Introduction

Almost all the serious studies on Islamic banking have indicated that, this important aspect of Islamic economics system is still at its ‘infancy stage’ of development.\(^1\) It has a practical experience of about four decades and it would be unjustified comparing Islamic banking with conventional banking which is more than three centuries old.

In addition Islamic banks have their own conceptual mainspring, defining objectives, procedures and practices in which they are involved and there is hardly any collision with hundreds of non-Islamic banks who co-exist with them. However, there are factors that make a distinction between the two systems of banking. As a matter of fact, unlike the Islamic banks, the existing conventional banks originally germinated in Europe. With the prime concern to gain control over resources and livelihood of people, through the utilization of funds. Hence, the realization of these two factors justified the adoption of any means or method available. Islamic economists give much emphasis on the objective side of the Islamic banks. That is, unlike the western commercial banking system, Islamic banks are “governed by controls derived from Allah’s course”, while conventional banks are controlled only by hard competition. In this regard one writer argues that Islamic banks constitute an integral part of

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society, in harmony with its other constituents; on the march towards achieving ‘Allah’s course’ while commercial banks are not related to their own society except through profit making. In practice, Islamic banks work in the field of investment as they hold to the belief that money is but a means to an end. Hence they do not trade in it. Conventional banks work in buying and selling money, which they treat as a commodity and not a medium of exchange. This gap between the two broadens dramatically when it causes to their objectives.

In this chapter an attempt is made to analyze the Islamic banking vis-à-vis conventional banking from the point of view of efficiency, stability, growth and justice. The theme of the chapter revolves around these concepts; however, in later part an empirical analysis of both the system is presented.

Efficiency is considered the primary criteria by economists; therefore, we would like to start our discussion from efficiency, which system is more efficient in the task it is assigned to. In the case of banks their primary business is financial intermediation. It would be discussed whether the system Islamic or the conventional performs this function more efficiently. Another very important aspect from the economic point of view is stability. Which system is more stable shall also be looked upon. Which system leads to growth, as it is the objective of all concerned, shall be our third point of discussion. Justice is the goal for which we all strive for, which system is more justifiable, is also our concern. I have put it as the last point of my discussion, however, in no way our purpose is to demean its importance. It is one of the most important aspects of one’s life especially when it comes to public life. However, only for economic reasons we shall try to attempt this issue a little later. In the end we shall present an empirical picture of both the banking systems. There is a lack of comprehensive study mainly due to Islamic banking being a relatively new phenomenon and also due to the fact that conventional economists have still not taken Islamic banking as seriously as they should have. There may be many
reasons to it which we shall try to highlight in the course of this chapter. However, first we shall begin from the issue of efficiency.

**Efficiency in Banking Sector**

The issue of bank efficiency is important at macro as well micro levels. At the macroeconomic level, bank efficiency is a socially optimal target since it reduces the average cost of financial transactions and therefore enhances the societies welfare. The issue of banking efficiency is important for various reasons few of them are as follows.

The financial sector is a major player in modern economies, as a producer of financial services and as an employer. Banking system fulfils essential functions in intermediating between the savers and investors, financing private sector trade and investment and helping to ensure that the economy’s financial resources are allocated effectively.

The measurement of financial efficiency is important to all parties that participate in the banking industry. Assessing bank’s performance through measuring efficiency helps bank management to improve managerial performance. It assists investors in making investment decisions whether to participate in financial activities. Regulators are also interested in banking efficiency since the performance of the banking sector has significant impact on other parts of economy. Al-Jarhi, a senior economist at the IDB/IRTI, observes that “Banks in Islamic economics system operate on the bases of universal banking, i.e., they can take equity and provide credit finance simultaneously to the same enterprises. The practice of universal banking in a word of asymmetric information is known to reduce the cost of monitoring borrowers. This means that the transaction costs of credit finance provided by banks to enterprises in which they take stock would be lower with universal
rather than commercial banking. This in turn would imply lower transactions costs of providing credit purchase to enterprises in which banks have stake”. 2

**The Efficiency**

Islamic economics researches and their practical application have shown that the economic system can function without interest. A system using profit-sharing modes where possible and trade based modes, e.g. Murabahah, leasing, etc. where necessary, will be more equitable, more efficient and more stable than the current interest based system.

Islamic economists in their researches have shown that interest has had bad consequences for the economy. As it results in inefficient allocation of society’s resources, it contributes to the instability of the system and also it increases the inequality in the distribution of income and wealth. As Professor Siddiqi rightly points out it that the interest based system “guarantees a continuous increase in the monies lent out, mostly by the wealthy, and puts the burden of bearing the losses on entrepreneurs and, through loss of jobs of the workers”.3

On the contrary, Islamic modes of finance not only expose the money owner to some risk but also bring him opportunity for higher returns. And so it is fair to the entrepreneur, as it does not oblige him/her to bear losses occurring despite good, and honest management. It is better for the society since it allocates financial resources on the basis of expected profits which reflect productivity. In the conventional finance funds are allocated on the basis of creditworthiness of borrowers, which may not reflect his/her productivity. In Islamic finance the project financed have the advantage of being double-checked, once by the fund seeker and secondly by the fund supplier, since both’s returns depend on the actual outcome of the project.

