ISLAMIC VS CONVENTIONAL BANKING
SIMILARITIES & DIFFERENCES

By:
Dr. Mohamed A. Elgari Bineid
Associate Professor of Economics,
King Abdulaziz University

Islamic banking is unique, but by no means anomalous. It is neither at odds with nor incomparable to conventional banking. Is it possible to contrast the two models?

I- They are both financial intermediations. A financial intermediary is the institution that acts as a middleman between cash surplus units (savers) and deficit spending units (users of fund). It is quite obvious that the main function of conventional banks is financial intermediation. However, there are those who would like to think that there is no such thing in the Islamic economic system as financial intermediation and that an Islamic bank can only be “sufficiently” Islamic if it can operate like a trader, one who buys and sells goods and commodities.

The financial intermediary in conventional banking is a “borrower-lender” institution. Since such institution will not survive unless it at least covers expenses, then an income must be generated from such arrangement. This is where interest appears. An Islamic bank, on the other hand, is based on a multi-tier Mudarabah. A Mudarabah is a partnership in profit where capital and management may joint together to create value. The income accruing to the Islamic financial intermediary is coming out of profit not from interest. The root of such a conception is the fact that Shari'ah doesn’t distinguish between a seller being a trader or a final intermediary, unlike positive law where civil law is different from commercial law. In Shari'ah all people stand against one legal code.

II- A case in mind is Murabaha. There are those who say if an Islamic bank does Murabaha any other form but the traders way of doing things it will not be permissible from Shari'ah point of view, and an Islamic bank would be in their view a “dubious” conventional bank. They say: since it is never the intention of the bank, to own there assets and hold on to them then, such bank is not sufficiently Islamic.

According to this viewpoint, an Islamic bank must have huge warehouses and elegant stores full of goodies for sale. This is not valid and those who think so miss two important points:

Intention is of no consequence on the permissibility or otherwise of any exchange contract in Shari'ah. In an authentic *Hadith*, the Prophet (PBUH) showed one companion how to substitute a usurious transaction by another non usurious to reach the same purpose, He (PBUH) didn’t object to the intention nor that he nullified the contract on the basis of intention. Rather he corrected the form of contract.

If the anatomy of the contract is in line with Shari'ah requirements, then the transaction is acceptable. Hence, if bank actually buys and then sells, with ownership passing from seller to buyer and that the subject of contract is a good or commodity then the transaction is correct. In conventional banking the subject of contract is money hence any increase is usurious.

III-The way conventional banks render financial intermediation is very simple. They borrow money and lend money. Both assets and liabilities are one form of lending. Islamic banking function in a rather “elaborate” (not perplexing) way. They have to continuously innovate to satisfy the needs of their clients. It is because of this we see Murabaha, Musharakah, Mudarabah, Istisna’a, Salam to name just a few Islamic modes of finance. This makes the job of an Islamic banker “not all roses”, but certainly a more interesting one.

IV- A conventional banker is a risk manger. He is concerned with all kind of credit, market, interest rate, legal and other risk factors. An Islamic banker should be just as concerned. However, there is one added risk for the Islamic banker, this is what we may call “Shari'ah disobservance risk”. Risk analysis refer to the forces that may cause the outcome of investment to be sub optimal. Certainly an Islamic investor earning non-permissible income is an outcome that is most undesireous, and it may cause the value of his investment to be reduced.

V- Contrary to popular opinion, being concerned about time value of money is a similarity not a difference between Islamic and conventional banking. There is no basis for the current thinking that Shari'ah doesn’t allow the attachment of monetary value to time in the contracts exchange. The contract of Salam and differed-payment sales fly in the face of this argument. It is only in loans that Shari'ah requires that no time value of money is considered (but replaced by great rewards in the hereafter).

VI- A major difference, however, remains in the handling of delinquency and default. When a borrower delays payment of debt, interest will accrue on his delayed portion. Unless, such borrower defaults and become incapable of paying back his debt, such interest will compensate the conventional bank for lost business. This can’t be done in Islamic banking as this is considered usurious.

Clearly, this is a disadvantage from two aspects: Firstly, an Islamic bank will not have the opportunity in a Murabaha transaction for example, to be compensated for lost profit. But more importantly, it increases significantly, the Murabaha risks. Since bank clients are *rational* people who will seize an opportunity when they see one, they will always delay payment. One major *Ijtihad* of contemporary Shari'ah scholars, is to allow the Islamic bank to impose penalties. Rather than accrue such penalties as income, and hence become usurious, they are disposed off to charity. This way the pressure will mount on the debtor to pay in time, without falling into Shari'ah impressibility.