Comparison between the Islamic and conventional banking system

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***Abstract*-In order to meet the growing financial needs, Islamic banking has emerged as the important facet of an economic system in recent times, the philosophy of Islamic banking, i.e. interest – free banking is to creat a healthy financial system. It augers well for both the banker as will as the borrower and create a win – win situation. The conventional banking by large supports, the banker and it is observed that only rich people could comply with it. Basically, it promotes capitalism. Whereas, interest – free banking instills a sense of confidence even among small business men. A business firm with limited cash reserves can also be benefited by the interest – free banking system. Despite its unique features and advantages, it has not gained momentum in the world of business.**

Introduction:

The concept of banking is as old as human civilization. It dates back to the evolutionary phases of human society. Over a period of times, the world economy has witnessed paradigm Shift. It has been transformed from production-oriented economy to consumption economy, and now it is leading to service economy. Banking has always been the essential component of service sector. The banking is an institution through which financial needs of people are met. Basically, the banks provide loans to the businessmen, traders, and merchants to conduct their business operations. In conventional banks, the bank charges an interest over the money or loan given to businessmen, traders, and merchants. Due to the traditional banking system, the common businessmen suffer. It is observed the common business men have to pay huge debts in the traditional setup of banking. It is also found that conventional banking develops economic instability in the society where in the wealth is concentrated among the moneyed class. This results in the economic disparities among the people at large. Often, it leads to conflicts and violence in societies across the world.

In today's age of Globalization, A nation can progress by adopting the best practices prevailing over in different parts of the world. Rather picking the best method has become the order of the day. One of the important concepts that have emerged in the world of business is Islamic Banking, i.e. Interest-free banking. It is basically a banking system that adheres to the Islamic rules and regulations regarding financial management.

Islamic Financial institutes are expanding globally. The number of Islamic banks had grown significantly in the Southeast Asia and Middle East countries, not only in nations with a majority of Muslim populations, but also in other nations where Muslims are a minority, such as the Japan and United Kingdom. There are as well universal Islamic banks in United States and the Europe adopting many Islamic products to attract investors who prefer the use of Islamic credit instruments, such as Musharaka Mudaraba Murabaha, and sukuk.

In order to know the framework of an Islamic banking system, we need to understand the Shariah (Islamic principles), that the reason behind Muslim society is not permitted to pay or receive interest, which is known in Arabic nations as Riba(interest), a reason of interest - free financing is to avoid the fixed return on capital. The principle of Shariah prevents the effort less and risks free transactions. In this respect, Islamic banking offers various instruments on the basis of profit and loss sharing principle of Shariah.

According to the Institute of Islamic Banking and Insurance. There are more than 300 Islamic banks were operating in the world from USA to the China managing funds to the tune of $300 billion, while the development of Islamic financial institutions around the world was 20% that of conventional banking were much less. The system has the added features of curbing speculative activity as all its financing is linked with commercial transactions. The largest Islamic banks are located in Bahrain, Kuwait, Saudi Arabia and Iran. Western banks through their Islamic units in the Switzerland, Germany, UK, Luxembourg, etc. also practiced Islamic institution. The Islamic Banking will be increased to, from 3 per cent to 10 percent in Indonesia, 13 to 20 percent in Malaysia, 10 percent from 2.5 per cent in Pakistan and 60 per cent in the Gulf Cooperation Council (GCC) countries.

Riba:

Riba is derived from the holy Quran means excess, addition or increase, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration. The reason of prohibition is the fixed return where there is no physical effort. In context to finance it means the Leander levy the extra charges on the money he lends to the borrower of the time when the borrower returns the money back to the lender. This practice was common during pre Islamic period. With the advent of Islam, riba was prohibited from the economic system society. More unfortunately, it has been prevailing over in the society for centuries in one or the other forms. In olden times, the capitalist used to lend loan to the poor peasants artisans and people from different class doing so, they were amassing wealth and becoming rich.
In the present context, the modern banking is emulating the erstwhile capitalist in a more refined and a sophisticated way. It would not be wrong to say that the traditional banking nothing but an old wine in a new bottle.

Concept of Traditional and Islamic banking:

The unique feature of an Islamic bank system is that allows sharing profit and loss with clients; on the contrary, traditional banks have no such provisions. This gives competitive advantage to Islamic banking over traditional banking. It also provides ownership rights to the clients. Islamic banking in contrast to the conventional banking system, is drivan on interest based ideology. While an Islamic banking system has interest - free system and principles and distribut, their profit and loss with client and sometimes shares their services with business intermediaries.

The reason behind the forbidding of interest (Riba) and importance of an Islamic institution system has been taken in many Islamic economic systems. principles of the Islamic financial system is creating a financial atmosphere between partners, intermediaries, borrowers and lenders. Islamic institutions are similar to those of traditional institution in as the far as services are concerned.
In principle, the main objective of both the systems, i.e. Islamic and traditional is to ensure the economic growth of the society at large, to what extant they suffice the purpose in area of our research theory.

