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Comparison of Islamic banking and conventional banking: an empirical review

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ABSTRACT: *An attempt has been made in this paper to write the review of different papers relating to efficiency comparison of Islamic versus conventional banking. Two main approaches have been followed; 1st Stochastic Frontier Approach (SFA) and traditional financial ratios. Higher Rate of return has been seen for Islamic banks as compared to Conventional banks and customers with Islamic background prefer Islamic banking system as Islamic banks are based on Islamic Sharia principles.*

Keywords: Islamic banking, conventional banking, SFA, financial ratios.

Interest (Riƅa) free banking is said to be the critical element of Islamic banking. But most of the time it is argued that interest (Riƅa) contributes towards a fairer allocation of income and wealth, irrespective of that sort of arguments interest (Riƅa) has no place in Islamic jurisprudence (Chapra, 1996). Despite of the purpose and function of finance and Finance Cost (Rate of interest) at which finance cost (rate of interest) is charged Islam does not allow Muslims to take or give interest (Riƅa). Few of so called Muslim scholars, imbued with the ideas of western Civilization argued that Islam does not prohibit Interest (Riƅa), what islam prohibits is the Usury. So, efforts have been made to make a distinction between interest and usury and between the issuance of finance for productive purpose and the issuance of finance for consumption. Moreover some of the so called Muslim scholars argued that usury is the (Riƅa) that was initially practiced by Moneylenders and Qur'an prohibits from usury not from Interest that is the key element of modern conventional banks. They argued that if Finance is issued for productive purpose, interest charged on that finance is not Riƅa, but their arguments were all in vain and have no place in Islam because it is generally accepted by all Muslim scholars (except some unorthodox views) that interest andRiƅa are same and the only difference between these two words is the difference of spell not in the meaning.On the other hand productive loans and so called unproductive loans only differ in degree not in kind. So, whatever name one may use for interest ether usury or Riƅa its characteristics will not change as it's only the addition money through unfair means that is against the Islamic jurisprudence and Qur'an(Ariff, 1988).

Ban on interest (Riƅa) is clearly stated in different revelations in the Holly Qur'an.

- In first revelation it is revealed that interest (Riƅa) takes away the Blessings of ALLAH.
- Second revelation prohibits Interest (Riƅa) as it is the unlawful acquisition/use of the property of others.
- In third revelation Qur'an asks Muslims to stay away from taking or giving Interest for their own betterment.
- Clear segregation in fourth revelation is made between interest (Riƅa) and trade and asked the lender to forgo even if the borrower is unable to return or repay the sum.

Qur'an has further declared that those people who close their eyes to the ban/prohibition of interest (Riƅa) are considered to be at war with ALLAH and His Holy Prophet (S.A.W) as they have denied the sayings of ALLAH (Ariff, 1988)

In saying of Holy Prophet (S.A.W) (Hadith) interest (Riƅa) is also Quoted in definite terms. Prophet (S.A.W) held all alike in guilt, those who charge/take interest (Riƅa) and those who give/pay (Riƅa) and also those who record/ witnessed the transaction. A range of succeeding explanations to support the institution of interest (Riƅa) has been warded off by Islam. Arguments are there which contended that interest (Riƅa) was the key factor/element of International monetary crises and the crises were due to the institutions of interest (Riƅa). So instead of interest (Riƅa) value of money and its erosion has been compensated by Islamic jurisprudence in such a way that: Goods of same kind must be replaced by same goods, salt for salt, dates for dates, barley for barley, wheat for wheat, silver for silver, gold for gold, hand to hand, equal to equal and like for like. So nutshell is that proofs are not needed for Muslims to reject the institution of interest (Riƅa) because it is the matter of "IMAN" (Faith)(Ariff, 1988)