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Another aspect of this argument is raised by Chapra who is of the view that the resources of the financial institution come from a wide cross section of the population; they must be utilized for the well being of all the sections of the population. The financial resources are extremely scarce, therefore it needs to be used with optimum equity and efficiency, which according to Chapra can be done only when finance goes to (a) the optimum number of enterprises and (b) the production, import and distribution of goods and services needed for the need satisfaction of all the members of the society. Chapra points out that the conventional interest based financial system is not capable of helping realize either of these two goals. It leads to both inequity and inefficiency in the use of resources.4

The inequitable allocation of financing in the conventional banking system is now widely recognized by Western scholars also. According to Arne Bigsten, “the distribution of capital is even more unequal than that of land” and “the banking system tends to reinforce the unequal distribution of capital”.5 The point behind Chapra’s argument is that the present interest based banking system is inherently biased in favor of rich as they are the people who could offer sufficient collateral required for finances. Has this not been the case finances would have gone on the merit of the project, which would have been more equitable and just for the society as a whole. To stress his point Chapra quotes some other western economists and Morgan Guarantee Trust of the US, which admitted that the present banking system has failed to “finance either maturing smaller companies or venture capitalist”6

Western scholars on the other blame that in Islamic finance too the most practiced form of financing (Murabahah) is based on fixed return, which is hardly distinguishable with interest based finance. Islamic economics, in reply.

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content that *Murabahah* and other trade-based modes of Islamic finance may create debts. But these debts cannot be traded except at par value which prevents them from ballooning into several times their original volume. Since they arise in the process of supplying real goods and services, they do not have much expansionary effect on the system. This is quite unlike interest-based finance in which debts are created on the basis of creditworthiness of borrowers and they are traded like any other commodity. This kind of financial sector acquires a life of its own independent of and only tenuously linked with the real sector of the economy. This makes it vulnerable to speculation bordering on gambling in which risks are created for the purpose of taking risk, with no relation to the production of wealth.\(^7\)

Another notable feature of *Murabahah* finance as pointed out by Islamic economists is that any change in spending pattern is automatically reflected in change in demand and supply of goods and services. Islamic economists concede that modern economy cannot function without credit. But the way credit is created in the absence of interest rules out the possibility of excessive debt creation or its continued accumulation at an accelerated rate because the price to be paid in future for goods and services supplied in the present once determined cannot be increased. No debt crisis can take place in a system without interest in which all debt is for goods and services supplied and, most likely, against collateral.\(^8\)

At other place Siddiqi recalls, “You exchange money either for goods and services, or for money or for debt. In the Islamic framework we have no problems with the first, the second, exchange of money for money is severely constrained, and the third is almost eliminated. Islamic law allows cash for debt only at par, which leaves no room for a market in which debt could be sold for

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\(^7\) See Siddiqi, M.N. at www.siddiqi.com/mn

\(^8\) Ibid.
cash. It also allows exchange of debt for debt at par and with further restrictions. 

On the charges of separating financial economy from the real one and banking from the commerce Patrikis argues that, this policy of separating banking and commerce is grounded upon a mixture of safety and soundness concerns and a broader public policy concern about fair and equal access to credit and control over society's resources by banks. On the other Islamic economists charge that separation of commerce and banking is the result of interest mechanism which in turn has been responsible for disproportionate and independent growth of financial economy to such a state where these debt instruments are themselves treated and traded like a commodity.

The Stability

Several researchers have compared both the banking systems in order to assess their implications for the stability of the banking system. In this regard Mohsin Khan (1986) and Abbas Mirakhor (1987) of IMF have proved that banking contracts as found in Islamic form of banking are more stable than the contracts found in conventional banking. United Nation Development Report describes the implication of conventional contracts in these words. "When the market goes too far in dominating social and political outcomes, the opportunities and rewards of globalization spread unequally and inequitably concentrating power and wealth in a select group of people, nations and corporations, marginalizing the others. When the market gets out of hand, the

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9 Siddiqi, M.N., Islamic Finance and Beyond Premises and Promises of Islamic Economics in Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities, Harvard University, Cambridge, October, 1999, p 50
11 See Khan, S. Mohsin, "Islamic Interest-Free Banking: A Theoretical Analysis" International Monetary Fund Staff Papers, March 1986
instabilities show up in boom and bust economies as in the financial crisis in
East Asia and its worldwide repercussions, cutting global output by an
estimated $ 2 trillion in 1998-2000. When the profit motives of market players
get out of hand, they challenge people’s ethics and sacrifice respect for justice
and human rights".13

For Islamic economists profit-sharing finance synchronizes payment
obligations of firms with its revenue accruals, thus removing a great source of
instability in the system. On the other, interest based finance subjects the firm
to a rigid schedule in which the amounts due for payment as well as the dates
payment is due does not take the current project status into account. This may
oblige the firm either to borrow (usually at a higher interest rate) or to sell its
products at a lower than expected price in order to meet its contractual payment
obligations. The third alternative is default which sends shock waves through
the system.14

