

# **Mature and Significant Link between Islamic & Conventional Banking**

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## ABSTRACT

Basically a jointly shared goal of the banking system is to serve the humanity for their needs that leads towards their betterment of the persons individually, a family, vicinity, society and the economy of the countries as a whole. It is mutually consensus by the think tanks globally that the past experiences now paved the way to redesign the policies for economic development as this proved from the researches about Natural and Social Sciences. Currently banks are designing number of services to boost up the wellbeing of the populations in which they are operating. All these services/products are basically essentials to everyone's routine life without any discrimination at all.

Hence the banking industry are repeatedly trying to introduce distinct services/products in different ways to the earlier or existing ones for the future according to the requirement of their customers/societies needs that fulfills and satisfies them. However due to the proliferation of various types of Banks a common man who is believer of any revealed religion including Islam, Christianity and Judaism or any other is very much in a state of confusion.

On one hand is the very cherishing dream of development while on the other hand is faith. So these developments lead to the question among the peoples over two kinds of Banks (*Islamic and Conventional*). I want to discuss that what are the similarities and differences between these if there are, and how big are these?

**Key words:** inevitable, pivotal, sufficed, steeply proliferated, and bluntly refused.

## ÖZ

Bankacılık sisteminin amacı insanlığın daha iyi bir hayat sürmesi için gereken ihtiyaçların karşılanmasını sağlamaktır. Günümüzde bankalar hizmetlerini halkın ihtiyaçlarını karşılamak ve yaşam standartlarını yükseltmek amacıyla şekillendirmektedir.

Bankalar insanların değişen ihtiyaçları doğrultusunda sundukları hizmetleri durmadan değiştirmek veya yeni hizmetler eklemek için çaba göstermektedir. Dinlere inanan insanların ihtiyaçları doğrultusunda da bu hizmetler değişiklik gösterebilir.

Bir yanda bankaların gelişme arzusu diğer yanda müşterilerin memnuniyeti sayesinde çeşitli bankacılık sistemleri oluşturulmaktadır. Bunlardan bir tanesi de İslam bankacılığıdır. Bu tezin amacı geleneksel bankacılıkla islam bankacılığı arasında bulunan benzerlik ve farklılıkları araştırmaktır.

**Anahtar Kelimeler:** İslam Bankacılığı, geleneksel bankacılık.

*To my beloved Family*

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# Chapter 1

## INTRODUCTION

We all agreed that banking is inevitable for the all-economic Systems (*eastern, western, old fashioned and modern*). It is most valuable medium for mobilizing funds globally without any discrimination for all that accumulated by the banks as a trustee of the general public.

From the last many decades banks proved themselves & playing pivotal role for the development of all economies & societies without any discrimination of the clans, castes, colors, religions, ethnicities etc. banks are instrumental that facilitate economic development in countries due to their essential role in every economy.

Experiences and development of knowledge of the past will lead to make or more strengthens the current practices and allows changes or modifications in the present operations to drive as smooth as we can almost in all walks of life.

### **1.1 Background**

Development of every economies stability and growth is very much related to its financial sectors. This is vital for all the stakeholders like public, government authorities, businesses etc. In this changing world every business including banking sectors providing thousands of services to the customers that may differs according to their needs and wants. Further these differences may be arises by knowing geographical, demographical, social, religious and ethical values.

According to the different believes (religiously) banking business are also molds themselves and banking divides into two sectors Islamic and conventional and hence new version of banking system emerges. Presently Islamic banking system is trying to remake their services in the light of their faith upon sharia (*Islamic Laws*). Upon this new version of banking business there are number of critics argues about their existence, performance, riskiness etc. especially after the last resentment of financial crunch in the wake of 2000,s.

## **1.2 Aim of the Study**

The performances of Islamic and conventional banking system have been adjudged previously by using different tools by number of scholars, researchers through this stuff everyone can analyze the performance of both the banking systems. Everyone discussed previously about these two banking Systems (*Islamic & conventional*) in the context of their stability, capital adequacy, productivity, market share, liquidity, growth, efficiency, profitability, solvency etc.

But through this paper I want to disseminate that: Are there any pros and cons in any one (*Islamic & conventional*) banking system? Or both the systems are sufficed for the productivity, stability of every society because of their mature and significant link with each other.

## **1.3 Research Methodology**

Due to vast personal practical working experience in the Banking Industry, through this paper I would like to discuss these two banking streams (*Islamic and conventional*) on descriptive and analytically by getting information from the previous researches, published work, journals, etc.

## Chapter 2

### LITERATURE REVIEW

Observations and evidences declared that number of conventional banking products can be revisited according to the Islamic values called Sharia. There are very fewer differences between both the banking systems (*Islamic & conventional*). In comparing both, some distinctions in assets quality, efficiency, and stability revealed by the authors. Authors find that conventional banks are less cost effective than Islamic banks but the conventional banks working in the countries where market share of Islamic banks are higher may more cost effective but less stable. In the countries where share of Islamic banks are higher, proved higher capitalization hence due to their higher liquidity reserves that results comparatively better outcome of Islamic banks during the recent recession (*Thorsten Beck, Asli Demirgüç-Kunt, Ouarda Merrouche, 2010*).

