Islamic Finance(02)

Differences Between Sharia and Conventional Financing

The differences between sharia and conventional financing institutions are fundamentally significant, in terms of basic principles, product mechanisms, risks, and penalty mechanisms. Understanding these differences is crucial for those who wish to choose the financing method that best suits their needs and values. Here are six key differences:

1. Basic Principles

The distinction between Islamic and conventional financing can be observed in their basic principles. Islamic financing is based on Sharia principles that emphasize justice, transparency, and social welfare. One of its main principles is the prohibition of *riba*, which, in the context of financing, means the prohibition of charging or paying interest.

In contrast, conventional financing operates on the principle of profit generation through interest. This system does not require a real transaction or detailed contract as long as both parties agree to the terms. This is one of the main differences between Islamic and conventional loans.

2. Products and Contracts

In Islamic financing, several types of contracts are used depending on the type of transaction and customer needs:

- **Murabahah**: This is a sales contract where the bank purchases goods needed by the customer and resells them to the customer at a profit margin agreed upon.
- **Ijarah**: Similar to leasing in conventional financing, but without interest. In *ijarah*, the bank leases goods or assets to the customer for a specific period with agreed compensation.

- **Musyarakah**: In this contract, the bank and the customer participate in business capital and share profits or losses based on their respective contributions.

- **Mudharabah**: This involves a partnership between the capital provider (the bank) and the business manager (the customer). The bank provides capital, while the customer manages the business. Profits are shared according to an agreement, while losses are borne entirely by the capital provider unless caused by the manager's negligence.

Conversely, conventional financing offers more diverse and flexible products, most of which are based on the interest concept. Common products include:

- **Interest-Based Loans**: The most basic form of conventional financing, where the bank provides loans to customers with interest to be paid over a specified period.

- **Leasing**: A rental system similar to *ijarah*, but using interest as compensation. The customer rents assets from the bank and has the option to purchase the asset at the end of the lease term.

- **Mortgage**: A loan secured by real estate collateral. The customer receives a loan with property as collateral, and interest is paid over a certain period. If the customer fails to pay, the bank has the right to seize the property.

3. Penalties

The approach to penalties in Islamic financing is very different from conventional financing. In Islamic financing, penalties are applied as compensation for losses caused by late payments but cannot be a source of profit for the bank.

The penalties imposed are usually directed toward social or charitable activities, in accordance with Sharia principles that emphasize justice and welfare. This is intended to prevent the bank from profiting from the customer's difficulties and to encourage timely payments.

In conventional financing, late payment penalties are often used as an additional source of income for the bank. These penalties are calculated as a percentage of the unpaid loan amount, which can increase the financial burden on the customer.

4. Mitigation of risk

In this regard, a significant distinction between Islamic and conventional finance is how risk is handled and shared.

Islamic banks can employ some of the same techniques as traditional banks. They can study and monitor the businesses they fund to reduce the risk of default. In fact, profit and loss sharing may provide still another reason to keep an eye on the business.

Islamic banks, on the other hand, confront unique risk management concerns. Some instruments used by traditional banks are unavailable. Financial derivatives, for example, fall into this category.

The value of a financial derivative is determined by the value of another financial instrument. This immediately contradicts the materiality principle, which states that finance must be linked to real economic activity. Derivative markets that are Shariah-compliant have yet to emerge.

Challenges To Islamic Finance

Despite the huge growth of the Islamic Finance and Banking Industry over the past few years, the industry currently faces considerable challenges and in particular:

1. Lack of Human Capital

Qualified human resources play a pivotal role in the development and success of any industry. There is a dearth of qualified bankers and professionals who are well versed in Islamic laws as well as contemporary economics and finance. Currently, various universities and training institutes are offering courses in Islamic finance but they also face lack of competent human resources to conduct these courses. There also remains a huge lack of human resources on the expert level. There remains a significant shortage of Shariah Scholars who are well versed in Islamic Finance. Business schools and religious schools should offer Islamic Finance qualifications in co-operation and conjunction with industry experts to create the next generation of Shariah experts and professionals. Academic Institutions should also be encouraged to establish centres of excellence for the Islamic Finance Industry.

2. Shariah Standardization and Harmonization

Islamic Law accommodates for differences of opinion and interpretations of classical Islamic texts. This leads to different practices and policies adopted across different jurisdictions. This may impact on the growth and internationalization of the Islamic Finance Industry. Islamic Finance Laws, policies and practices should be standardized and harmonized in order to create more unification and consolidation within the industry. This would strengthen the industry from a Shariah perspective and root out weak and rejected views. Furthermore Shariah scholars should adopt these policies and procedures to prevent and mitigate Shariah non-compliance risk.