The IMF has also put its weight in favor of equity financing by arguing
that “Foreign Direct Investment, in contrast to debt creating inflows, is often
regarded as providing a safer and more stable way to finance development
because it refers to ownership and control of plant, equipment and
infrastructure and therefore funds the growth creating capacity of an economy.
whereas short term foreign borrowing is more likely to be used to finance
consumption. Further more in event of a crisis, while investors can divest
themselves of domestic securities and bank can refuse to roll over loans.
owners of physical capital cannot find buyers so easily”.15

Islamic economists quoting Western scholars argue that interest is one
of the most destabilizing factor in the economy. Milton Friedman has
considered erratic behavior in interest as one of the most disturbing phenomena

Oxford University Press 1999, p.2
14 Siddiqi, M.N., Paper Presented at La Riba annual meet at Los Angeles, CA. on 30 March 2002. See
www.siddiqi.com/mn
15 IMF. “World Economic Out Look”, May 1998, p. 82.
while Mr. Iacocoa, the chairman of the Chrysler Corporation, observes that interest rates have been so volatile that no one can plan for the future.\textsuperscript{16} In fact the erratic behavior in interest rates has largely been responsible for erratic movement of financial resources between the savers and the users which has brought a high level of instability in the financial market. According to Chapra, “The high degree of interest rate volatility has injected great uncertainty into the investment market which has had the effect of driving borrowers and lenders alike from the longer end of the debt market into the shorter end, thus fundamentally altering the investment decisions of businessmen”.\textsuperscript{17}

In contrast to this the equity based Islamic financial system is not prone to such vulnerability as the resultant profit is based on the actual outcome of the business. This is also more equitable in the sense that no participants of an economic activity are ensured of any fixed return in advance of the business result. Several of the Western economists too have endorsed the view that equity based system is more stable as compared to the interest based and blamed interest for their economic woes.\textsuperscript{18} As Sundarrajan and Luca have pointed out in their very recent study that owing to the structure of their balance sheet and the use of profit and loss arrangements, Islamic banks are better poised than conventional banks to absorb external shocks. Solvency risks are typically lower in Islamic banks than in conventional banks.\textsuperscript{19}

\textsuperscript{16} Both quoted by Chapra, M. Umer, ‘Towards a Just Monetary System’, The Islamic Foundation, Leicester, 1985, p. 117.
\textsuperscript{17} Chapra, M. Umer, ‘Towards a Just Monetary System’, The Islamic Foundation, Leicester. 1995. p. 117.
The Justice

As mentioned earlier that conventional banks lend money to earn interest while Islamic banks provide finance to share profit. This fundamental difference leads to many other important differences between the functioning of the both.

Interest of the conventional banks lie in ensuring that the loan is paid back together with interest. Naturally the conventional banks, therefore, are not much interested in the kind of economic activity, or the profitability of the projects financed or any other moral concern, for which the loan is sought.

Thus, the conventional bank grants higher preference to the credit worthiness of the borrowers than the viability of the project to be financed or the ability or the idea of the entrepreneur. Islamic economists argue that this method of financing is the primary cause of miss allocation of the economy’s resources.

Efficient entrepreneurs who are unable to provide collaterals are fail to get credit at the cost of relatively rich entrepreneurs who are granted credit. Since those who are granted credit have to pay a fixed interest irrespective of the actual out come of the project. Since there is no monitoring of the funds available to the entrepreneurs there are very likely chances that, to ensure their own profit plus the cost to be paid to the bank, many a times entrepreneurs would try to adopt various methods that are actually not in conformity with the societal objectives and lead to various speculative and other harmful activities. Professor Siddiqi in his recent address at the Harvard has rightly pointed out, “At the top of the list is the opportunity the current (Conventional) system provides for money to be exchanged for more money, making the moneyed richer. Next in importance is the immense scope for gambling-like speculation provided by the huge volumes of debt-based securities in a system that permits sales on margin, short selling and other exotic money games. Last but not the least is the philosophy that regards profit maximization as the only legitimate
concern of the investment managers to the neglect of all the other ingredients of human weal.\textsuperscript{20}

Various researches have shown that even if the funds are used in proper economic activities, the cost of the items produced has risen significantly. This has had harmful effects on the consumers of those produced item as well on the employment in that sector due to predetermined high cost of the capital. Many a time it is observed that the increased cost of product is borne by the poor and it is again the poor who is to suffer if the increasing costs lead to low demand resulting in lower production and employment. Interest based financing by the conventional banks and the production result in two other side effects that leads to high instability in the economy.

- Firstly, under this method of finance only those who are rich enough get finance and so the profit, thereby rich getting richer. In the long run this result in transfer of funds from poor to the rich.
- Secondly, since most of the industrial activities are financed through banks, the costs of industrial products, therefore, perpetually become higher as compared to the production of other sectors of the economy like agriculture. This also leads in transferring of funds from non-industrialist to the industrialist sector. And thereby making one sector of the economy richer at the cost of other.