Modern Islamic Banking: Evolution

Without projecting the project's Islamic viewpoint, in Egypt the first experiment with modern Islamic banking was undertaken so that no one can consider it as manifestation of Islamic fundamentalism. In 1963 Ahmad El Najjar led the pioneering effort in MitGhamr (Egyptian town) by introducing savings bank that was based on profit and loss sharing principles of Sha'ria (Ariff, 1988). It lasted until 1967 and at that time about nine banks were operating in the country. Interest (Riƅa) was neither paid nor charged by these banks and investments were made in trade and industry through partnerships with others or in shape of direct investment, and profits from those investments were shared with the owners (depositors) of funds. So their function was not like commercial banks but was like saving investment institutions. The first interest (Riƅa) bank was established in 1971 in Egypt with the name: The Nasir Social bank, while its charter did not make any reference to Sha'ria or compliance with Islamic laws. To provide funds for development projects to its member countries, The Organization of Islamic countries (OIC) established IDB in 1974, which was primarily an inter-government bank. The function of IDB was to provide fee-based profit sharing financial assistance and financial services to member countries. Operations of IDB are according to Sha'ria principles and are free of interest (Riƅa). In Middle East when political climate changed many of Islamic banks came into existence both in spirit and in letter such as Faisal Islamic bank of Sudan (1977), The Dubai Islamic bank (1975), The Faisal Islamic bank of Egypt (1977) and The Bahrain Islamic Bank (1979). The wind of change also blown in Asia-Pacific region and Amanah Bank (PAB) in Philippine was established as a specialized banking institution by presidential orders but there was no reference to its Islamic spirit in its charter. To facilitate the banking needs of the Muslim rebellions in south, Philippine Amana Bank was established by

Philippines Government. To save the amount for Pilgrim (Hajj) Muslims Pilgrims Savings Corporation was established in Malaysia as the first Islamic institution in 1973. Later on in 1969 this body was converted into the Tabung Hajj or pilgrim management and funds board, as it is known now. Tabung Hajj is non-bank financial institution with limited role that invests the savings of prospective pilgrims according to Sha'ria Laws. Bank Islam Malaysia Berhad (BIMB) was established as full-fledged Commercial Islamic Bank in Malaysia as in response to the success of Tabung Hajj Finance Company. Islamic Financial institutions were also established in non-Muslim countries like during seventies Interest-free saving societies were in abundance in India. In 1978 the Islamic banking system (known as "Islamic Finance House" now) in Luxemburg was regarded as the first attempt at Islamic banking system in West. Islamic bank International of Denmark and The Islamic Investment Company in Melbourne Australia has also been established.

Islamic and Conventional Banking: Competitive Conditions

Pressure on banks returns has increased over the past decades due to intensified competition in banking sector. Key Financial institutions are trying to enter into new markets strategically by offering diversified portfolio of products and services to increase their profitability. Islamic banking is one of such developments, since 1975 Islamic Financing is considered as a viable mode of financing. Due to this there is rapid increase in number of Islamic banks in the Arabian Gulf and Far East and most of the banks have diversified their operations from conventional practices to Islamic practices by opening new Islamic products or Full-fledged Islamic banking system (Ariss, 2010) Bahrain and Malaysia are in race to become the regional hubs for Islamic financial services providers. Roundabout 270 Institutions are operating worldwide that operate in Islamic financial services, including: Insurance or Takaful firms, Mortgage Firms, Mutual Funds and Islamic Banks.

