

ISLAMIC BANKS: INTRODUCTION AND COMPARISON WITH THE CONVENTIONAL BANKS

Corresponding Author: Houssam Mabrouk

The Banks represent the heart of the economy of any country. In countries with muslim beliefs, where the society doesn't accept "interests", and are sceptic to deal with the conventional banks, because of their religion that forbids "Riba/Intrests". Islamic banks have been created and introduced to these muslim population to meet their demand and to provide its services with no interest on any bank transaction.

Since we are living in muslim countries, and that our religion is Islam. We follow the laws and principals of Islam. One of these principles treats the question of the interests in the financial transactions. In Islam the interests - or what's called Riba- is simply prohibited.

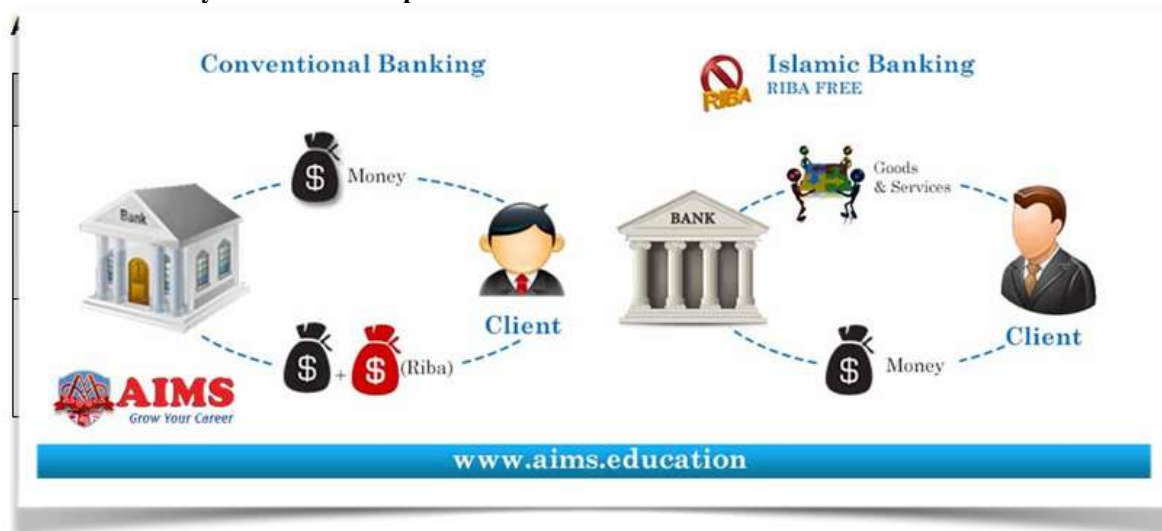
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As we mentioned before, the role of the banks in our actual world and society is undeniable, and since the religion forbids the transactions of these conventional banks, it was mandatory for these muslim countries to create banks that are in accordance with their islamic laws and principals. But now with the islamic banks, the aim is the development of the economy and at the same time get these muslim clients, who do not like to transact with the conventional banks. This article compares the main differences between an Islamic bank and a conventional bank.

Let's start by understanding one of the biggest differences between an Islamic bank and a conventional bank through this small illustration. On the left we have the conventional Banking with the bank giving Money (credit/loan) to the client, and the client giving it back with extra addition - which is called "Riba". On the right we have the Islamic banking, with bank giving either goods or services. No money, to avoid Riba: If you need money to buy a good or services, the bank buys it for you, and sells it to you. The client gives back the agreed value/amount of the goods or services he received.

Analysis: detailed comparison between Islamic banks and conventional banks



Conventional Banking System	Islamic Banking System
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	Musharakah & Diminishing Musharakah agreements are made after making sure the existence of capital good before disbursing funds for a capital project
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
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

Conventional Banking System	Islamic Banking System
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

Let's try to resume the most important differences between the conventional bank and the islamic one