Overall no any significant distinction have seen between Islamic and conventional banks while studying of 33 conventional and 43 Islamic banks throughout the period from 1990 to 2005 of 21 countries by using Data Envelopment Analysis especially comparing cost, profit efficiency, revenue. Efficiency of both the systems (*Islamic and conventional*) studied over their age, size and region using static and dynamic panel (*Bader, 2008*). The conventional banks led to the difficulties from the financial crunch in the recent past due to their fixed rates of interest whereas on the other hand

the Islamic banks to some extent absorb this crunch due to their profit and loss sharing ideology (*Yilmaz 2009 and Willison 2009*).

Performance assessment of interest free and interest based banking system, *Safiullah 2010* took four conventional and four Islamic banks in Bangladesh from the period 2004 to 2008 of both streams (*Islamic / conventional*) for gauging their services in terms of liquidity, solvency, business development, profitability and commitment for the service to the community. The outcome proved that conventional stream providing better outcome according to their commitment for development of economy, productivity, community and efficiency.

Profitability of 10 banks in Pakistan assessed during the period from 2004 to 2008 and found that bigger volume of total assets may not perfect indicators of large profits. Further they summarized that excessive lending are somehow leads in profitability but not significant but the deposits / equity have an effect over profitability (*Javaid, Anwar and Zaman 2011*). It was concluded that more or less customers of both the medium of banks (*Islamic / conventional*) are satisfied with their products depending upon their nature (*Sheikh, 2010*). The efficiency only varies between Islamic and conventional banks significantly country to country (*Abdull-Majid, 2010*).

A study of Bahrain Islamic banks and conventional banks in the period from 1991 to 2001 according to t-test disclosed that no any countable difference seems in liquidity and profitability amongst them but the Islamic banks are relatively less at credit risk (*Samad, 2004*). By using CAMEL framework, they examined both banking system in Pakistan from 2005 to 2009 and arrived to the conclusion that in quality management, quality assets and liquidity Islamic banks' lending through debt than

equity and found better performing than conventional. Further, they added that despite of that conventional banks are making greater earnings whereas Islamic banks' earnings are less on their assets (*Jaffar and Manarvi 2011*). If confined performance, statistically there is no difference arrived (*Samad and Hassan 1999*). A comparative study about these systems (*Islamic / conventional*) from 2006 to 2009 in Pakistan by the perspectives of ROE and ROA Islamic banks are more liquid than conventional hence less risky, however according to the capital adequacy ratio performance of both the systems not showing any comment able difference (*Ansari and Rehman 2011*). Study found that development of Islamic banking in Malaysia was very speedily during the phase of 1997 to 2003 whereas on the other hand conventional banks maintained stability but final findings declared that efficiency of conventional banks better than Islamic (*Mokhtar, 2006*). Five years study from 2004 to 2008 about the performance of both banking streams (*Islamic / conventional*) in Malaysia found that profitability of conventional banks is higher but Islamic banks playing their role better in the context of liquidity (*Masruk, 2007*).

The performance of dual banking system in Malaysia especially period from 1996 to 1999 shows that Islamic banks are better in terms of ROA than their counterparts. Because their expenses overhead is lower but it doesn't mean that due to this conventional banks are lower in efficiency. Further they added that there is no conformity between investment margin and low assets utilization and Islamic banks mostly depends less on interest like products than their rivals (*Rosly and Abu Bakar 2003*). This work tried to know the profitability and viability of both the banking system in Pakistan and concluded that in terms of profitability, both are equal but the

ratio of solvency and liquidity shows that the conventional banks are little bit behind from their counterparts (*Zahoor,2011*).

The study targets banking in Pakistan during the period of 2007 to 2011 wherein financial performance of Islamic and conventional banks assessed and concluded that according to riskiness the Islamic banks performing well however, there is no any big difference in the context of profitability(*Sehrish 2012*).This research covers performance of both the banking stream in terms of their growth in credits, assets and profitability especially the effects on credit growth, assets and profitability during the phase of financial crises and concluded that the growth in assets are greater than their counterparts but effected by decrease in return on assets therefore they do not susceptible big losses as compared to conventional during the financial crush(*Hassan and Dridi 2010*),(*Hassan 2006*) studied that efficiency of banks especially Islamic during the phase from 1995 to 2001 according to Data Envelopment Analysis and observed that conventional banks are more efficient than Islamic stream but this study highlighted that efficiency measures are mostly correlated with technical, pure technical, cost allocative with ROA and ROE.Hence,hesuggested while assessing performance of these two systems all measures should have used simultaneously.

After using technique of Data Envelopment Analysis from 1997 to 2000,*Yudistira, 2004*claims that difference between efficiency and inefficiency of conventional banks and Islamic banks is very nominal, Islamic banks also suffered during the crises however, after this displeasure Islamic banks showed better performance. By using t-test during the period 2000 to 2009 in Malaysia no major difference seen in terms of profitability (*Hamid and Azmi 2011*).

Mostly the Islamic banking system argued that the operational functions of Islamic banks are as of conventional banks but their approach is literally different (*Ahmad, 2000; Chapra, 2000; Warde, 2000; Henry and Wilson, 2004; Iqbal and Molyneux, 2005; Iqbal and Mirakhor, 2007*). To illustrate the theme of the Islamic banking that distinguishes it by characteristics from its rivals is balanced and developed societies according to the Islamic ethical means as conceived by the economic of Islam (*Mirakhor, 2000; Warde, 2000*). Restrictions of all unethical means for example interests, gambling, speculations in any trades transactions that evolve a ground to overcome risks by protecting the benefits and interests of all stake holders and develop / promote society better (*Ahmad, 2000; Chapra, 2000*).

