WHAT IS THE FURURE OF BANKING INDUSTRY? DIFFERENT APPROACH: ISLAMIC VS. CONVENTIONAL SYSTEM

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Abstract
This paper comes to present the distinguish approaches between Islamic banking system and Conventional banking system. The author aims to find out which system can sustain a healthy economy, resist to financial turbulences, and help individual and businesses to develop themselves and the entire society. And yes, through this paper, the study found out why Islamic banking system is more sustainable, secure and pass successful the financial crisis from 2008. Furth more, the research paper concludes that for an economic sustainable development these two-banking systems can come together, learn from each other. Conventional banks can offer Islamic banks products, even more can open Islamic bank breach. During the research paper, the finds are very interesting, and presented a different way of approaching trade, financial transactions, risk, profit and economic development. The Islamic banking system is much closer to citizens, based on profit-loss-and risk sharing, real assets backed, coming from the principles of life preached by Islamic religion. The Conventional banking system is based on financial and banking laws strictly on economic flows, based on debtor-creditor and profit principles, leaving the whole risk on the customer side and not all the time financial transactions are real assets backed. Research has discovered and comes to present and sustain that, in the last decade, Islamic banks' efficiency was better than Conventional banks, especially during a crisis period. This efficiency of Islamic banks comes from their unique and special principles of life, which is risk-averse and anti-speculation, compared to Conventional one, which are profit oriented. These Islamic principles of life drove and lead to the capacity of resisting to the financial turbulences. Islamic banking system has more helpful, and realistic approach.

Key words: *banking system; banking products; Conventional banking; Islamic banking; financial crisis.*

JEL Classification: E03; E21; E22; E43; G02; G21; G31

I. INTRODUCTION

This paper rises from the author experience in Arab countries. Coming from Western countries, the author faced the different approach to the banking system. Along with a long practical experience in banking industry, conventional system, through this work paper the author noticed that there are distinguishes between these two systems. From outside, many people believed that the Islamic banking system is a closed one and the products and services offered are 100% different. Some other people claims that Islamic banking approach only changes the banking terminology (*interest rate* against *profit rate*)[22]. During the journey of finding the differences of approaching the banking industry, the author understands that Islamic System is much closer to people and business, more correct in their approach, emphasizing certain and realistic products and services. The Islamic banking system revolutionized the relationship between the client and the bank.

Can Islamic banking system be applied in European countries? Yes. Would Islamic banking system will help European countries to develop a healthy economic environment? Yes. Can be conventional banking system be applied in UAE? Yes, however it might be asked to respect some *fair* rules. Would conventional banking system improve the economic development of UAE much more than Islamic banking system? The recent history proves that till this moment, Islamic banking system faced much better financial crisis.

II. LITERATURE REVIEW

After the recent financial crisis, many international organizations have begun to pay more and more attention to the Islamic banking system. And this because the Islamic banking system was the one that was least affected by the financial crisis. The Islamic banking system experienced global growth rate of 10-15% per annum (over 9% only in 2015[23]), and has been moving into an increasing number of conventional banking

[22] Al Naqiy Islamic Solutions, http://alnaqiy.com/article/islamic-vs-conventional/
[23] http://www.thenational.ae/business/banking/global-islamic-banking-assets-to-grow-at-98-diedc-says

system at such a rapid place that Islamic banking are present today in over 51 countries[24]. Despite this consistent growth, many supervisory and finance practitioners remain unfamiliar with the process by which Islamic banks works (Sole,J., 2007), and how conventional banking system can merge and work with Islamic banking system.

One of the most important objective of Islam is to greater justice in human society. Islamic finance comes to help to rise substantially the share of equity and profit-and-loss sharing in business (Mohammad U.Chapra, 2009). Islamic banks have powerful strength to attract a huge number of customers mainly due to their religious orientation (Shohrowardhy H.S, 2015). The Islamic banking is a banking system that complies with *Shari'ah* (Islamic law) and its practical application through the development of Islamic economies. Application of principles and rules of *Shari'ah* in financial and economic field can stop the disorder and financial turbulences which shaking the financial world markets because of manipulating the rules of fictitious and illegitimate speculations. *Shari'ah* bans interest (*Riba*), products with excessive uncertainty (*Gharar*), gambling (*Maysir*), short sales, as well as financing of prohibited activities as considered harmful to society. Transactions must be underpinned by a real economic activity, and there must also be a sharing of risks in economic transactions (Kammer A., Norat M., Pinon M., Prasad A., Towe C., Zeidane Z., 2015).