Islamic institution compared with conventional banks seeks a "just" and "equitable distribution of resources". Islamic Fiqah governs Islamic banking and it ensures that all operations of Islamic banking are in the circle of Islamic law and Shariah.

According to the Institute of Islamic Banking and Insurance, there are more than 300 Islamic Financial Institutions in the world. These institutions are working in the following countries: Yemen, Oman, Saudi Arabia, Iran, Morocco, Egypt, Iraq, Sudan, Palestine, Jordan, Qatar, United Arab Emirates, Algeria, Kuwait, Turkey, Malaysia, Albania, Niger, Nigeria, India, Pakistan, Philippines, Russia, Senegal, Cyprus, Djibouti, France, Australia, Bahamas, Bahrain, Switzerland, Tunisia, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, Guinea, Indonesia, Gambia, Germany, Italy, Ivory Coast Kazakhstan, Lebanon, Luxembourg, Mauritania, The Netherlands, United Kingdom, South Africa, Sri Lanka, Trinidad, Tobago, and United States.

Traditional banks VS Islamic banks:

Islamic Banks	**Traditional Banks**
The operation and functions of Islamic banks are based on shariah i.e. principles of Islam.	The operation and functions modes of traditional banks are not based on religious aspects.
Involvement investor and entrepreneurs in the profit and loss.	The conventional banks determine the interest rate in advance.
Islamic banks also maximize profit, but it should be in compute adherence to Islamic shariah.	Profiting is the sole object of traditional banking.
Islamic banks need to do charity by paying zakah (compulsory religious levy) out of their income.	It does not deal with *Zakat.*
Partnership in business is the fundamental function of the Islamic banks, interest is strictly prohibited.	The fundamental function of the conventional banks is Lending money and getting it back with interest.
They do not charge any extra amount to defaulters.	It can charge additional money (penalty and compounded interest) in case of defaulters.
In abroad sense, it helps in establishing an egalitarian and brings stability in bridging the gap between pro and	Very often it results in the bank's own interest becoming prominent. It makes no effort to ensure growth with equity.
In Islamic banks, the clients of the banks are not mere stakeholders they are treated as the partners of the banks.	The relationship between client is of creditor and of the debtor in traditional banks.
Islamic bank can only guarantee deposits for a deposit account, which is based on the principle of *al-wadiah*, thus the depositors are guaranteed repayment of their funds, and however, if the account is based on the mudarabah concept, clients have to share. A loss if it occurs.	Traditional banks have to guarantee all its deposits.

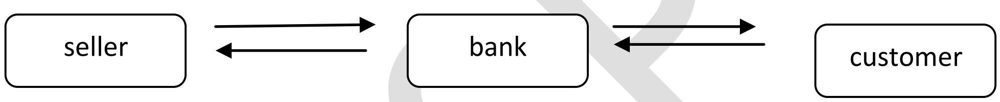
Islamic ethics of investment:

Islamic banking is premised on the concept of shariah. The shariah is the moral code of conduct laid down for the people to follow in their personal life and worldly affairs there is no separation between personal life, and religion dominated every sphere of human society. Islamic banks in consonance to the Islamic shariah does not allow an individual to invest money in the production of alcohol, consumption and distribution institutions involved in pork drugs, and gambling. These businesses are strictly prohibited in islam, thus, Islamic banks are effective in preventing the moral decay of the society. Whereas, conventional banks are not concerned about the nature of business. Their sole objective is to maximize profit even if it affects the society adversely.

Instruments of Islamic banks:

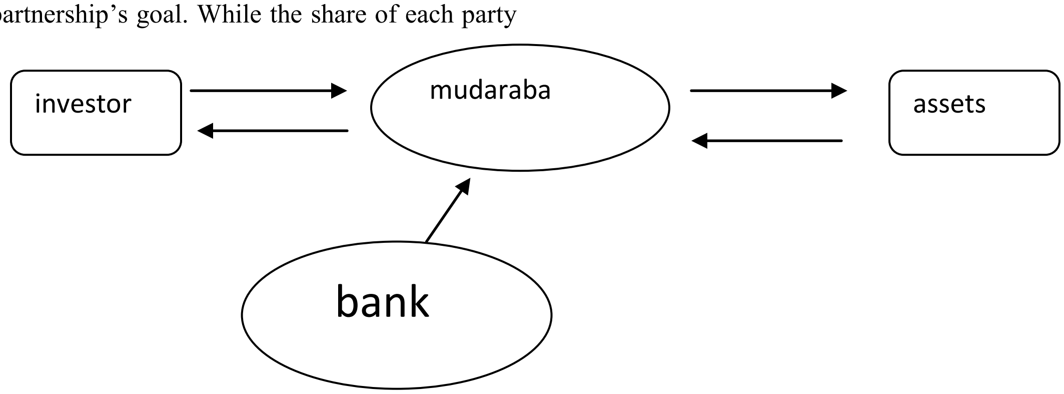
Wadiah:
wadiah is a contract between client and the bank, either cash or assets in the bank for safekeeping, the bank guarantees the items from stolen.