As in the traditional practice in conventional banking stream borrowers have to pay interests on their loans with or without any consideration of the output, which is in Islamic concept, is unjust. On the other hand this is also untrue for the lenders because return on their deposits routed through the banks to the entrepreneur not proportionate to the actual outcome of the investment (*Lewis and Algaud, 2001; Iqbal and Molyneux, 2005*). Islamic banking system basically is developed on to the concept of support, cooperation with each other and stands for a theme wherein sharing the risks between investors or provider of funds to the entrepreneur or borrowers promotes social development (*Ahmad, 2000; Iqbal and Molyneux, 2005*). Islamic banking system also differentiates from the traditional due to moral and ethical norms and social commitments as well according to the Islamic Law of Sharia (*Ahmad, 2000; Mirakhor, 2000; Warde, 2000*).

In the Islamic system according to the Islamic ideology of halal (*permissible*) and haram (*prohibited and undesirable*) allows the entrepreneurs and lenders operates at different levels to promote a good social climate providing desirable legal framework(*Chapra, 1992*).According to the Islamic Sharia due to morally and ethically banks cannot lend the money to the project or entrepreneurs who are involved in any businesses like a night club, brewery factory etc. that are clearly prohibited in Islam(*Ahmad, 2000*).Since the mid of 1970s in the U.K socially responsible firms expands their businesses for ethical investment and the field of corporate social responsibility develops rapidly and not remain limited into the financial sector (*O'Brien, 2001; Snider et al., 2003*).

By knowing the impact of the above concept according to the EIRIS (*Ethical Investment Research Services*)there are more or less 50 funds exists for the ethical investments because their selection criteria for investment covers all social and ethical means (*EIRIS, 2003*). The value of these funds enumerated bytheForum of Social Investment in 2003 the total assets 11.3 % (*exhibiting approximately 2.16 trillion \$US*) invested using philosophy of social responsibility under the professional management in the USA(*Benson et al., 2006*).This signs shows that the investment industry by ethical means captures attention of the companies in dealing ethical norms. Due to adaptation of this trend the companies realizes that they are getting attention as ethically and socially responsible firms (*Porter and Kramer, 2002; Snider et al., 2003*).

The companies are foreseeing that due to their share in economic social and environmental friendly behavior with responsibility disseminating their reputation to their suppliers customers and ultimately gain attraction of skilled staff which must



helpful to strengthened their corporate reputation (*Turban and Greening, 1997*).Hence, it has proved by number of researches that delivering any kind of services with the commitment and believe of social responsibility by ethical means paved the ways towards better profitability, performance, risk management and competitiveness (*Waddock and Graves, 1997; O'Brien, 2001; Porter and Kramer, 2002; Brinkman, 2003; Johnson, 2003; Snider et al., 2003*).The emerging activities of Islamic financing and their proliferation through Islamic products according to the Islamic ideology of social obligations in the west need inspection in terms of customer's perspectives.Anyway this advancement requires Islamic operations to counterbalance between social responsibility and in profit making activities (*Wilson, 1997*).

There are number of reasons in selecting any kind of banking services from the customer's point of view as studied by the number of researchers time and again in their researches. Due to these researches it transpires that the most probably selection of banking activities by the customers are that what products they offered, quality of their services, efficiency, reputation, cost and benefits, confidentiality, location (*convenience / parking space*) personnel empathy and most important which is being considered religiously (*Erol and El-Bdour, 1989; Erol et al., 1990; Omer, 1992; Haron et al., 1994; Gerrard and Cunningham, 1997; Metawa and Almosawi, 1998; Naser et al., 1999; Ahmad and Haron, 2002; Abbas et al., 2003*).The Islamic banking operations were first emerged on experimental basis from a town of Egypt in 1963 to examine its validation. Experiment was successful and got millions as deposits but due to political influenced forced to discontinue. However it was proved that the Islamic banking version could be adopted. After that experiment now numbers of

Islamic banks are functioning in the regions especially where the population of Muslims greater. They are now expanding their operations in non-Muslim countries where a Muslims are increasing significantly (*Metwally 1997*).

The study about (*Islamic and conventional*)banking disclosed and anticipated that the assessment of both the banking systems about their financial services is very much unfair as the Islamic banks are also operated within the conventional banking laws nevertheless they are practicing differently.They suggested that Islamic banks should have a distinctive interbank money market according to their faith. Further they added that they should have an independent authority for their regulations (*Ahmad and Hassan 2007*).The outcome of the research about the banking system in Kuwait is that the Islamic banks are not showing steadily earnings as compared to their counterparts and they (*Islamic banks*) requires appropriate tools for analyzing their performance as only few financial tools are not adaptable.Further they added that they are not pursuing researches properly on financial analysis about Islamic banks hence lack of integration (*Alani, Yaacob and Hamdan 2013*).Thisstudy argued that satisfaction of the customers of both banking stream prevailed upon the facilities they offered but the customers of conventional banks exhibits their satisfaction more as compared to the Islamic banks (*Liaqat Ali, Azmat Ali, Hamza khawaja 2013*).

## Chapter 3

### BANKING FUNCTIONS

In this chapter, I would like to elaborate the framework and the basic theme under which the banking system generally works especially for the persons who do not know the cycle of the banking functions like:

1. How do they operate?
2. Basic concept of Islamic & conventional banking system

#### **3.1 How Do They Operate?**

The banking system flourished day by day throughout the world because for every development, you need resources in the form of land, labor, raw material and the most important factor the funds for deploying these altogether for the development. The banks have proven themselves the biggest source of arranging funds to utilize for the development as a whole. First of all for a layman we have to distinguish this question that: Are the banks owned these funds?