- The biggest difference between the 2 banking systems is as follows. The Islamic banks system have the Islamic Law (Sharia) as fundamental basis. The conventional banks system is based on self-made principles and rules. The Sharia governs and rules all the laws and rules governing the Islamic population in all the aspects of life.
- Unlike the conventional banks, which make the customers pay interests even their businesses are making no profit (suffer losses), the islamic banks runs on the basis of loss/profit sharing. If their customer makes profit, they also get profit. But if their customer suffer losses, the bank shares the loss as well. The loss shared with the bank depends on the mode of financing adopted.
- While the orthodox banks employ the money as a store of value, mode of exchange and commodity. The Islamic banks employ it only as store of value and mode of exchange. But never as Commodity. The explanation for this is that, unlike the Islamic banking, conventional banks trade money with huge prices and also rent it out.
- Concerning the profit-making, the Orthodox banks relays on time value to charge interests on Capital. While the source of profit charging of the Islamic banks is based on the profit of the exchange of goods and services.
- Unlike the orthodox banks, where they predetermine the income coming from loan. The Islamic banks concentrate their activities on debtor investment projects, assessments and valuations. This point is a result of the profit/loss sharing.
- While the conventional banks never share the losses of their customers. In the Islamic laws, the banks guarantee to repay the sums for the deposit accounts under one condition. the account has to be an Al-Wadiah based account. Otherwise, the losses will be shared by the depositor and the banks following the Mudharabah guidelines.
- As the Islamic banks system follow the Islamic laws (Sharia'a), it's logical that the banks are excepted to care for the public interest FIRST. Also the banks should guarantee a lawful economic development and progress. The conventional banks have as main objective " The Profit". Unlike the Islamic banks, the conventional banks's interest comes first.
- Compared to the orthodox banks, it's proven that Islamic banks have a better capitalisation, better asset, and a higher inter mediation ratio. Also fairness is one of the biggest difference between the two banking systems. Islamic banks represent fairness in all aspects by sharing the losses of their customers, while the conventional banks only think about the maximisation of their profits and the minimisation of their losses.

Size and Location: reach of the banks in the world: Islamic vs conventional

It's known that banks are implemented in almost every country in the world. it's the heart of the economies and the motor of any GDP development. In this part we would like to compare the extension of the islamic banks compared to the conventional banks.

Unlike the conventional banks which are implemented in every country in the world the islamic banks have a limited number of countries compared to the conventional ones.

With an annual growth rate of 17.6% between 2009 and 2013 and an estimated size of \$2 trillion, the Islamic banking system have grown even faster than the conventional banks. But it still represents only 1%, and therefore, compared to the conventional banks, is much smaller. In 2010, They Islamic banks were present in a way or other in almost 105 countries. Analysis and statistics converge concerning the country with largest number of Islamic institutions. But according to World Islamic Banking Competitiveness Report the 6 top countries would probably be as follow:

- Saudi Arabia
- Malaysia
- United Arab Emirates
- Kuwait
- Qatar
- Turkey

These 6 countries alone cover 87% of the international Islamic assets.

However, Ibrahim Warde- a famous scholar in the field of international finance- with \$345 billion in Islamic assets Iran should be on the top, then comes Saudi Arabia with \$258 billion. Malaysia comes in the third place with \$142 billion. Kuwait and UAE follow with respectively \$118 and \$112 billion.

Another studies conducted by Reuters claims that Iranian Islamic banks represent a 1/3 of the Islamic finance assets in the whole world. Indeed, the economical sanctions applied against Iran by the west affected the Iranian conventional banking sector; as result the Islamic banks have known an immense development and progress in the country.

as we mentioned before, there's Islamic financing branches in almost 105 countries in the world. But if we talk about a real significant market part, there's **only 9 countries** where Islamic banks are dominating. These following 9 countries - without surprise- are all Muslim countries.

Percentage of world market share of Islamic banking industry by country, 2016	
Saudi Arabia	33
Malaysia	15.5
UAE	15.4
Kuwait	10.1
Qatar	8.1
Turkey	5.1
Indonesia	2.5
Bahrain	1.6
Pakistan	1.4
Rest of the world	7.3
Source: World Islamic Banking Competitiveness Report 2016	

A selection of our prominent and very active Islamic bank clients in London include: Gatehouse Bank, ABC International Bank, QIB (UK) and Ahli United Bank.