Stakeholders of common religion is not said to be the limitation for Islamic banks and Islamic financing as planning to convert London into world central hub for Islamic finance has been announced by Britain (Ariss, 2010) On the other hand HSBC, BNP Paribas, Citigroup and other international banks are also trying to expand their businesses into Islamic banking industry. In different countries according to structural point of view Islamic banks are operating alongside with conventional banks and Islamic financial services are being offered in parallel market. Both the Islamic and conventional bank's services can be enjoyed if there are surplus and deficit units in the market. A client will prefer to transact only with full-fledged Islamic bank for financial services if religious underpinnings do matter for him/her. Although there is possibility that customer may have relation with both segments of banking (Islamic and Conventional) but Islamic banks restrain customers to trade with conventional banks if pre-determined rate of interest (Riƅa) is there. That is why both segments of banking market are different in nature and inter-industry links of both segments are limited. In regulatory perspective, segregation of both segments is also valid, as Islamic banks operate under Islamic Sha'ria law and have different rules and regulations and unique Risk profile as compared to other financial institutions. Specificities through regulatory framework are generally addressed to put Islamic banking into sound practices. Islamic banks regulated and supervised by Central bank through special circulars and promulgate new laws in such countries where both conventional and Islamic banks operate, for example: Extra capital will be required to establish an Islamic bank as compared to conventional bank, or there are special regulatory requirements for taxation for Islamic banks. According to Islamic finance, banks will first purchase the physical asset and then can sell the asset to customer on a premium if a customer wants to finance the physical asset through bank. Thus, bank will pay the registration fees but at the time of transfer of ownership customer will also pay the similar fees to bank. UK as well as several Arab states have exempted the requirements of double taxation from Islamic banks to make Islamic banks efficient in sale transactions and to improve competitiveness (Ariss, 2010).

Empirical Review

Existing studies to check the efficiency of Islamic and conventional banks can be classified into two broad groups. Studies that are conducted (by; (Bader, Mohamad, Ariff, & Hassan, 2007; Bashir, 1999; Hassan & Bashir, 2003; Samad, 1999) to check the performance of Islamic banks through traditional financial ratios are classified as the first group. Some of the studies also matched their results with conventional banks. The other group can be those researchers that studied the performance and efficiency of Islamic and conventional banks, by using frontier analysis Approach instead of traditional financial ratios. The second group may further be divided into three groups; as 1st group (Bader et al., 2007; Brown &Skully, 2004; Hassan, 2006; Yudistira, 2003) studies to check the efficiency of Islamic banks, 2nd group; (Bader et al., 2007; Bos& Kool, 2006; Weill, 2004) studies to check the efficiency of conventional banks and the 3rd group (Al-Jarrah&Molyneuxa, 2003; Al-Shammari, 2003; Bader et al., 2007; Hussein, 2004) that studies the comparison of efficiency of conventional and Islamic banks. Researchers (Iqbal &Molyneux, 2005) found that

Frontier Approach as compared to traditional financial ratios is considered superior because in Frontier Approach statistical techniques or programming is used and also it removes input and output price differences and factors that affect the performance of a firm. Performance of managers and their firms can be estimated more accurately through Frontier Approach. That is why in most of the studies Frontier Approach has been used in literature to find out and measure the effects of capital regulations, mergers and acquisitions, deregulations deposit found rates, and holding company acquisitions and performance financial institutions in general. So, useful information for benchmarking and comparative analysis can be yield through Frontier Approach. On the other hand information for benchmarking provided by simple Ratio-based analysis can give important insights but is of limited scope as it only takes single-dimensional view of a product, service and/or process and also does not consider substitutions, trade-offs and interactions between different key variables.(Mohamad, Hassan, & Bader, 2008).

During last two decades Islamic banking has shown rapid growth. Many factors have contributed to growth of Islamic banks i.e. Globalization of financial markets, product innovation, delimitation in financial regulations, new technological improvements, development of new Islamic states and the presence of Islamic institutions in Western world. But unfortunately, data to measure the exact volume and extent of Islamic banking is not available, however current estimates show that assets held by Islamic banks worth between US$ 250 to US$ 800 billion.Whereas, near about 300 Islamic financial institutions, including conventional banks “Islamic windows” are operating worldwide. 50% of total market has been capitalized by Sha’ria compliance funds and products in Pakistan and Malaysia. Studies have shown that in some states Islamic banks have shown better performance than conventional banks.On the other hand studies (Hasan &Dridi, 2010) also show that results for Islamic banks were more adverse than conventional banks during the recent economic crises. In last two decades many articles and books have been written on this subject in both extremes (in favor and against) (El-Gamal, 2006)

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