Money in the form of cash can merely transfer by delivery from one to another, means that money does not have any title. So keeping money with their own for the public is very cumbersome hence to overcome this, the decades ago think tanks designed this framework say banking institutions who kept the safe deposits of the public and are payable on demands at once.

So, the answer is that the funds with the banks are the property of their depositors who deposited these funds in the banks for their safe custody that are payable on demand at once. Now this is very much clear that the banks are carrying deposits of the public as a Bailee or Trustee.

### **3.2 Basic Concepts of Islamic & Conventional Banking System**

In order to justify this research paper I have to elaborate banking in two sections as follows.

1. Conventional banking
2. Islamic banking

#### **3.2.1 Concept of Conventional Banking**

Mostly well-known economists maintain that “Banking was Italian by birth”. As the technical word bank have originated from the Italian word Banco that translated a table or a bench in which Italian moneychangers used to display their moneys and records and conduct their transactions. It may be assumed that in the beginning these types of institutions (*Banks*) may charge for their services by keeping deposits of the public in safe custody but later on it was understood to the then Economists and Law makers that lying idle of the money won't be benefitted at all to any one (*depositors / bankers*).

Hence the Conventional Banking evolved gradually, because by pooling these funds under the predetermined Rules & Regulations especially after maintaining liquidity (*as we have clarified above that the funds with the banks are the public property and payable on demand at once*). Therefore, banks started lending to the borrowers at specified predetermined rate of interest that will be received from the borrowers and started paying interests to the depositors who have contributed to finance the

borrowers that in turns benefitted economically to the society as a whole. The amounts of interests charged by the banks upon the borrowers are slightly higher than the amount of interests paid to the depositors and the spread between these is the banks Income.

Hence it is established that the banks works as an intermediary between the depositors & the borrowers and we can say that they are doing businesses by pooling the moneys with them deposited by the depositors & sells this huge pooled amount after maintaining of liquidity for the depositors on buy back arrangement at higher rates. This is the basic function of the conventional Banks.

### **3.2.2 Concept of Islamic Banking**

Islamic Financial System or Islamic Banking System have based upon the Islamic values and basic Islamic principles that have given by the ***“QURAN“****(The last Holy Book for the Human Beings by the ALLAH SUBHANA HU TAALA and the “SUNNAH” (The practical life of the last prophet MUHAMMAD S.A.W.W PEACE BE UPON HIM).*

The Islamic Financial System according to the Sharia ruled out the Riba or Usury or interest that basically means the lending or practice of lending money at an exorbitant interest or an exorbitant amount or rate of interest, especially in excess of the legal or nominal rate. According to the Islamic values & traditions the main essence of this system is based upon cooperation & support of the needy with goodness & piety instead of to exploiting their weaknesses by lending moneys and merely charging interests.

According to the jurists of Islam for the financial businesses it only be possible when the financial institutions or banking will be Governed by ethical means or ethical lending procedures derived by the Islamic Sharia (*Rules for the Human beings from the QURAN or codes of conduct to live*), instead of fixed rate of interests bearing transactions not all but those that are exorbitantly above the normal means and with or without any consideration.

The principles of Islamic banking or economic system mitigated extreme communism and capitalism which allows freedom to the individuals / businesses and the society as whole & defines moral norms to create & produce wealth under the divine guidance not the human rulers. This requires fair intentions, sincerity that results peace & prosperity for a good and lasting society. This also not supported competition by all or negative means but only to cooperate and help to the needy. Hence it ensures profit and loss sharing mechanism in lending for all financial commitments as per Sharia which means to share the amount of gains or losses in return of all or any kind of investments which will not overburden the borrowers or to the weak participants in all businesses and financial activities.

As discussed above that the banks and the Financial Institutions are playing role of trustee or Bailee of the depositors funds & act as intermediary between depositors & borrowers who are in need of money for their development and the development of economy as whole.

In the Islamic approach, the Human beings are the trustees over the resources provided by the *ALLAH SUBHANA HU TAALA* and accountable to *ALLAH SUBHANA HU TAALA* for its uses and deployment. Therefore this should be used by

ethically, spiritually and morally acceptable to the public or the society and to serve for the development as whole without exploiting the weaknesses of the participants.

It is practically proved that happiness and satisfaction for all walks of life will come with their collective interactions transparency, faith and fairness hand in hand. As we all know that experiences of the past will lead to make or more strengthens the current practices and allows changes or modifications in the present to drive as smooth as we can almost in all walks of life. That is why since the last two decades in the banking sector it is very hot issue because, everyone wants to know that what were the problems with the present (*conventional or traditional banking*) which paved the way for the Islamic banking sector to introduce.

## Chapter 4

# ROLE OF BANKING SECTOR IN DIFFERENT SOCIETIES

This section presents the roles of banking sector in the societies like developed countries and less developed or developing countries. This is a general perception that banks are providing services alike in every society especially in the context of charging fixed rate or high rate of interests which is the most debatable element in both banking Systems (*Islamic and conventional*), but this is not true. I would like to disseminate this perception that this is not as much as this seems by proving empirically but it does not mean that banks are providing services discriminatively in the different societies. There are very solid reasons for doing that.