Murabahah: (cost plus)
The murabaha is cost plus, basically, it refers to purchase tangible goods form third party at a request its customers, and resells the good to clients at pre agreed price on installments by adding a profit margin. On one hand, it is the sales of goods at a price that covers the cost and plus added profit, which is based on agreed a profit margin.



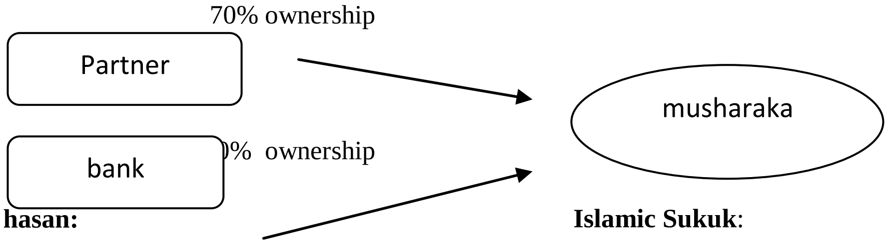
Mudarabah (interpreted as trust-financing):

under this mode of financing an Islamic bank, as a limited partner, provides cash (capital requirements) to a borrower or an entrepreneur who is free to use the funds in pursuit of the partnership's goal. While the share of each party in the profits and losses must be in percentages, and all expenses related to the partnership are deductible before profit distribution.the bank or investor alon bear the losses if any.



Musharakah (joint venture):

Musharaka is an Arabic word which literally means (sharing). which known as joint venture. Here the bank as its customer agrees to contribute in a business and share all the net profit and loss together. This concept is basically used for investment projects.



Qard hasan:

In this instrument, a loan is given for a fixed period on a goodwill basis, and the borrower is only required to repay the amount borrowed, without profit-sharing and interest.

Islamic ethics of investment:

Islamic shariah (Islamic principles) is the basis of the laws and regulations in Islamic banks from which is extracted the basic principles of investing and trading, where it is in Islamic Ethics does not allow Muslims to invest in the production, consumption and distribution institutions involved in pork, alcohol, drugs and gambling illegal, and to the piece even if profitable revenue large, where the aims of Islamic finance by investing to involve the largest possible number of members of the community to benefit from this money, on the other hand, the traditional bank does not have the restrictions on such investments and this, which sets it apart from Islamic banks.

Islamic Sukuk:

Islamic sukuk (bond) is one of the Islamic instruments based on the division of investment capital into equal shares, by issuing financial sukuk of capital on the basis of units of equal value, and registered by names of their owners as have the common shares in the capital and what turns him by the ownership of all of them in it for ensuring investment projects generate revenue and be of fixed assets, and the ownership of these Sukuk to be sharing ownership, lease or mortgage the assets of this project.

Conventional bonds:

The bonds are a fixed interest financial asset issued through banks, companies. And Government to the public on a particular date in these bonds the holder will not bear any loss.

(Islamic) sukuk Vs bonds (conventional|):

	Sukuk(Islamic)	**Bonds(Conventional)**
Asset ownership	The Islamic bank gives Sukuk to the investors and allows them to own the assets under the Agreed Framework.	The Bonds in the conventional banks do not allow the investor to get a share of ownership in the projects, and the business, or the ownership of assets in which only the commitment of the bank to the bondholder.
Investment criteria	The asset on which sukuk are based must be sharia-compliant.	Bonds used in conventional banks to invest and finance the business, assets, projects, or any joint venture consistent with local legislation.
Issue unit	Islamic sukuk represent a share	Conventional bonds represent a share of the

	of the essential asset.	debt.
Issue price	The face value of islamic sukuk is based on the market value of the essential asset.	The face value of traditional bonds depends on the issuer's credit worthiness, including its rating.
Investment rewards and risks	Sukuk holders receive a share of profits from the essential asset and accept a share of any loss incurred.	Bond holders receive regularly scheduled (and often fixed rate) interest payments for the life of the bond, and their principal is guaranteed to be returned at the bond's maturity date.
Effects of costs	Sukuk holders are affected by costs related to the essential asset. Higher costs may translate to lower investor profits and vice versa.	In general, the bondholders aren't affected by the value of the projects, and the business and assets, joint ventures and dose not affect the rewards investors.

Conclusion:

The Islamic institutions are emerging concept. They are spreading global phenomenon; in specific, the number of Islamic banks had grown significantly in the Southeast Asia and Middle East. The presence of Islamic banks is not only in felt in Muslim dominated countries. Even countries where Muslims are minority, Islamic banks are gaining acceptance such as countries are Japan, UK; etc. Traditional banks promote capitalism and augment interest.
Ridden financial system, the Islamic banks i.e. interest-free banks strengthen the economic condition of the people large and establish a parallel economy.

The guiding principles for an Islamic financial system are a set of rules and laws, collectively referred to as shariah (principles of Islam).
The Islamic financial institution do not permit financing any project, which conflicts with the principle of shariah for example; Islamic banks will not finance a night club, a casino. The unique feature of Islamic institutions is profit and loss sharing model, where the conventional banks deal with their clients as the financial intermediary.

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