**The Growth**

Islamic bank, which has to share the profit, due to Islamic prohibition of \textit{ex ante} price of the capital, is always more interested in the beauty and viability of the project as compared to the face or wealth of the borrowers. Islamic bank is naturally more concerned about the entrepreneurial capabilities, honesty, and truth fullness of the borrowers. Islamic bank will provide capital to those who

\begin{flushright}
\textsuperscript{20} Siddiqi, Mohammad Nejatullah. ‘Comparative Advantages of Islamic Banking and Finance’. Presented at the Fifth Harvard University Forum on Islamic Finance, 6 April 2002.
\end{flushright}
are known for their entrepreneurial capabilities rather than those who are famous for the assets of their fathers. Inbuilt monitoring coupled with other Islamic prohibitions like speculation, gamble and other kinds of frauds (Gharar) and cheating ensure that the funds of Islamic banks are utilized for the overall benefit of the community. Unlike the conventional banks where absence of monitoring may leads to private profit but at the social cost.

Under Islamic system of banking projects with low expected profit may also be undertaken as there is no ex ante cost involved to the capital. This will enhance the entrepreneurial capabilities of the society as a whole and led to overall growth of the economy unlike the commercial way of financing, which helps in producing a class of elites out of the funds of the masses. Islamic economists affirm that the projects that are chosen for their viability will naturally be more growth oriented than those that are chosen because they are propose by rich borrowers.

Justifying the rationale of Islamic banking, Professor Khurshid notes, "The central issue is that the contemporary financial system is exploitative, unjust, discriminatory, unstable and crises generating. There is no denying the fact some positive contributions that have been made by the banking and financial system towards the promotion of economics development and global capitalism. But when a balance sheet of achievements and failures is made, its failures outweigh and outnumber." He further says that in Islamic system of banking money does not beget money rather used as a facilitator for the greater production of goods and services, resulting not merely in increasing the number of billionaires but producing real well-being for the people.

In Islamic finance money is no more than a servant and used no more than a medium and measure, on the other in conventional finance money itself becomes a commodity and object. Thus the historical role of money an intermediary for exchange (commodity-money-commodity, C-M-C) gets

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transformed into money-commodity-money (M-C-M) and ultimately ends up into M-M-M. According to Professor Khurshid derivatives trade at the rate of 1.2 trillion a day is almost 50 times more than the daily physical international trade in goods and services. The balloon of the financial economy is expanding at an alarming pace via speculation, while the real economy is only crawling. For Islamic economists the real economic progress and development consist in the expansion of the physical and human aggregates of the economy via the creation of assets, products and services, and not merely in the form of fiduciary expansion.

Convergence of Islamic and Conventional Banks

Several of the scholars, however, are of the view that the comparative advantage of conventional western banks over Islamic banks in terms of their systems, management experience, and techniques of product innovations are expected to bring competition, resulting in the sharpening of techniques and procedures of Islamic banking modes. In the process, profitability rather than profit constraints is gaining dominance in Islamic banks' operations. The western conventional banks that have Islamic windows lack an understanding of the ethical and moral foundation of Islamic finance. The Islamic banks in the corporate sector are running the risk of being submerged in the wave of market economy and marginalizing the social and ethical elements of Islamic finance. While this point of convergence may bring efficiency to their operations, it is expected to bring following dilemmas for Islamic banks in the corporate sector:

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22 Ibid. p. 68.
23 Ibid. p. 61.
1. An increasing concentration of ownership and beneficiaries of Islamic banking and finance having links to the global elite and its network of reciprocal obligations;
2. The crucial neglect of the vast masses of people in Muslim countries incapable of entering the market;
3. An increasing trend toward the secularization of Islamic economics, banking, and finance;
4. The marginalization of the social, ethical, and moral ingredient of Islamic modes of financing; and
5. A developing barrier to the growth of perpetual social capital, which expresses the shared values of a society, reinforces them, and stimulates the growth of the caring society.⁵⁶

Several attempts are being made to highlight the differences and similarities between Islamic and conventional banking. A brief review of those attempts is given in the following section.

**Similarities Between Islamic and Conventional Banks**

There are many similarities between Islamic and conventional finance, since both deal with a common set of operating business realities. In most cases, Islamic and conventional finance simply travel different paths toward the same goal. For example; most business need long term financing. In conventional finance, this is accomplished through some mix of long term debt and owners’ capital. In the Islamic finance, passive partners contract for a certain share going to the entrepreneurs who manage the business.

Another operational similarity between Islamic and conventional banking is their common requirements for inventory financing. An Islamic business in need of short term inventory financing can purchase the inventory on credit that credit being supplied either by the inventory supplier or a bank.