Whenever you intended to start any kind of work behind this you have a goal to achieve definitely positive but you must have to take into account that there are certain type of risks also.

These risks are related to various factors and differ from societies to societies and countries to countries. Especially in those societies (*welfare Societies*) wherein the sovereign authorities are assumed themselves as public servant not the rulers of the peoples and make decisions only for the welfare of the societies and accountable to



the societies and spiritually to their creator(*General thought given by all religions including Islam*).

Hence, in the well-developed societies / countries the risks related to any kind of work comparatively lesser than the less developed and developing Countries because of the following factors:

1. Political stability.
2. Economic Stability.
3. Controlled law and order situation (*nothing is beyond the law*).
4. Good / Strengthened infrastructure.
5. Equal rights for all (*without any discrimination*).
6. Welfare states (*community based services*).
7. Ethical norms / values for all (*religiously*).

As we are discussing here the banking sector so, due to all above given factors the lending banks providing financial services or bridging the gap of funding requirements for the businesses in the developed societies have an edge above because of the expectation of low rate of default risks. For these solid reasons they charge very nominal rate of Interests against their investments because they assume that their invested funds won't be stuck-up or you can say that very limited chance to stuck-up. Therefore the borrowers are very aggressively induced to get the finance for enhancing their businesses that ultimately creates employment opportunities, fulfill the demand of the society and reduce per unit costs of the proposed products hence happily agree to pay this nominal rate of Interests in return.

Due to these advantageous conditions the banks have to face never ever or very limited liquidity problem or liquidity crunch (*but must have to maintain liquidity according to the requirement of the local Regulators*) as they (*banks*) can easily repels this by matching the maturities of their Assets and Liabilities (*assuming no default or nominal default due to unavoidable conditions*).

Changes in the market interest rates may affect these but due to matching of the maturities of their Assets and Liabilities portfolio this also may less affected or effect only for a limited time period.

On the other hand like any kind of work the risks of banking services in less developed and developing countries are much higher than the developed societies because of the following factors (*more or less adverse as developed societies / countries as given above*).

1. Bad or not very good / Un-Strengthened infrastructure.
2. Political instability.
3. High rate of unemployment.
4. Un-Controlled law and order situation (*influence of various sources beyond the law*).
5. Un-Equal rights (*various sources leads discrimination*).
6. Religiously sensitive.

Therefore considering all above given factors the banks working or involves in lending practices providing financial services or bridging the gap of funding requirements in the trades to the less developed or developing Societies may expect high rate of default risk.

Nevertheless, because of their first and foremost function is trustee of the depositors / investors funds that have to pay on demand at once. Hence, due to the higher expected rate of default in repayments of these investments, this is inevitable to them (*banks*) to charge slightly higher rate of return, interests, profits, shares whatever the name suggested for making provisions to the depositors / investors funds who shares these investments through the banks and payable on demand at once. The effects of these situations are that only those borrowers will take interests in the funds or take financing from the banks who are more risk takers and because of the banks charging high rates of Interests, they (*borrowers*) induce to work / invests in more risky trades for getting higher Return / Speculations (*which is strictly forbidden in Islam*).

Hence due to these dis-advantageous situations the banks may have to face liquidity problem or liquidity crunch (*but must have to maintain liquidity according to the requirement of the local Regulators*) so they (*banks*) cannot easily repel this by only matching the maturities of their Assets and Liabilities (*assuming high default / risks expectations*). Changes in the market interest rates may also affect these due to mismatching of the maturities of their assets and liabilities portfolio because of the time and again defaults of repayments in their overall average investments.

In addition to all these various sources beyond the law who leads discriminations (*as mentioned in the factors above*) will influence to the banks or may tend to rescheduled

/ restructured the terms and conditions of the funds time and again (*with or without any solid reasoning*), or may force to prepare and present a policy before the authorities concern for writing off / waived the invested funds. This may tends to fix the interests rates higher as compare to the developed societies.

Some critics must argue that so why the liquidity crunch aroused in the recent past if only these factors could supports the systems?

In this respect, I would like to state that the banking Industry must have to diversify their investments in all the sectors of the societies instead of one or few as they did e.g. the industry invested in the mortgaged sector. The banking Industry experienced the crises in the wake of 2000,s but it has been debated that the causes or reasons of these crises are bad scrutinizing / screening incentives and non-diversification (*sector wise*) of the credit approach at the peak of the financial business cycle. It disclosed that in the wake of the peak business era in which the amount of feasible applications are greater, the competition between the banking industry intensifies followed by decreasing return (*minimizing cost of funds, minimizing cost of deposits, cheaper credit in the interbank market, minimizing discount rate*) due to improper screening of loan applications. Hence scrutinizing standards deteriorated tends to pile up the bad loans and caused crises / excessive risks for the banking sector (*Mukminov, Rinat,2015*)

However, after combat with that great recession in the wake of 2000,s they (*banking industry*) have now taken concrete efforts about diversification of their investments of funds in more or less all the segments of the societies that will fence against the latter resentments.

According to the European Institute of Public Administration (*EIOPA 2008*) that: the satiable needs are essential for the organizations and the markets including banks but it differs from products to products, societies to societies and persons to persons.

As we are discussing here the banking sectors hence Merits and demerits of interest based and PLS (*profit & loss sharing*) based banking attributes the dominance throughout the world at large to the problem of existence of the "**Moral Hazards**" and charging of Interests, Profits, Shares, and Mark-ups whatever the name suggested can be reduced up to a normal or minimal level when every society eliminate these hazards and promotes ethical values for all.