III. RESEARCH METHODOLOGY

The study was conducted on 2 banking systems: Conventional banking system and Islamic Banking system. The purpose of the research was to discover the reasons why more and more economists now claim that the Islamic banking system is more suitable for a balanced and lasting development. For this reason, the analysis focused on finding the principles of operation and on the banking operations that these two systems offered, find where the differences are, and whether it can be implemented in countries other than those in the Arab world. The database necessary to the research was provided by the International Monetary Fund, World Bank, Arab Monetary Fund, Central Banks, and another international financial organizations website and many dedicated articles and reports.

IV. RESEARCH FINDINGS

The research undertaken has found, from the outset, that in recent years there has been a significant increase in the number of Muslim populations in the Western and Eastern countries. This incensement, as well as the increase in the number of investors from the Arab countries (the majority from GCC) that want to diversify their investment portfolio, it has made the banking system in Western and Eastern countries to open the door and offer the Islamic banks the possibility to operate in this part of the world. On the other hand, the conventional banking system has received the Islamic banking system as a threat to reducing its market share and profit, and, in the same time as an opportunity, becoming more and more interested in cooperating with Islamic banks and offering Islamic banking products and service.

Both conventional banks and Islamic banks have emerged to meet the financing needs that individuals and investors have for improving their living conditions or developing their businesses. Before presenting the differences between the conventional banking system and Islamic banking system it is better to underline on what these both systems are based on. Conventional banking system is based on a pure financial intermediation, whereby banks mainly borrow from servers and then lend t enterprises or individuals. They make their profit from the margin between the borrowing and lending rates of interest. Conventional banks provide a variety of products and services, starting from different types of deposits and loans, to letter of credits and guarantees. Islamic banks play as an investment manager, it has the same purpose as conventional banks but adhering to Islamic law. The basic principle of Islamic banking is based on risk-sharing which is a component of trade rather than risk-transfer which is seen in conventional banking. Islamic banking introduces concepts such as profit sharing (*Mudharabah*[25]), safekeeping (*Wadiah*[26]), joint venture (*Musharakah*[27]), cost plus (*Murabahah*[28]), and leasing (*Ijar*).

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[24] The Islamic finance industry has expanded rapidly over the past decade, growing at 10-12% annually (Word Bank Report, 2015). In 2009, there were more than 300 Islamic banks and 250 Islamic mutual funds, around the world. https://ro.wikipedia.org/wiki/Banca_islamic%C4%83 ; Standard and Poor's reports that, while many of the world's financial systems were deleveraging, assets of the top 500 Islamic banks expanded by 28.6 per cent to total $822 billion, http://www.vitainternational.media/en/article/2016/04/15/islamic-finance-the-future-of-banking/333/ .

[25] According to http://www.mib.com.mv/blog/guide-to-islamic-banking/what-is-mudarabahbn, *Mudharabah* is a form of partnership where one party provides the funds while the other party provides expertise. The people who bring in money are called "Rab-ul-Maal" while the management and work is an exclusive responsibility of the "Mudarib". The profit-sharing ratio is determined at the time of entering the Mudarabah agreement whereas in case of loss it is borne by the Rab-ul-Mal only. In case of Islamic banks, the depositors are called Rabb-ul-Maal and the bank is called Mudarib.

[26] According to https://www.islamicbanker.com/education/wadiah, *Wadiah* corresponds to safekeeping, custody, deposit and trust. In Islamic finance, *wadiah* refers to the deposit of funds or assets by a person with an Islamic bank. In this arrangement, the depositor deposits his funds or assets with the bank for safekeeping and in most of the agreements the bank charges a fee for the safe custody of the depositor's funds.