3. Lack of Public Awareness

There remains a low penetration rate and lack of critical mass in the Islamic Finance Industry. This is due to mainly a lack of public awareness and knowledge of Islamic Finance. Islamic Banks, regulators and Governments should undertake mass awareness programmes to drive the growth of Islamic Finance and create critical mass for the industry.

5. Access to Finance

Muslim countries have shown a lower level of financial inclusion than other countries in the World. This can be resolved by creating a better business model, reforms to increase competition within the banking sector, consumer protection, better credit information and education.

6. Monetary Policy and Liquidity Management

Money and interbank markets for Shari'ah-compliant instruments have not yet developed in most countries, in part because of a lack of available instruments. There remains a huge shortage of Shariah central banking facilities. Moreover many Islamic Banks operate under a dual system of conventional and Islamic Banking policy framework and are heavily influenced as a result by conventional banking instruments and conditions. Central Banks should adopt more effective instruments and policies for Islamic Banks. Many jurisdictions do not have a lender of last resort for Islamic Banks. Only 6 out of 24 Jurisdictions for Islamic Banking have a lender of last resort for Islamic Banking.

7. Tax Policy

Regulatory/tax reforms play a pivotal role for the growth of any industry. There remains various tax issues which need to be resolved in order to level playing field between Islamic Banks and conventional banks. Some of these issues include the treatment of Islamic finance under income taxes, sales taxes (for example, value added taxes), specific transaction taxes, and bilateral tax treaties. International standards can encourage governments and jurisdictions to facilitate tax reforms.

8. Benchmark

The usage of the conventional interest based benchmark (Libor) creates a negative perception among investors who tend to associate the Islamic Financial system with the conventional financial system due to the usage of the interest based benchmark. Furthermore Islamic Banks are placed at the mercy of the movements in the conventional money markets by using the conventional interest based benchmark.

9. Regulation and Supervision

Islamic Banks are exposed to various risks such as displaced commercial risk (DCR). This forces Islamic Banks to lose profits in order to pay comparable returns to investment account holders (IAH) and depositors. This create huge challenges for Islamic Banks in creating excess reserves to cover losses and how this is viewed from a regulatory perspective.

Islamic Banks also face equity investment risk, rate of return risk, Shariah non-compliance risk in the event of perceived non-compliance and liquidity risk due to the shortage of liquidity products. Other challenges include the divergent interests of Investment account holders and the Islamic Bank's shareholders. One of the major issues is that IAHs share profits and bear losses, but do not have shareholder rights. This leads to a lack of transparency in the reporting of profits and losses to the IAH. Various standards have been issued by the IFSB and AAIOFI. However many jurisdictions have failed to implement these standards.

There also remains a huge challenge in the adoption of Shariah Compliance. Various jurisdictions do not regulate and supervise the way Shariah Compliance is adopted. There should be a proper selection criteria for Shariah Scholars. Many jurisdictions have begun adopting central shariah boards in order to ensure harmonization of Shariah compliance within the industry.

❖ ***<u>Text Based Activities</u>***

Exrtcise 01 : Comprehension Questions

1. What are the main differences between Sharia and conventional financing in terms of basic principles?
2. How do Islamic banks mitigate risks compared to conventional banks?

3. What is the role of penalties in Islamic financing?

Exercise 03: Determine whether the following statements are true or false.

- Islamic banks can use financial derivatives for risk management.
  Islamic finance prohibits interest but allows profit-sharing.
- Conventional financing prohibits interest-based transactions.
- One of the challenges of Islamic finance is the lack of human capital.
- Islamic banks cannot invest in real estate.

Exercise 2: Complete the following sentences using the correct academic term related to financial inclusion:

Q9. Complete the sentences using appropriate academic vocabulary:

1. One of the primary distinctions between Islamic and conventional financing is the prohibition of ____ in Islamic finance.
2. In a ____ contract, both the bank and the customer contribute capital and share profits and losses.

3. The lack of ____ in Islamic finance across different jurisdictions poses challenges for its international growth.
4. The fundamental difference between Islamic and conventional finance is the prohibition of ________, which refers to interest-based transactions.
5. ________ is an Islamic financial contract in which the bank and the customer jointly invest in a business venture, sharing both profits and losses.
6. Unlike conventional finance, where derivatives are common, Islamic finance restricts their use due to the principle of ________, which requires all financial transactions to be linked to real economic activity.
7. One of the major challenges facing the Islamic finance industry is ________, as there are not enough trained professionals with expertise in both Islamic law and modern finance.

Exercise 03: **Match the following terms with their correct definitions**

1. Murabahah
2. Ijarah
3. Musyarakah
4. Mudharabah

A. A partnership where one party provides capital while the other manages the business.
B. A profit-sharing agreement where both parties contribute capital and share profits/losses.
C. A sales contract where the bank buys and sells goods at an agreed-upon profit margin.
D. A leasing contract where the bank rents an asset to a customer for a fixed period.