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⁵⁶ Ibid.
Many businesses find it necessary to supply credit to their customers through accounts receivable. An Islamic business can do this but is not permitted—as in conventional finance—to refinance by pledging or selling those receivables because they are not real assets.\(^{27}\)

Few Western scholars think that Islamic banking is more like mutual fund institutions or like venture capital funds. For example, Sundarrajan and Errico of IMF point out that Islamic banks show an operational similarity with conventional investment companies, including mutual funds owing to the fact that they do not guarantee either capital value or the return on investment deposits and that they basically pool depositors’ funds to provide depositors with professional investment management.\(^{28}\)

Warren Edwardes, a venture capitalist, observes about Islamic finance in these words, “What I, as a non-Islamic observer would call "pure" Islamic banking, seems to be structurally very similar to venture capital finance, non-recourse project finance or ordinary equity investment. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital. It involves investing but not lending and therefore on a systemic basis is similar to the German, Japanese and Spanish banking systems rather than the British or American systems”.\(^{29}\)

Some other major similarities between the Islamic and conventional banks are given below:

1) Both are governed by the general rules of the regulatory authority covering establishment, control and general operations.

2) Both the system operate within the context of professional efficiency, cost effectiveness and cost / benefits.


3) Both are directed towards useful employment of resources for the society.

4) Both are usually established as shareholding companies.³⁰

**Differences Between Islamic and Conventional Banks**

As mentioned earlier Islamic and conventional banking are totally at different footings. One treats its depositor like equity holders and therefore provides no guarantee of even the principal amount, while the other treats its deposits like safekeeping. It not only guarantees deposits but also some returns. There are some big differences in both the systems both at the macro as well as micro levels. These differences are in approach, in concepts, and in the resulting behavior. The first and foremost difference that lie between Islamic and conventional banking begins with the prohibition of interest (riha) that basically emanates from the Islamic Shariah which controls and guide the Islamic banks in all its operations while there is no such religious prescription for conventional banks. Conventional banks are free to choose any business and activity they like unless they are contravening the regulatory guidelines of the country in which they are functioning. Conventional banks, in this regard, have a free ride unlike Islamic banks which are twice regulated. First, under the regulatory supervision of the country where they are functioning and secondly under the Shariah guidelines. Some times for Islamic banks later (Shariah) becomes more important than the former in the sense that Shariah guidelines are not bounded by time and space. Regulatory guidelines on the other is relatively easy to follow which very often may differ from county to country and time to time. Some times large conventional banks succeed in not allowing the regulatory authority to bring a change that is not liked by the conventional banks or goes against the interest of the promoters of the banks. This is never possible in case of Shariah guidelines controlling Islamic banks.

Some other differences between both the banking systems stem from the nature of their operation. For example, Islamic banks by default are faced with more risks as compared to their counterpart. Though, Islamic banks just like conventional one analyze their risks. However, Islamic banks are faced with more risk as they are more exposed to business and trade as compared to the conventional banks. Fuad and Abdel Haq summarize the potential risks of the Islamic banks in the following table. (5.1)

As can be seen in the following table that Islamic banks are comparatively at high risk than their conventional counterparts. For example, credit, maturity mismatch, and liquidity risks in Islamic banking are high as compared to these risks in conventional banks. Islamic banks are not faced with interest risk instead they are more exposed to trade and investment risk which is not confronted by conventional banks at all.

Table No. 5.1
Risk Faced by Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>Types of Risk</th>
<th>Conventional Banks</th>
<th>Islamic Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>A</td>
<td>A (High)</td>
</tr>
<tr>
<td>Maturity Mismatch</td>
<td>A</td>
<td>A (High)</td>
</tr>
<tr>
<td>Currency Risk</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Interest rate Risk</td>
<td>A</td>
<td>NA</td>
</tr>
<tr>
<td>Risk of Trade and Investment</td>
<td>NA</td>
<td>A</td>
</tr>
<tr>
<td>Transaction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity Risk</td>
<td>A</td>
<td>A (High)</td>
</tr>
</tbody>
</table>

Source: Omar, al Fuad and Abdel Haq, op cit p 105

Another notable difference between Islamic and conventional banking and finance lie in the focus on financial accounting and information. The

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11 Credit risk, capital adequacy, liabilities and assets matching risks, currency fluctuation and liquidity risk etc.
conventional banks put more emphasis on interest rate spread, provision of loan portfolios and maturities of the liabilities, while in Islamic banks the emphasis is more on assets allocation and return from investment and trade. Some other mentionable differences between Islamic and conventional banks are as follows:

1) Islamic banks would concentrate more on public welfare as compared to the conventional banks.

2) Islamic banks are more like universal and multi purpose as compared to the conventional banks.

3) Islamic banks would have to make more careful evaluation of applications for equity oriented financing. As they are naturally more exposed to risks.

4) Profit and loss sharing tends to foster closer relations between Islamic banks and the entrepreneurs. This opportunity is not available to conventional banks.

5) In case of emergency access to money market is not an option for Islamic banks.

6) Islamic banks have different moral basis, i.e. Jurisprudence (Shariah).

7) Islamic banks are universal “Comprehensive” whereas in conventional framework there are commercial investments, merchant or specialized banks.

8) Structures of Assets and liabilities i.e. sources and uses of fund are different and consequently the earnings and expenditure structures are different.