In the European side, the Islamic banking system is available, but not everywhere. Britain is the largest market for the Islamic banking system in Europe. Islamic banking system is becoming significant in the United Kingdom. More than any banking sector in Europe, we can count 6 real Islamic banks in the UK. To these 6 banks we add more than 20 lenders, who offer services and products in accordance with the Sharia's laws and values. Among these Islamic banks or lenders with Islamic services and products we can list:

- Gatehouse Bank
- ABC International Bank
- QIB (UK)
- Ahli United Bank
- United Bank
- Al Rayan BANK

What's the reason behind this fact? Well, the British legal jurisdiction fits with the Islamic banking laws. Also there's complementation between the English legal system and the Islamic Laws.

Moreover, since 2003 in the framework of a series of Finance Acts the British government has decided the removal of tax barriers. As a result, the Islamic banking services were way less tax efficient compared to the orthodox counterparts.

Clients: Islamic banks vs conventional banks

As the conventional banks are implemented in every country, it's logical that they have much more clients than any Islamic bank. There's no margin for comparison between the conventional market share and the Islamic market share. In reverse what's interesting is the study of the Islamic banks's clients. Indeed we notice that many Non-Muslims are trying the Islamic financing and banking system.

It's known that Islamic banks aren't only for Islamic population. This statement has 2 explanations. The first one is that even Non-Muslim individuals can open and use an account in an Islamic bank. The second one is that Islamic banking services could be provided to non-Muslims.

Because of the fixed lending rules and principles Islamic financing institutions are getting bigger and more success even with non-Muslims in the whole world. Since the Sharia'a is mixture of Islamic principles and modern banking principles, its services and products are provided to Muslims and non-Muslims

Non-Muslim investors have also been looking for less risky alternatives since the onset of the global credit crisis over a year ago cast doubt on many Western risk management practices.

As we know, the market of the Islamic banking system has been created by and for Muslims. In order to avoid Riba, which is interests in the western banking system. With the years the interests-fee system of the Islamic banks became more popular and reached the non-Muslim countries. This could be explained by the rich Arab investors from Saudi Arabia, Qatar and UAE, who through their wealth are constantly investing in Europe, and are demanding for ethical investments.

Since the crash and crisis occurring in the worldwide economy there's more and more non-Muslims investors who started to trust less and less the conventional system with their hunger for the profit. Therefore they step into the Islamic banking system.

Balance Sheet: the Comparison

Let's analyse the comparison of the balance sheets of the Islamic banks and conventional banks.

Balance Sheet: conventional banks

Assets	Liabilities
Loans and advances to customers	Customers' deposits
Cash and cash balances with other banks	Due to banks and other financial institutions
Investments in associates, subsidiaries and joint ventures	Other liabilities
Financial assets held for trading	Sundry creditors
Cash and cash balances with the central bank	Equity and reserves

Concerning the asset side of the conventional balance sheet, we can notice a much bigger diversification. This big variance can be explained by the marketable securities, trading accounts, or even corporations and consumers lending.

Liabilities are immediately generated through the deposits without taking in consideration the purpose of use of the money on the asset side. Therefore there's a discrepancy that results between the assets and liabilities. Liquidity of the short-term liabilities cover the long-term assets, which increases the chances for a bank to encounter a maturity discrepancy and becomes skeptical regarding the long-term non liquid investments. By enlarging the amount of the funding/deposits, which aren't retail, the conventional bank could face a huge volatility in meeting its funding requirements, thus needing a liquidity risk management, which has to be developed and sophisticated.

The Islamic financial institutions and the conventional financial institutions have not the same nature of financial intermediation. The contract of Mudarabah is the vital element of the financial negotiation and also of banking for the Islamic banks. The concept can be explained as follow; all the parties involved in the operation share the profit/losses. The financial intermediation is slightly a passage agreement, which is identical to the management of funds. But on the asset corner, there's several portfolios.

Balance Sheet: Islamic Bank

Application of funding	Sources of funding
Cash balances	Demand deposits (amanah)
Financing assets (murabaha, salam, ijara, istisna)	Investment accounts (mudarabah)
Investment assets (mudarabah, musharakah)	Special investment accounts (mudarabah, musharakah)

Fee-based services (ju'ala, kafala, and so forth)	Reserves
Non-banking assets (property)	Equity capital

Here we can see a balance sheet of an Islamic bank showing various activities and financial instruments. It will serve us to understand the fundamental risks faced by the Islamic institutions. The Classification of the Functionalities and the use of different instruments is a normal proceeding in the islamic banks.