## Chapter5

# PRODUCT ANALYSIS OF ISLAMIC AND CONVENTIONAL BANKS

This chapter defines the distinction and similarities between Islamic and conventional banking System, especially basic product to product:

**Islamic Perception:** First and the foremost step to get deposits from the depositors / investors for various types of accounts as a custodian of their moneys which is payable on demand at once.

**Current Accounts:** No any profit only for the safe custody & payable on demands at once.

**Savings or Investment Accounts:** Profit & Loss sharing basis and some of the investments wherein the investors or depositors have an option to choose the activities / businesses in which he or she satisfied to invest and agreed to share Profits& Losses.

**Conventional Perception:** First and the foremost step to get deposits from the depositors / investors for various types of accounts as a custodian of their moneys, which is payable on demand at once.

**Current Accounts:**No any profit only for the safe custody & payable on demands at once.

**Savings or Investment Accounts:** Profit and Loss sharing but there is no option to the investors or depositors to choose the activity / business in which he or she satisfied to invest but agreed to share Profits& Losses.

The basic responsibility of both the systems is that to financing the deposits of the investors to the borrowers after scrutinizing or preparing the feasibility of the trades and businesses in which the borrowers are interested. However, because both the banking systems are playing a role as custodian of the public funds and committed to pay on demand hence should be careful while lending.

For example, they must ensure the following:

- The requirement of the businesses for the society.
- The businesses won't be harmful for any one.
- The proposed businesses have capability to flourish in the market.
- The management of the businesses have skills to run or if they are new in these businesses, they have enough capabilities to overcome the hurdles if occurs.
- The businesses that are suggested will help / support to the needy for the development of their own and that will ultimately beneficial for the Society and without harming dignity of every one.

Further, after justifying of all these both the systems should have to back to these investments by some collateral from the borrowers.

## **5.1 Musharkah/s Conventional Product**

### **5.1.1 Musharkah**

In this product the banks and investors makes partnerships to participate in businesses to the entrepreneurs (*that are already in trades / businesses and have already invested*

*capital at their own*) with the capital for stimulating the activity against the agreed period of time and on an agreed rate of profit. This is like Joint Venture. Rate of Profits & periods may change in trades to trade and businesses to businesses. If losses occurs will bear proportionately as agreed.

### **5.1.2 Conventional Product**

As the conventional banks are the oldest one, hence they have numerous products wherein the basic requirement of lending is the contribution of the funds from the borrowers or the ratio of the investment that should have to be invested by the borrowers at their own. The logic behind this is that the entrepreneurs must take interest diligently into the businesses for making these investments fruitful. The period and rate of interest is agreed in advance. In the conventional banking this is the duty of the banks to monitor the performances of the businesses and if found that this will not work appropriately may recall the finance before maturity of the periods.

## **5.2 Mudarbah/s Conventional Product**

### **5.2.1 Mudarbah**

These are another type of partnerships in which one injects the capital or investments and the others provide labor or services means banks injects capital & the borrowers or entrepreneurs who have potential or knowledge about the particular businesses will provide labor or services to handle. In this situation the time period & the rate of profits have to be decided in advance. However, if losses occur the banks may lose the whole of the capital or a part thereof, but the borrowers only lose their labor and services. Hence, to secure the investors' moneybanks have to take some collateral from the borrowers.

### **5.2.2 Conventional Product**

In the conventional system there are number of products in which the banks after going through all the pre-requisites (*as illustrated above before lending*) lend the public funds



for the agreed period & on agreed rate of interest. In this case again this is the banks duty to look after the functions of the businesses and if found that the outcome won't seem as expected may recall the funds before expiry of the terms. Further before these types of lending Banks should have to take collaterals for securing the public funds.

### **5.3 Murabahav/s Letter Of Credit**

#### **5.3.1 Murabaha**

This is an arrangement of partnerships wherein the customers contact with the banks requesting to buy certain items or commodities for them from some particular suppliers according to the pre-determined terms and conditions. And after completing the procedures (*means receiving the items / commodities according to the preset conditions*) the customers will get these items or commodities from the banks by paying the amount of the items / commodities in full along with the certain profit that is fixed previously. The items or Commodities may be from the local suppliers / manufacturers or international suppliers or manufacturers. These types of arrangements are required when the suppliers of the items / commodities needed assurance of payments, hence the customer's request to their banks for making partnership. These are very risky partnerships as if any complication occurs the banks are at greater risk as they funded the entire amount and the profits are justified whereas the customer lost their reputation & face legal implications.

#### **5.3.2 Letter of Credit**

In the conventional systems this type of arrangements called Letters of Credits, wherein the customer request to their banks to pay to the suppliers after fulfillment of all the pre-requisites conditions as documented earlier between the customers and the suppliers on their behalf. After getting the green signal from the banks and the customers, the suppliers board the items / commodities and the banks made the payments to their

(suppliers)banks. The customers then have to pay the amount of the commodities in full along with the profit to the banks as fixed earlier and get the goods. These arrangements are on the suppliers demand ensuring the payments of the commodities.

As for as the Islamic Systems these arrangements are very risky as the whole amount is funded by the banks and if any future discrepancy will arises the banks are at stakes whereas the customers damaged their reputation and face the litigation.