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9) Because of *Shariah* guidelines relationship of Islamic banks with regulatory authority is totally different.
10) Target customers are partly different.\(^{36}\)

### Table No. 5.2

**Synoptic Comparison Between Islamic and Conventional Banking**

<table>
<thead>
<tr>
<th>Features</th>
<th>Islamic Banking</th>
<th>Conventional Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Guarantee of the Capital</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand Deposits</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Investment Deposits</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Rate of Return on Deposits</strong></td>
<td>Uncertain, not guaranteed for investment Deposits. Demand Deposits are never remunerated</td>
<td>Certain and guaranteed</td>
</tr>
<tr>
<td><strong>Mechanism to regulate final returns on deposits</strong></td>
<td>Depending on bank performance/profit from investment</td>
<td>Irrespective of bank performance/profit from investment</td>
</tr>
<tr>
<td><strong>Profit and Loss principle applies</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Use of Islamic modes of financing:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PLS and non PLS modes</td>
<td>Yes</td>
<td>Non Applicable</td>
</tr>
<tr>
<td><strong>Use of Discretion by banks with regard to collateral</strong></td>
<td>Generally not allowed to reduce credit risk in PLS modes. By way of exception, may be allowed to lessen moral hazard in PLS modes. Allowed in non-PLS modes.</td>
<td>Yes Always</td>
</tr>
</tbody>
</table>


\(^{36}\) Tamini, al- Younes, ‘Practical Requirements for Establishing an Islamic Bank’, op cit. p 47-48
Sundarrajan and Errico, two IMF researchers, have given a synoptic comparison of Islamic and conventional banking (Table 5.2). They state that there is a fundamental conceptual difference between the two which lies in the fact that investment companies (conventional) sell their capital to the public, while Islamic banks accept deposits from the public.\textsuperscript{37}

As Sundarrajan and Errico illustrate that the only similarity between both the banking system is the guarantee of the capital put under demand deposit. For investment deposit Islamic banking provides no guarantee of the principal while conventional banking provides guarantee of the capital as well as some returns. It is the case with return on deposits. Under Islamic banking, according to authors, it is uncertain and not guaranteed for investment deposits while in conventional banks this is certain and guaranteed.

Final returns to deposit in Islamic banking depends upon bank’s performance and profit from investments. While in conventional banking the final returns on deposits are irrespective of bank’s performance and profit from investments. Another important difference between both the systems lies in their requirements for collaterals. For Islamic banks, according to author, it is generally not allowed except in rare cases to lessen the moral hazard. On the other hand, in conventional banking it is always required.

Comparative Analysis of the Financial Statements of Islamic and Conventional Banks

Islamic and conventional banks assigned certain risk-associated weights to both side of their balance sheet. (Assets and Liabilities). Following table 5.2

\textsuperscript{37} Sundarrajan, V and Luca Errico, "Islamic Financial Institutions and Products in the Global Financial System Key Issues in Risk Management and Challenges Ahead", op cit p 25 (Emphasis added)
gives a comparative picture of both the banking systems. The financial statement of bank represents in numerical form its assets and liabilities.

Table No. 5.3

Components of financial statements and their respective weight in
Islamic and conventional banking (%)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Islamic Banks</th>
<th>Respective weights</th>
<th>Conventional Banks</th>
<th>Respective weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid Assets</td>
<td>25</td>
<td>Liquid Assets</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>36</td>
<td>Investments and Deposits</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>Murabahah and others</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>24</td>
<td>Loans</td>
<td>52</td>
<td></td>
</tr>
<tr>
<td>Fixed and other Assets</td>
<td>16</td>
<td>Fixed and other Assets</td>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Equities</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current and investment Accounts</td>
<td>78</td>
<td>Deposits</td>
<td>90</td>
</tr>
<tr>
<td>Deposits</td>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other liabilities</td>
<td>2</td>
<td>Borrowing Other liabilities</td>
<td>0.5</td>
</tr>
<tr>
<td>Depositors share of profit</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholder’s equity</td>
<td>4</td>
<td>Shareholder’s equity</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: Fuad and Abdel Haq op. cit. p 107

It can be seen from the table (5.3) that on assets side Islamic banks give most weight (35%) to receivables. Second in order for Islamic bank is liquid assets (25%) followed by investments (24%). On the other hand conventional banks, on their assets side give maximum weight to loans (52%). Even investment weight for Islamic and conventional banks is almost same (24% & 23% respectively). Conventional banks give less weight to liquidity and fixed assets as compared to Islamic banks.

19 This shows heavy reliance of Islamic banks on non-investment modes of finance, these aspects are discussed in chapter six in detail
On the liability and equity side, Islamic banks give most weightage to their current and investment accounts (78%) followed by 14% and 4% for deposits and shareholders' equity respectively. Conventional banks on the other give most weight to their deposits 90% followed by 9 % to shareholders’ equity.

**Islamic and Conventional Banks: An empirical comparative study**

Munawar Iqbal, the Chief of IDB/IRTI research division, has conducted a comparative study of 12 conventional banks vis-à-vis Islamic banks to evaluate their performance. These banks are selected from the same country where from Islamic banks are. Size of the selected banks from both the category is also the same. Results found are summarized in the following tables (5.3 & 5.4).