[27] According to https://www.islamicbanker.com/dictionary/s/shirkah-al-amwal, *Musharakah* is a type of *Shirkah al-Amwal* (partnership where each partner brings in some capital in the form of money and all partners contribute their labor and skill, agreeing to share profit or

To make clear what are the differences between these two banking systems, the research has found that, over the last few years, due to the proven stability of the Islamic banking system, many economists have tried to emphasize the main differences and similarities. Analyzing all these research papers and representative materials from Islamic institutes, the present paper structures these differences into three categories: general characteristics; operating principles; products and services offered.

4.1. Characteristics of conventional and Islamic banking system

The Islamic banking has been making headway into an increasing number of Western countries. Easter countries faced a less success with conventional banks in the recent years, due to reduction of the level of own funds caused by the deteriorating the quality of loan portfolio. However, if conventional banks what to approach the Islamic banking system, from the very beginning they need to know the following main differences (table no.1.)

Table no.1: Main differences between Conventional and Islamic banking system

Conventional banks approach	Islamic banks approach
• Money = a product besides medium of exchange and store of value;	• Money = **just** a medium of exchange; **is not** a product (cannot be sold for a higher price);
• Time value is the basis for charging interest on capital and making profit;	• Profit is made on exchange of good and services;
• Interest is charged no matter what the organization having profit or suffering loss. There is no concept of sharing loss;	• There is no interest. The profit and the loss are sharing, depend of the model of finance used (*Mudharabah; Musharakah*);
• During the finance process, there is no agreement for exchange of goods & services;	• The execution of agreements for the exchange of goods & services is a must, from the very beginning of the finance process;
• Using money as a commodity, the inflation is created; the inflation will lead to the incensement in the cost of products and services;	• Using money as a medium of exchange, no inflation is created; doe to the control over inflation, no extra costs, prices will be created;
• Government can make loans from the Central Bank through Monetary Market Operations without initialing capital development expenditure;	• Government cannot obtain loans from Monetary Market Operations without making sure the delivery of goods and services;
• The failure of the projects financed are written off as non-performing loans;	• The failure of the projects financed can been taken over by the bank to hand over to a better management;

Source: based on http://www.kantakji.com/media/2225/c226.pdf

4.2. Operating principles in Conventional and Islamic Banking

Although many products offered by Islamic banks look like those offered by Conventional banks, however these two entities differ conceptually and both have different business operating principles (table no.2). Two major differences are in how the price in setting for using the money (Conventional banks cannot exist without dealing in interest while Islamic banks prohibit interest-based dealings), and the way that the risk is taken in the event of a failure.

loss) which literally means sharing. In the context of business, it refers to a joint enterprise in which parties share the profit and loss of the enterprise. It plays a vital role in financing business operations based on Islamic principles, which prohibit making a profit on interest from loans. Musharakah may sometimes include Shirkah al-Amal, where a partnership is formed to render some services without requiring any capital investment.

[28] According to http://www.mib.com.mv/blog/guide-to-islamic-banking/what-is-murabaha, *Murabahah* is one of the most common modes used by Islamic Banks. It refers to a sale where the seller discloses the cost of the commodity and amount of profit charged. Therefore, Murabaha is not a loan given on interest rather it is a sale of a commodity at profit. The mechanism of Murabaha is that the bank purchases the commodity as per requisition of the client and sells him on cost-plus-profit basis. Under this arrangement, the bank is bound to disclose cost and profit margin to the client. Therefore, the bank, rather than advancing money to a borrower, buys the goods from a third party and sell those goods to the customer on profit. A question may be raised that selling goods on profit (under Murabaha) and charging interest on the loan (as per the practice of conventional banks) appears to be one of the same things and produces the same results. The answer to this query is that there is a clear difference between the mechanism/structure of the product. The basic difference lies in the contract being used. Murabaha is a sale contract whereas the conventional finance overdraft facility is an interest based lending agreement and transaction. In case of Murabaha, the bank sells an asset and charges profit which is a trade activity declared halal (valid) in the *Shari'ah*. Whereas giving loan and charging interest thereupon is pure interest-based transaction declared haram(prohibited) by *Shari'ah*.

