring costs reduces business failures and adds efficiency to the banking system.

Following the above logic, many economists have given their preference to universal banking, because of its being more efficient. Commercial banks are not allowed to trade, except within the narrow limits of their own net worth. As we have noticed, many Islamic finance modes involve trading. The same rule cannot, therefore, be applied to Islamic banks. It may be possible for Islamic banks to establish trading companies that finance the credit purchase of commodities as well as assets. Those companies would buy commodities and assets and sell them back to their customers on the basis of deferred payment. However, this involves equity participation. We may, therefore, say that Islamic banks are closer to the universal banking model. They are allowed to provide finance through a multitude of modes including the taking of equity. Islamic banks would benefit from this by using a combination of shareholding and other Islamic modes of finance. Even when they use trade-based, debt creating modes, the financing is closely linked to real sector activities. Credit worthiness remains relevant but the crucial role is played by the productivity/profitability of the project financed.

Major Differences between Islamic and Banking System	
Conventional System	**Islamic System**
Money is a product besides medium of exchange and store of value.	Real Asset is a product. Money is just a medium of exchange.
Time value is the basis for charging interest on capital.	Profit on exchange of goods & services is the basis for earning profit.
Interest is charged even in case, the organization suffers losses. Thus no concept of sharing loss.	Loss is shared when the organization suffers loss.
While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is must, while disbursing funds under Murabaha, Salam & Istisna contracts.
Due to non existence of goods & services behind the money while disbursing funds, the expansion of money takes place, which creates inflation.	Due to existence of goods & services no expansion of money takes place and thus no inflation is created.
Due to inflation the entrepreneur increases prices of his goods & services, due to incorporating inflationary effect into cost of product.	Due to control over inflation, no extra price is charged by the entrepreneur.
Bridge financing and long term loans lending is not made on the basis of existence of capital goods. Rather, they are disbursed on the basis of Windo Dressed project feasibility and credibility of the entrepreneur.	Musharakah & Diminishing Musharakah agreements are made after making sure the existence of capital good before disbursing funds for a capital project.

Reference: Mabid Ali Al-Jarhi and Munawar Iqbal

Government very easily obtains loans from Central Bank through Money Market Operations without initiating capital development expenditure.	Government can not obtain loans from the Monetary Agency without making sure the delivery of goods to National Investment fund.
The expanded money in the money market without backing the real assets, results deficit financing.	Balance budget is the outcome of no expansion of money.
Real growth of wealth does not take place, as the money remains in few hands.	Real growth in the wealth of the people of the society takes place, due to multiplier effect and real wealth goes into the ownership of lot of hands.
Due to failure of the projects the loan is written off as it becomes non performing loan.	Due to failure of the project, the management of the organization can be taken over to hand over to a better management.
Debts financing gets the advantage of leverage for an enterprise, due to interest expense as deductible item form taxable profits. This causes huge burden of taxes on salaried persons. Thus the saving and disposable income of the people is effected badly. This results decrease in the real gross domestic product.	Sharing profits in case of Mudarabah and sharing in the organization of business venture in case of Musharakah, provides extra tax to Federal Government. This leads to minimize the tax burden over salaried persons. Due to which savings & disposable income of the people is increased, which results the increase in the real gross domestic product.
Due to decrease in the real GDP, the net exports amount becomes negative. This invites further foreign debts and the local-currency becomes weaker.	Due to increase in the real GDP, the net exports amount becomes positive, this reduces foreign debts burden and local-currency becomes stronger.