## **5.4 Ijarah Al Bai (Lease, Rent) IjarahWallIqtina v/s Leasing**

### **5.4.1 Ijarah Al Bai (Lease, Rent) IjarahWallIqtina**

These types of partnerships are in the products wherein the physical possession of the items / commodities rests with partners or the customers. In these arrangements on the request of the partners / customers, banks buys the assets & gives possessions of the same to the partners / customers against the payments of some fixed amount of rent up to a certain period of time. During this period the ownership of the items are with the banks whereas the partners are enjoying full usage of this against payment of rent. At the maturity of the periods the ownership may be transferred to the partners / customers on the predetermined rate of profit by adjusting the time value of money. Throughout the periods the risks are rests with the banks as they invested the full amount and for the longer periods. If there any miscommitments occur the banks will be at stakes whereas the partners / customers are paying rent for their usages. These partnerships / arrangements are commonly related in the Auto loans, Mortgaged loans (*Housing Finance*), equipment's etc.

### **5.4.2 Leasing Arrangements**

In the conventional banking scenario, these arrangements are like same as in the Islamic banking. The ownership of the assets will rests with the banks till the end of the fixed periods but the customers only use these assets by paying the fixed rental

value. At the maturity of the periods the ownership may be transferred to the lessee (*customers*) on the fixed stipulated amount by adjusting the time value of money. During the maturity of the contract the bankers are at the high risk due to the whole funds invested by them & the partners / customers are enjoying its features by paying only rents.

## **5.5 Sukuk (Debt/Lease/Wakalah) v/s Bonds**

### **5.5.1 Sukuk (Debt/Lease/Wakalah)**

These instruments are issued by the banks in the shape of bonds by creating debts (*a form of debts*) but especially are backed by those assets purchased from the proceeds of the issues. In the Islamic banking systems their returns are not fixed. Maturities of these bonds are very limited or medium in terms. These are competitive in pricing and have an edge due to their lesser risk structure.

### **5.5.2 Bonds**

In the conventional banking sector, these are a particular type of debt instruments, issued by the commercial banks and some big Firms / Corporations for meeting their funding requirements. Coupons of interests are attached with them at predetermined rate of interest up to a certain maturity. At the maturity the holders enable to get the face value along with the last coupon payment.

## **5.6 Takaful (Islamic Insurance & Re-Insurance) v/s Insurance**

### **5.6.1 Takaful (Islamic Insurance & Re-Insurance)**

These are the arrangements wherein the basic theme is to share or reduce the implications of misfortunes or the risks which may arise without any intimation or unexpectedly. According to the Muslims tenets Takaful Policies are providing support to the persons in the wake of sudden or unexpected events. Takaful insurance may support each individual by consolidated the risk of many peoples by the Law. Therein

a certain amount called premiums are to be paid by the investors up to a predetermined period & if during this period these particular events occurs the company have to pay the amount agreed to the Takaful policy holders or their heirs after fulfillment of certain conditions and the payments of further premiums terminated in the concept of supports.If these unexpected events won't occur the companies have to pay some additional amount in appreciation because of the hands / participations provided by the investors to whom who affected these misfortunes.

### **5.6.2 Insurances**

In the existing system (*conventional*), these arrangements are in a form of investment wherein the banks or insurance companies (*registered for doing insurance businesses according to the law*)pooled the funds invested with them by the public or investors with certain conditions about the unforeseen or unexpected future happenings. The most common insurance is life insurance in which the investors are invested a sum of a particular amount for the certain periods (*as in the Takaful*)and if these particular events occurs the policy holders or their heirs have the right to get the compensation as agreed in advance and the further premiums will ceased. Further if these events won't occurs during the validity of the periods then the companies have to pay a sum accumulated by paying the premiums along with the certain profit as agreed by calculating the time value of money.

In the cases of default in any of the trades activities the conventional banks may have policies to provide the concessions / rebates / reliefs in payment of some (*taken only costs of funds instead of actual or fixed amounts of interests, mark-ups, profits, shares etc.*) or all amount of mark-ups, interests, profits, shares after considering the factual positions or knowing the unavoidable circumstances in which the defaults occurs.

On the basis of this research it revealed that the numbers of similarities are in the basic products of both the banking systems but because the banking is evolving new dimensions and emerging new avenues for the investors / depositors and the customers / borrowers by focusing their faith / understanding and satisfaction, hence in order to maintain and improve the customers satisfaction banks are in a bid to offer or enhance the quality of services without hurting their beliefs and faith.

## Chapter 6

### ANNOTATION OF MY WORK

Since decades various researchers doing researches upon various subjects but here I want to disseminate especially the researches about the human behavior for example, psychological inducement, sociological behavior, status consciousness, family background, religious affection, education that motivates the humans for making their decisions in order of the preferences. The objective behind discussing here some of the researches / cases because these are authenticating my point of view about the requirement of both the banking system (*Islamic and conventional*) as patronizing to choose the systems relates upon the attitude / behaviors according to their understandings, absorptions which comes out as a result of their (*humans*) capability. Due to these researches more or less every bank has now open their Islamic operations windows and providing services according to the requirement of society.