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Equity</th>
<th>Total Deposits</th>
<th>Total Investments</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Islamic Banks</td>
<td>Comm Banks</td>
<td>Islamic Banks</td>
<td>Comm Banks</td>
</tr>
<tr>
<td>1990-94</td>
<td>7.9</td>
<td>6.4</td>
<td>9.3</td>
<td>3.1</td>
</tr>
<tr>
<td>1994-97</td>
<td>10.5</td>
<td>4.7</td>
<td>6.1</td>
<td>7.2</td>
</tr>
<tr>
<td>1990-97</td>
<td>9.0</td>
<td>5.6</td>
<td>7.9</td>
<td>4.8</td>
</tr>
</tbody>
</table>


It can be noted from the table that Islamic banks have performed better than their counterpart conventional banks. The rate of growth of total equity for Islamic banks during 1990-97 was substantially higher 9.0 percent as compared to the conventional bank, which was 5.6 percent during the same period.
Though conventional banks achieved higher growth (7.2 percent) in deposit during 1994-97 as compared to the Islamic banks (6.1 percent). However, the gap was not only covered up but Islamic banks registered higher growth in deposits as well if one compares the data from the period 1990-97. As for the total investments are concerned Islamic banks during 1994-97 registered low growth (7.3) as compared to conventional banks (9.1). However, on an aggregate level, during 1990-1997, the former outperformed conventional bank in this sphere also. And almost similar is the scenario for growth in total assets for Islamic as well as conventional banking, where Islamic banks have maintained their lead by a fair margin except during 1994-97.

As for the ratios are concerned here too Islamic banks seem to have performed better as compared to the conventional banks. However, we shall begin our analysis only after defining these ratios.

The Capital Asset Ratio: This is one of the most important ratios to measure the health of any financial concern. Higher capital/asset ratio shows better health of the financial concern. Almost all the regulatory authorities of the world prescribe certain minimum capital asset ratio for a financial concern. However, some times the definition of capital differs from region to region. In this present analysis the author has taken capital as the sum of paid up capital, reserves and undistributed profits.

The Liquidity Ratio: This ratio measures the ability of a firm to meet its current liabilities and is calculated as following;

\[ \text{Liquidity Ratio} = \frac{\text{Cash and Accounts with Banks}}{\text{Total Deposits}} \]

Deployment Ratio: This is another aspect of performance evaluation. In the present analysis it is further subdivided as Deployment Ratio 1 & 2.

\[ \text{Deployment Ratio 1} = \frac{\text{Total Investment}}{\text{Total Equity} + \text{Total Deposits}} \]
\[ \text{Deployment Ratio 2} = \frac{\text{Total Investment}}{\text{Total Liabilities}}. \]
Iqbal in his study found that the Capital Asset Ratio (CAR) for Islamic banks, during 1990-97, was higher 9.6% as compared to conventional banks 9.0% during the same period.

While the Liquidity Ratio (LR) for Islamic bank 18.5% was found much lower than their counterpart conventional banks 31.9%. Iqbal in this regard emphasizes that his findings reject the hypothesis that Islamic banks are facing excess liquidity problem. (See, chapter six, Problem of Islamic Banking)

As far the Deployment Ratios (DR) are concerned, Iqbal found that Islamic banks (93.7 & 82.0) have used their funds better as compared to the conventional banks (73.7 & 68.9). Iqbal, further, mentions that in terms of cost effectiveness also Islamic banks as a group have performed much better than the conventional banks.

### Table No. 5.5

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Islamic Banks and Conventional Banks (1990-1997)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Islamic Banks</td>
</tr>
<tr>
<td>Capital Assets Ratio</td>
<td>9.6</td>
</tr>
<tr>
<td>Liquidity Ratio</td>
<td>18.5</td>
</tr>
<tr>
<td>Deployment Ratio 1</td>
<td>93.7</td>
</tr>
<tr>
<td>Deployment Ratio 2</td>
<td>82.0</td>
</tr>
</tbody>
</table>


In conclusion Iqbal writes that Islamic banks have done fairly well as compared to the conventional banks during the period of study. In his own words, “Islamic banks as a group out performed (conventional banks) in almost all areas and in almost all years”. Moreover, according to him, several of the

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common perceptions like excess liquidity in Islamic banks have been found untenable in this study.\textsuperscript{41}

The above analysis, though, projects a good picture of Islamic banks in comparison to the conventional banks. Few doubts can be raised about the study which includes the author's choice of using secondary data in case of conventional banks\textsuperscript{42} especially when these data are more easily available as compared to the Islamic banks. Another shortcoming, which limits the scope of present study, is the choice of country. Three countries, which are highly acclaimed for their efforts in Islamizing the economy, did not get a place in Iqbal's sample. On the other some of the Middle Eastern countries, which have few of the largest Islamic banks, were over represented in the sample.

One of the most striking points of this study is that its findings are almost in contradiction to a similar study conducted\textsuperscript{43} by Fuad and Abdel Haq who had made a comparative analysis of three banks in Kuwait and came to conclude that Islamic banks are under capitalised and Islamic banks are faced with huge excess liquidity problems, almost double of their counterpart.\textsuperscript{44}

Iqbal's study is important in respect that it has covered more banks as compared to the earlier studies and also the time span under analysis is larger as compared to the study done by Fuad and Abdel Haq.