Table no.2: Operating principles in Conventional and Islamic banking system

Conventional banks approach	Islamic banks approach
The basic operating principle	
Conventional banks are built upon the fundamentals of **debtor-creditor** relationship with interest being the price of credit and reflecting the opportunity of cost of money.	Islam bank are built upon the fundamentals of partnership and participatory in nature. The risk and reward relationship is guided by socio-economic principles.
Main purpose of activity	
Focused on intermediation activity and income from loans.	Focused on debtor investment projects, assessments and valuations.
Sanctity of contract	
In many cases the conventional banks accepting transactions without a real and valid proof of existence of capital goods and services. Sometimes the credibility of entrepreneur makes the project feasible.	Before executing any Islamic banking transaction, the counter parties must satisfy whether the transaction is *halal* (valid) per *Shari'ah*. That means that all operations must **not** be invalid or voidable. If there are any invalid components in the contract and unless these invalid components are eliminated, the contract will remain voidable. All terms must be clear without any gate of interpretation.
Price of using the money	
Money are commodity. For all operations between conventional banks and clients, the interest (price for using money) it is collected.	Money are just a medium of exchange. Collection and payment of interest (*Riba*) is prohibited. Islamic banks cannot lend money to earn additional amount.
Risk sharing	
The risk is totally on the client side.	Any Islamic banking transaction take into consideration and share the risk of ownership of the tangible asset, real services or capital before any earning and profit there from.
Banking transactions are backed by tangible assets	
No. Only mortgages, and any other products backed by tangible assets.	Yes, all of them.
Economic purpose/activity	
Not all the transactions have a certain economic purpose and not all of them are backed by tangible assets.	Every transaction has certain economic purpose/activity. All transactions are backed by tangible asset or real service. Activities
Taxes	
For its profit, Conventional bank is paying taxes. For the profit earn from interest rates on deposits, the clients also must pay taxes.	There is income tax or corporate tax. However, *Zakat* is an amount that, per the pillars of Islam, it must be paid to the poor and needy. All Islamic banks paid *zakat*. Clients of Islamic banks don't have to pay *zakat*.
Penalties	
For any delay in complying with the contractual conditions, a penalty is charged. Penalties are part of the bank's profit.	As a rule, there is no penalty, because the contract is profit-loss-risk-share based. It can be an additional charge, but these amounts will go automatically for charity and not for bank's profit.

4.3. Different approach on banking products and services

As the research showed above one of the main difference between these two banking systems is that Conventional banking is based more on financial and banking laws, rules and regulations while Islamic banking is following also *Shari'ah* (Islamic law) which promote profit and loss sharing.

To be able to compare these two banking systems, the research has taken into account the banking products that can be comparable (see table no.3), at least in terms of covering individual and business needs. For any banking transaction, both of two systems conclude agreements with clients. Conventional banks make agreements as debtor-creditor, while Islamic Banks make agreements as seller-buyer.

Table no.3: Products and services offered by Conventional and Islamic banking system

Conventional banks approach	Islamic banks approach
Deposits/ Safekeeping (*Wadiah*)	
Deposits = In this arrangement, the depositor deposits his funds or assets with the bank for safekeeping.	**Wadiah = Safekeeping or deposit of funds** In this arrangement, the depositor deposits his funds or assets with the bank for safekeeping and in most of the agreements

