BRIDGING CONVENTIONAL AND ISLAMIC BANKING

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In the last 20 years commercial banks share of US financial assets has declined to 24.5% from nearly 40%. New technologies of communication and computerized financial transactions made it possible for many savers to by-pass commercial banks and directly reach out to users of funds. This diminishing role of banking is, effectively compensated for by growth of financial markets (money and capital markets). Rather than taking the risk of the bank, more and more savers prefer to take the risk of borrowers. This is exactly the idea of Islamic banking. An Islamic bank is a financial intermediary. However, its operation is not based on a "borrower-lender" relationship with savers. Alternatively, it functions as an agent procuring investment opportunities to its depositors, where they directly take the investment risk. To prevent adverse selection and generate incentive compatibility, this agent gets fixed fees for its fund-management, rather it is compensated on the basis of actual profits of these investments.

The model of Islamic banking is built on what is called in Islamic jurisprudence "Mudarabah". Mudarabah is a principal-agent contract. It is based on trust, where assets remain the ownership of the principal (the saver in this case) managed by the agent (the Islamic bank).

Islamic banking raison d'être is the prohibition of usurious transactions. Because usury arise in loans, a financial intermediary established on the idea of borrower-lender relationship is not compatible with the Islamic system.

Both being essentially financial intermediaries, the differences between an Islamic bank and a conventional bank are basically that of operation. These difference can be summarized in two main points:

- that an Islamic bank advances are, effectively, off-balance sheet assets, and

- that value can pass from the bank to its clients either in the form of goods and services sold on differed payments or in the form of money. In the latter case risks and returns are shared between the bank and the users of funds.

It is not too difficult to see, therefore, that there is “common ground” between the two models of banking. Many conventional banks are discovering that Islamic banking is not as intricate as the name may sound. Responding to increasing demand from its clients, numerous conventional banks started offering interest-free banking products in the last 5 years. Most popular of these products is the Murabahah, where the bank takes constructive possession of assets and then re-sell on differed payment with a mark-up. Murabahah, which is in vogue now-a-days in automobile and housing finance, is not very dissimilar to bank lending, and actually creates comparable assets. Interest, however, is not compounded and no penalties are charged in the case of delayed payments.

Murabahah is the main stay mode in commodity transactions, where banks extend short term facilities to major commodity houses through purchase and re-sale on mark up. Because the prohibition of interest is very serious in Islam, pressure to innovate new banking products is very strong.

One bank is now testing a new credit card based on the idea of Murabahah.