Islamic Banking vs. Conventional Banking

[Client Name]

[Institute Name]

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Executive Summary

The main objective of this paper is to analyze the concept of Islamic banking and to prove whether it would be profitable in the United Arab Emirates. The concept of Islamic banking has come up for the past couple of years but there has been any logical proof if the conventional banking should be rejected for the Islamic way of doing business.

The paper is meant to help the bankers and the consumers in the future since there is a big boom in the market for Islamic banks, however, their true worth is not understood till there is a complete research of the profitability that the Islamic banks provide to the society rather than the conventional banks.

The paper will be discussed in two parts. The first part will cover the literature review which will mean that the paper will discuss the past researches that have been performed on this topic. The research for this project may use some of the assumptions and may also face almost the same constraints as have been embedded in the previous researches.

The methodology will then be discussed in the latter part of the paper where the entire step by step process will be discussed. The methodology will then discuss how the research will be conducted and what necessary calculations will have to be done in order to prove the hypothesis of the research.

It will be discovered at the end of the paper that the hypothesis of the paper that Islamic banking is more profitable than conventional banking will be proved wrong because of the various measures that have been considered for the research. However, there is scope for Islamic banking to grow.

Importance of the Research

The reason why the Islamic banks are being stressed on is because there are a number of banks that are opening up with such a concept of being Islamic while banking at the same time. This concept however, must be made clear to the readers that Islamic banks tend to incline more towards profitability and welfare of the society rather than any other conventional bank.

With the help of this research, the concept of Islamic banks will be made vivid along with the understanding and the proof as to whether the facts about Islamic banks are true or not. The concept of Islamic banks must be clear in the minds of the consumers before they approach such a branch for creating a relationship because there are a number of conflicts and controversies by different scholars on the way the banking must take place.

The concept of Islamic banking will allow the individual reader to better gain an understanding of the Islamic banking as well as strengthen the faith that he / she has from within because believing that Islamic banking is also a true way of banking, is a way of accepting the way of Allah.

Introduction to the Islamic Banks

In the conventional mode of financing, the financier usually receives money on money which is a rejected concept in Islamic banking. In the conventional way of banking, the loan is given on the terms and conditions set by the lender and these must be accepted and abided by from the borrower. Incase there is a disruption in obeying the rules, they may change and hence the new rules may be more stressful for the borrower to fulfill.

This is just one concept of conventional banks that can be compared with Islamic banks. In the same way, there are a number of ways in which the Islamic banks can also provide an equally useful instrument in relation to the one that is provided by the conventional banks. The basic reason why Islamic banks help in building the society is because, when the terms and conditions of the transaction are fixed, it is ensured that there are no disadvantages to any of the parties.

In the Islamic banking, the financing creates real assets. This means that the Islamic banks usually handle assets and not money. The Islamic bank works only on assets and their renting or buying. There are no transactions made completely on money. This is the main difference of the Islamic system and the conventional system.

Islamic banking also leads to zero inflation. This concept has a direct relation with the interest that is applied on the loans for the borrowers to pay to the conventional banks. However, such interest is not paid to the Islamic banks and this is why the inflation for the society would reduce and hence, benefit the society.

Instruments Available To Islamic Banks

There are a number of Islamic instruments that are available to the people who are interested in investing in Islamic banking. There is also the need to understand that these instruments are a complete substitute for those that have been provided by the conventional banks, only that they follow the rules of Islam.

The instruments of Islamic banks should be studied so that the readers of the research can understand that there are some logical instruments that are available for the Islamic banks that can help them gain more profitability than any other conventional bank. And this is what the core concept of the research is.

There are a number of instruments that are provided by the Islamic banks such as the following:

1. Musharakah
2. Murabahah
3. Modarabah
4. Ijarah
5. Istisna
6. Salam

Each of these instruments will be further discussed in the paper in order to have a definition of the purpose and function of each instrument. It must be remembered that for any contract to be valid in Islamic banking, there are three requirements that must be fulfilled. They are:

1. Subject of sale must be in existence in the market
2. Subject of sale must be owned by the seller

3. Subject of sale must be in physical or constructive possession

Musharakah

Musharakah is defined as sharing which means that there are a number of investors that pool in money for a certain company or to lend to some one else. The definition for Musharakah is Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract, whereby the parties agree to invest in a commercial enterprise.

In such an investment, there is a need to understand that there will always be profit and loss sharing and then this profit and loss sharing ratio will be decided before hand. There are yet another set of guidelines that must be followed for the distribution of profit or sharing of loss.

Distribution of profit

1. Proportion to be agreed in the beginning to make it a valid contract. Can be according to the investment of each individual or different.
2. Ratio calculated should be of actual profits and not the face value of the instrument.
3. If there are any account payments that were taken before hand, adjustment must be made in the final accounts.
4. Sleeping partner should not get more than the ratio of his investment.