Bank is charging opening account fee and maintenance fee. For these safekeeping of funds, the bank will pay an interest rate. The percentage of the interest rate different, depending on the maturity of deposits, but it is fixed from the very beginning in the agreement. The risk is born by the bank and total rewards belong to it after servicing the depositors at the rate fixed in the agreement.	the bank charges a fee for the safe custody of the depositor's funds. The fee is charged only once. The bank is not offering interest rate of these safekeeping. For these safekeeping, can be a reward. This reward is variable. The risk and reward both are shared with depositors. Reward of depositors is linked with outcomes of investments made by Islamic bank.
Overdraft/ Credit Cards	
Conventional banks offer the facility of overdrawing from account of customer on interest. The limit of overdrawing is set by the bank. Credit card provides dual facility to customer including financing as well facility of plastic money whereby customer can meet his requirements without carrying cash. In case of default customer is charged with extra interest.	Islamic banks offer the facility of debit card whereby the customer can use his account carries credit balance. No credit cards. Extra charging is not allowed.
Short term loans	
Short term loans are provided to customers (individuals and businesses) to meet working capital of firm or for unspecified needs for individuals.	
Banks grants short-term loans for individuals or for businesses, under interest rate reward, based on debtor-creditor agreement. In case of fault, the bank is not taking any risk.	Short term loans for individuals and businesses are allowed, under the *Murahabah* agreement. It refers to a sale where the seller discloses the cost of the commodity and amount of profit charged. Therefore, Murabahah is not a loan given on interest rather it is a sale of a commodity at profit. **The mechanism of Murabahah is that the bank purchases the commodity as per requisition of the client and sells him on cost-plus-profit basis**. Under this arrangement, the bank is bound to disclose cost and profit margin to the client. Therefore, the bank, rather than advancing money to a borrower, buys the goods from a third party and sell those goods to the customer on profit.
Medium and long term loans	
Medium or long-term loans are provided for purchase or building of fixed assets by individuals or firms to expand or replace the existing assets.	
Banks give medium and long term based on the project/business plan, sometimes require the collateral deposit or a real asset as a guarantee. For the loan, the bank is asking for an interest rate. In case of delay in complying the agreement conditionality, the customer is subject to a penalty. The risk is totally in charge of the customer (debtor).	These loans are fulfilled through profit sharing agreements (*Mudharabah*), joint venture (*Musharakah*), cost plus (*Murabahah*). Under *Shari'ah* based financing system firms must prove the viability/profitability, because the bank will become the part of the project and will share the risk and the profit with the customer. Being a risk-profit-share agreement, there is no interest rate charge, and no penalty charged for the delay in fulfilling loan agreement.
Leasing	
Leasing is a source of financing whereby the usufruct of an asset in transferred to lessee for agreed number of rentals. Under leasing ownership may or may not be transferred.	
Under *leasing* agreement, the bank is buying the asset, and after provided to the customer, under loan form. The ownership is transferred to the customer after the final installment payment. During the contract agreement, all the risk is in customer charge. This loan come with an interest rate and penalty in case of default.	***Ijara***, the leasing is allowed by Islamic banks. Under *Ijara*, based on a pre-agreement, the bank is buying the asset desired by the client, later the same asset is provided to customer for use without the transfer of ownership for a specific period of time in exchange for agreed rentals. Ownership of asset can be transferred to customer through mutual agreement at the completion of lease term. All ownership risk is born by Islamic bank during *Ijara* tenure. Additional rent cannot be demanded in case of default. If the

	asset is destroyed or lost, Islamic bank cannot claim further installments hence all risks of ownership are born by Islamic bank.
Mortgages/ House loans	
Bank provides a loan backed by a house purchased. The loan is granted for an interest rate. The customer comes with a percentage from the total amount of the house (usual 25%) and the bank with the rest. The customer is the one which is buying the house, through loan, however, the house is mortgaged in favor of the bank. After the last installment payment, the mortgage is taken away, and the customer becomes the only owner.	Bank provides *Musharaka* contract, under which the house is purchased jointly by the bank and customer. The bank rents out its share in property to customer for an agreed amount of rent. Share of financier is divided in units of small denomination. Customer pays the installments to the bank. The installments consist of rental plus purchase price of a unit. Stake of customer in property is increasing while of bank is decreasing with payment of every installment. Finally, with the payment of last installment stake of bank reaches to zero and the property is transferred in the name of customer.
Investments	
Banks can make any type of investments.	Bank cannot invest in government securities; short term loans, bond and money at call and short notice because of interest based transactions.

Source: Hanif M., *Differences and Similarities in Islamic and Conventional Banking*, 2011; https://ijaracdc.com/ijara-vs-conventional-lease/;

V. CONCLUSIONS

The research undertaken in this paper was focused on finding the differences and similarities between the Conventional banking system and the Islamic banking system. Many economists (Garbois C., Gourp C., Pock A., Bhatnagar M., ATKearney, 2012)[29] argue that the Islamic banking system has managed to face much better with the financial crisis, it does not lead to inflation and, furthermore, it also helps the socio-economic development of the country. The purpose of the research was to discover the reasons why more and more economists now claim that the Islamic banking system is more suitable for a balanced and lasting development. For this reason, this analysis focused on the principles of operation and on the banking operations that these two systems offer, to see where the difference is, and whether it can be implemented in countries other than those in the Arab world. Recent banking scandals (financial crisis) that outrage citizens, has increased interest in *ethical finance*, which seems to have benefited Islamic banks (Straniero M., 2016).