On the asset side, we have Islamic financing and Investing accounts-which is the loans given to customers in a conventional bank. While we have investments accounts given by the customers and demand deposits on the liability side. The structure of this balance sheet displays the nature of banks and its role as intermediary. Also because of its low capital to liabilities, the leverage will not be accepted in any other business besides the financial services industry. Just the shares of different asset products and the changes operated on the shares with the time, should enable an analyst to evaluate profile risks of the bank.

The prices and supply features of all the different kind of liabilities, as well as the business conducted by the bank and the market orientation define the variation of the composition of the liabilities in an Islamic bank's balance sheet. The level of risk, potential profit and the cost of the transactions of any bank is determined by its funding structure. Also the specific asset-liability and the policy of the risk management is determined by the structure of the liabilities of the bank.

As we mentioned before, the balance sheet risk profile of an islamic bank is completely different from the one of an orthodox bank. The passage aspect of the nature of the balance sheet is the main characteristic of an islamic institution. Unlike the conventional banks, this aspect of the islamic balance sheet avoid the risk for its bank to get into an asset-liability discrepancy through the link between the depositors' return and the assets' return of the bank.

This nature of the balance causes some problems in the operational field. Indeed the estimation and the increase of the returns (ex-post) and also the intra-period withdrawal of deposits are considerably affect by these issues. Moreover the nature of assets of the conventional bank and the islamic bank isn't the same at all. The first one insists on keeping a fixed income and decreasing any credit risk on debt securities. Meanwhile the second one has a strong asset-based investments. But with a real asset backing the credit risk. These features of the islamic banking lead the institution's ability of lending to be restricted by the availability of the real assets, which also leads to the absence a (leveraged) credit creation.

This feature is not a design issue but is a temporal phenomenon until a well-functioning securities market for Shari'ah-compliant instruments is developed.

In the Assets of an Islamic institution we can find different assets such as financial assets, which are characterised by the sell of goods and commodities to the customers. Such practice exposes the bank until certain level. The assets are financed through a credit given to the customer in a conventional bank. But in an Islamic bank, the asset itself and the financing of this asset are linked. In Addition to these exposures mentioned above, the bank could face other issues coming from the physical assets. Another difference between the conventional bank and the islamic bank is the unavailability of the liquid securities on the asset side of an Islamic bank's balance sheet.

The hesitation towards the creation of leverage comes from the prohibition of Riba (Interests), which leads to an inability to distribute debts in order to finance the assets. The fact that there's little leverage makes the islamic banks more stable and less risky in a crisis period. Due to the increased leverage and the complex financial system, which lead to the development of several layers of intermediaries, the actual economy crisis has been accelerated.

Through a detailed analysis of the risk profile of the various financial contracts in the balance sheet, we will try to understand the risk faced by the Islamic financial institutions. The methods used in this analysis are standard. Such as:

- Trend analysis
- Impact analysis
- Bucketing
- Duration and maturity mismatch

These types of analysis would be used to analyse each financial contract and instruments. After the analysis finished and the results known. It should be integrated in the balance sheet to have a general view at an institutional level.

The classic analyse of risk is the one that always concentrate on financial risks on the asset side. An effective analysis of an Islamic bank always take in consideration the non-financial risks on the liability side. Indeed non-financial aspects (for example withdrawal risk and restricted geographical diversification) have to be included in the analysis as well as the competition made by the the orthodox banks.

increasing the share of financing on PIS basin and decreasing the share of financing on the basis of Mode of financing such as Murabah, these are the gradual steps that Islamic banks and financial institutions should conduct in order to gain more influence and market share.

In case the Islamic banks are capable creating and spreading a socio-economic justice example, by increasing their PLS (profit-loss-sharing) based transactions and getting more operational results, there will be a bigger cooperation between the european and western banks and the Islamic banks. Indeed many of these banks are already attracted by the PLS concept. Some of the western banks are already using and integrating Islamic services in their subsidiaries and affiliates.

The Islamic banks will no longer be the banks of muslim population, but all of the individuals who would like to deal with a bank, which put them first, rather than profit. Also as we mentioned before there's more and more non-Muslims who are changing from the conventional banks to Islamic banks, because of its fairness and interests-free operations.

The era of a fair banking system can be imagined where the products and services of Islamic banking system would be provided to a large amount of people, resulting to an over-all social and economic prosperity.

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