Loss sharing

1. Must be in proportion to the investment
2. Profit sharing as per agreement of the parties, but loss sharing is always in the ratio of Investment. There is no flexibility allowed in such a case.

Management of the business

1. Every partner has a right to take part in its management.
2. Through agreement, any one can manage.
3. The sleeping partners are to limit their profit sharing up to ratio of their investment.
4. If all partners agree to work, each one is an agent of the others.

Murabahah

Murabahah is simply a sale transaction in which the seller sales a specific commodity on a certain profit added to his cost. The seller discloses the actual cost directly incurred in acquiring the commodity and the profit he charges. The sale price may be paid on the spot or on deferred payment basis as agreed between the parties.

The reason why Murabahah is used by many is because there is a clear transaction where the date of delivery and payment is fixed and that there are no deferred payments that are involved. The buyer is told about all the details of what profit is being taken and this eases the role of the seller even more from the pressures.

However, there are two things that must be kept in mind. These pointers are:

1. If it is a cost-plus type sale, it is called a Murabahah.
2. If no cost /profit is disclosed it is called Musawamah.

Modarabah

Modarabah is a special kind of partnership where one partner (investor or rabb-ul-mal) gives money to another (manager or mudarib) for investing it in a commercial enterprise. The contract is built completely on the relationship of the investor and the manager. The mudarib authorized to do any thing normally done in that business. However, the permission of investor(s) is required for extra ordinary things.

Distribution of profits

The distribution of profits in Modarabah is a tricky business because there are a number of banks that have twisted the Islamic sense a bit in order to benefit from it by selling the Islamic instrument, Modarabah but using the conventional way for profits. This is not allowed and this is why there is a need to keep a few points in mind such as:

1. Distribution on a definite proportion of actual profits is to be agreed upon in the beginning of the contract.
2. No lump sum can be given as a salary or a profit distribution.
3. No percentage of capital invested can be used for profit distribution.
4. No salary for the mudarib is allowed.

Ijarah

Ijarah is an agreement whereby the lessor conveys to the lessee in return for rent, the right to use an asset for an agreed period of time. This means that instead of having the user to buy the asset, it can be leased to the user for a certain period of time for a profit by the Islamic bank. This would allow the user to reduce the financing overload it would receive by buying the asset.

Types of Ijarah

There are two kinds of Ijarah that are used for renting out assets to the customers. However, one of the lease types is in complete reconciliation with the conventional banks and this is why the Islamic banks do not use this kind of lease. The two types of leases that can be defined are as follows:

1. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. This means that during the lease period, the ownership is switched from the seller to the buyer. This is not allowed in Islamic banks.
2. An operating lease is a lease other than a finance lease.

Some basic rules for Ijarah

1. Contract: the owner transfers usufruct for an agreed period and consideration.
2. The asset must be of value.
3. Corpus remains in the ownership of the lessor.
4. Lease of any thing which will be consumed is not valid. It will be treated as a loan.
5. All liabilities emerging from the ownership is to be borne by the lessor.
6. Liabilities referable to the use of the property to be borne by lessee.

Istisna

Istisna is to manufacture of goods against progressive payment by the buyer. This contract violates the three rules that are available for the Islamic instrument to be true. However, there is a need for exceptions to also be addressed so that it is easier for the customers or individuals to access the Islamic banks for help.

Basic points for Istisna

1. Material to be supplied by the manufacturer.

2. A full description of the goods to be made and a commitment by the manufacturer for making.
3. Specs and price must be settled in clear terms;
4. The subject of Istisna be material that needs processing.
5. Advance payment not necessary.
6. Time of delivery not necessary to be fixed. Min. period may be fixed.
7. The contract is normally irrevocable but one of the parties may cancel the contract after giving a notice to the other before the work is started.
8. The buyer has the option to refuse delivery if the goods are not according to agreed specs but not otherwise.
9. Permissible to obtain collateral for the monies received or performance.

Salam

Salam is a type of sale in which the seller agrees to supply the goods in future against full payment of price received at the time of the agreement. This means that the buyer provides the seller with some amount of working capital so that the seller can begin to create the product that is required.

Basic points for Salam

1. Cannot resell, contract transference (hawala), or use in partnership capital.
2. Can not be entered into in exchange of commodities;
3. Can not be entered into for settling debt;
4. Can not be entered into for currencies;
5. Cannot be combined with Ijarah, Murabahah, Musawammah.

Al Wakalah

Al Wakalah is another form of an Islamic instrument that can also be used for investment purposes. “Al Wakalah means agency, or delegating duty onto another party for specific purposes and under certain conditions. Under the concept of Al Wakalah, the bank becomes your agent. You are then required to deposit the full amount of the price of goods to be purchased or imported.” (Emirates Islamic Bank, 2005)

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