The most important different approaches between Islamic banking and Conventional banking are:

- For Islamic banking *money* are just *a medium of exchange*; for Conventional banking *money* represent a commodity which can be trade;
- In Islamic banking system, the profit is made based on *seller-buyer* of goods and services. Collection and payment of interest (*Riba*) is prohibited; in Conventional banking system, the profit comes from the *interest rate* and *fee* charged on using any banking products and services;
- Islamic banking system operate base on the principle *profit-and-loss sharing* agreement, compare with Conventional bank which operate based on principle *debtor-creditor* agreement;
- In Islamic banking system, financing must be linked to real assets (materiality) and all banking operations must be moral and ethical;
- Islamic banking system *share the risk* of ownership of the tangible asset, real services or capital before any earning and profit there from; Conventional banks live the whole risk to the customer.

Banking activity, in general plays a role as intermediary, bringing together people or business which are in need on money with people which have surplus of money and are willing to make investments. Banking system is also largely responsible for the payments system. The research find out that there are significant differences in approaching banking operations, between Islamic and Conventional systems.

Regarding the economic and social impact that the financial crisis of 2008 left, and studying the operating principles of these two banking systems, the research concluded that, without discussion, the Conventional banking system also helps to develop the economic development in any country, however the Islamic Bank system is much more secure for the economic and social perspective of any country. And what's way:

- The Islamic banking system offers benefits for economic growth, it can significantly contribute to economic development, given its direct link to physical assets and the real economy. The emphasis on

[29] Garbois C., Gourp C., Pock A., Bhatnagar M., *The Future of Islamic Banking*, ATKearney, 2012, sustain that *Islamic banks that takes the time now to consider strategic choices and address operational fundamentals will be in a stronger position to capture untapped market opportunities and master the changing dynamics of their industry.*

tangible assets ensures that the industry supports only transactions that serve a real purpose, thus discouraging financial speculation.

- Islamic banking system emphasizes partnership-style financing and risk-sharing agreements, which could be useful in improving access to finance for the poor and small businesses. As the 2008 global financial crisis ravaged financial systems around the world, Islamic financial institutions were relatively untouched, protected by their fundamental operating principles of risk-sharing and the avoidance of leverage and speculative financial products.

Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim countries. Major financial markets are discovering solid evidence that Islamic finance has already been mainstreamed within the global financial system – and that it has the potential to help address the challenges of ending extreme poverty and boosting shared prosperity. Nowadays, The World Bank Report comes with a very precise conclusion, and our research is fully agreed with this: *Islamic finance is equity-based, asset-backed, ethical, sustainable, environmentally- and socially-responsible finance. It promotes risk sharing, connects the financial sector with the real economy, and emphasizes financial inclusion and social welfare* (Alawode A.A., Iqbal Z., 2015).

The Western and Eastern Conventional banks become less successful in the recent years based due to reduction of the level of own funds caused by the deteriorating quality of loan portfolio, while the Islamic banks managed to remain stable, because their financing activities are more focused with the real economic activities and backed by real assets. It can be hard to change and the Conventional system to Islamic banking one, however at least gradually, they can implement one by one the Islamic banking principle. This will can bring the economic stability, avoiding inflation, and encourages the provision of financial support to productive enterprises that can increase output and generate jobs. Conventional banks can adapt and offer also Islamic banking products and services. Once a Conventional bank will start to operate an Islamic window and creates confidentiality and recognition among clients, it may decide to establish an Islamic subsidiary. In this way, the Conventional bank will be able to offer, under the same umbrella, a wider range of Islamic banks products.

The research concludes that, generally in the last decade, Islamic banks' efficiency was better than Conventional banks during a crisis period. The efficiency of Islamic banks, which is risk-averse and anti-speculation, compared to conventional ones gave and gives the capacity to resist to the financial turbulences. Islamic banking system has more *helpful, and realistic* approach.

From the entire research perspective, a harmonious development at a worldwide level, the research undertaken concludes that the Conventional banking system may take over some of the operational principles practiced by the Islamic banking system, and the future of worldwide banking industry can be a close collaboration between these two banking systems.

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