As the age of Islamic banks grow one only hopes that many more studies would come to make the people aware about the strengths and weaknesses of both the systems. These studies will also enhance the competitiveness and performance of both the banking systems.

\textsuperscript{41} Ibid.
\textsuperscript{42} Ibid., p. 2.
\textsuperscript{43} This study was conducted in 1993, which is also the period of study for Iqbal who had covered 1990-97. This study, however, covered only three banks, two conventional and one Islamic.
\textsuperscript{44} Omar, Al- Fuad and Haq, A. Mohammad, 'Islamic Banking Theory, Practice and Challenges'. Oxford University press, Karachi, Pakistan, 1996, p. 105-6.
One more comparative analysis jointly conducted by Munawar Iqbal, Ausaf Ahmad and Tariqullah Khan has compared the key financial indicators of the top ten banks of several groups table (5.5).

One can easily deduce from the above table that the performance of Islamic banks in comparison to few of the topmost conventional banks is much better on all fronts i.e. capital assets ratio which for the topmost ten banks of the world was 4.8 as against 9.7 for the Islamic banks. The same ratio for top ten Asian and Middle Eastern bank was 4.2 and 7.6 respectively. As for the profit on capital is concerned here too the Islamic banks have performed better than their fellow conventional banks. The figure for profit on capital for Islamic banks was 21.8 as against the 16.1 for top ten of the world, 17.2 for the top ten of Asia and 16.3 for the top ten of Middle East. The Assets of Islamic banks are more profitable i.e. 1.4% as against the Assets of other conventional banks like top ten of the world 0.9%, top ten of Asia 1.1%, and top ten of Middle East 1.5%.

Table No. 5.6

Key Financial Indicators: Islamic Banks vis-à-vis Conventional Banks

(1996, figures are in percentage)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Top 10 of the World</th>
<th>Top 10 of the Asia</th>
<th>Top 10 of the Middle Eastern Countries</th>
<th>Top 10 Islamic Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Asset Ratio</td>
<td>4.8</td>
<td>4.2</td>
<td>7.6</td>
<td>9.7</td>
</tr>
<tr>
<td>Profit on Capital</td>
<td>16.1</td>
<td>17.2</td>
<td>16.3</td>
<td>21.8</td>
</tr>
<tr>
<td>Profit on Assets</td>
<td>0.9</td>
<td>1.1</td>
<td>1.5</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Conclusion

In the present chapter a comparative analysis of both the system is presented. An attempt has been made to analyze both the banking systems under efficiency, stability, growth and justice criteria. Some important differences, similarities and converging points of both the systems are also described. In the study it has been found that the first and foremost differences between the Islamic and conventional form of banking is the prohibition of interest in Islamic form of banking. Actually the basic idea behind Islamic banking is the prohibition of interest, which led the Islamic economists to search for a different banking model. The alternate searched by the Islamic economists lay in participatory principle, which eventually became the founding principle of Islamic banking. Hence the principal differences between Islamic banks and conventional banks arises from the fact that the Islamic banks are based upon participation principles where depositors cannot be sure of their principal amount while conventional banks’ deposits are protected through explicit or implicit guarantee of the government.

However, as widely perceived this is not the only between Islamic and the conventional form of banking. There are many other subtle differences between Islamic and conventional banking ranging from their philosophical background, worldview, objectives to their operations. Islamic banks are totally on different footings as compared to the conventional banks in spite of the fact that both are engaged in financial intermediation and also are working in the same kind of legal, operational, and economic environment. As Islamic banking matures it is expected that the differences will further increase. Professor Khurshid, in this regard highlights that “In the Western banking system, because of collateral, the banker moves only when he smells prospects of bankruptcy. In an Islamic system, as the bank is also an investor it remains an active participant throughout. As such, the bank is concerned with and responds to early warning signals if things start going wrong. In this way mistakes can be set right before the rot goes too far. Further more the system is
more stable and transparent. In such a system there is an automatic adjustments of real assets and their financial counterparts. In the conventional banking system there is no such mechanism for adjustment. It is, therefore, hoped that banking that operates on Islamic principles will ensure growth with financial stability, equity and distributive justice. It can be sustainable both horizontally, that is at a particular time, and vertically, deep into the future. The ecological dimensions and the needs of the future generations would equally be taken care of.45

Professor Samuel on the other points out, "there are important differences, even if they might not be obvious to some Western observers Islamic Finance has to be rational and reasonable to Muslims, and as long as that is the case, it does not matter if some academic has done a study of the Murabahah contract and concluded that it is a carbon copy of short term bank lending in the western sense. The subtle differences are meaningful to Muslims".46

The focus of the present chapter has been to put both the banking systems face to face. In the coming chapter, however, we would specifically focus on the problems faced by Islamic banking in their operations.

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45 Ahmad, Khurshid, 'Islamic Finance and Banking: The Challenges and Prospects', op. cit., p. 75