In the recent past, December 2014 the World Bank published a report with the title "*Mind, Society and Behavior*" about the development of the World in 2015, that provided an insight about the humans thinking and how do they make decisions. The outcome of the research declared that the policies have to be redesigned for economic development. Traditionally the development of policies were based on assumption that the decisions made by the humans deliberately and independently due to their consistent preferences, self-interests but the latest research found that making

decisions this way deteriorating. New researches derived the following that the humans:

1. Think automatically: means deciding on what comes first in mind effortlessly, which can be produced astonishingly good outcome at very nominal cost of efforts.
2. Think sociologically: means that the humans guided by social norms and inclined to cooperate or follow to the others and add their share. Societies can stick in identical behavior pattern that may not serve someone's interests.
3. Think by creativity or mental models: that what they acquire and interpret it according to their understanding / interpretation as drawn by the societies and histories.

This report provides a richer view of human social behavior for achieving the goals of policy development in *(more or less)* every era of humans beginning from early childhood to maturity. It also shows that the behavior of humans leads towards new tools for interventions. By doing few changes in decision-making context based upon social preferences, allow individuals to make the ways, which may provide them to elevate their lives. The report provides new dimensions for the policy development work. It highlighted that the humans including policy makers, experts have psychological and social inducement up on thinking.

The highest education is that which does not merely give us information but makes our lives with harmony with all existence. *(Rabindranath Tagorean Indian poet born May 06, 1861 and died August 07, 1941)*

As in the previous pages, it discussed that from the experiences of the history, the Laws, Rules & Regulations have to be modified for the advancement of the individuals and societies. Hence we are enjoying immense number of facilities including notes or paper less money transactions globally introduced by the banking Industry in collaboration of the private companies. Because the moneys in the form of notes or paper doesn't bear any title of the ownership and can be transferred by mere delivery but in the societies wherein the social injustice is proliferating can be snatched from the actual or real owner by the culprits who don't value ethics

In this connection, I want to mention a report published in "The Guardian" and "The big on the internet" with the title of "*The Smart Card Detective*" that was published in December 2010 in which a genius graduate student of Cambridge Computer science named Omar Choudhry in his M.Phil.(*Thesis*) revealed some weaknesses / flaws in the magnetic strip systems (*embedded microchip in debit or credit cards and also uses some other security purposes*) which is now steeply proliferated globally. Thesis distinguished a flaw in chip-and-pin technology systems that allow criminals to use stolen cards and make transactions fraudulently by using any personal identification number they care to choose. In this M.Phil.(*Thesis*), he also provided suggestions for the improvements of the systems. Ok that was an achievement from the Student point of view. But in response the Cards Association of the UK Card Industry asked to the Cambridge to censor the work of student because this type of disclosures (*publically*) breaching the fence of the ethical norms / responsibility. Their basic emphasis essentially was that to publish this type of research (*publically*) leads to exploit loophole by the criminals and may accumulate multiple damaging effects not only to the businesses of the Card Association but also the customers or high users



of the product (*Cards*) means general public. Replying from the University Authorities by Mr. Ross Anderson Professor of Security Engineering bluntly refused and defended to take down the work of the student and drawn attention that he and his colleagues already discovered these flaws in October 2009 publically in a program of BBC February 2010. He said; it maligns that the Banking Industry trying to take down student's thesis even though it is unlawful and already published previously. He further added that it will disgrace our University's' deepest core values. (*Robert Quigley and Ian Sample, 2010*).

Purpose behind discussing this case is to mention here that there are numbers of occasions when both the parties have positive or you can say right up to their extent like Islamic and conventional banks and in this case (*The University and the Card Association*). Nevertheless, because due to opposite positions of each other or seeing the issue only up to very specific like only themselves or you can say for a limited group of people it is debatable. For example, if that disclosure (*flaws and weaknesses*) from a student use the criminals by using stolen or lost cards and make, transactions fraudulently must have to damage the reputation of the banks / Cards Associations and ultimately the customers or public will be worse off. But on the other hand after debating between both the parties upon this case have provided more leverage to the customers or public to be conscious in handling cards / cards transactions and also provided an insight to the bankers and the cards association to prepare themselves and further strengthens the system while making microchip magnetic strip system. This results ultimately proven beneficial for the humanity like banking systems because given concept of sharing (*profits / losses*) provide leverage to the financial activity through banks whichever the name is (*Islamic or Conventional*).

For more clarification, I would like to state here that in deed positive approach of both the systems (*Islamic / conventional*) have been proved like debate between banks and card association because the main goal is same that is to elevate and harmonizes the lives of the humans.

In addition to this I have to state here that there are number of product similarities in both the systems (*Islamic / conventional*) but it is sure that the Islamic ideology about sharing profit and loss or involvement of all the parties in the businesses will provide more confidence / support / satisfaction to all the stakeholders. Therefore, the new concept establishes a maturity to the existing (*conventional*) system.

## Chapter 7

### DISCUSSION AND CONCLUSION

As we are all aware that the Jurists of Islam are in a search of a banking system according to the Islamic ideology or Sharia in which the basic theme is to help / support to the needy for the development of their own and that will ultimately beneficial for the society without harming dignity of every one. Hence after endless and cumbersome work the Islamic Jurists has designed and still designing the products in which the concept of banking with Islamic ideology is emerging, the investors as a contributors or supporters with proud to be the part of investments means participates in the businesses as partners.

Thus, the concept of only charging and paying fixed rate of interests with or without any justification (*as in the conventional banking systems*) is completely abolished in the Islamic banking systems because, this is strictly not allowed by the Muslimsharia (*Rules for the Human beings from the QURAN or codes of conduct to live*). According to the Muslim believers, the meaning of discontinuation of interests from the financial systems provokes / harmonizes the trades, the economy and foster with freedom of participation in ethically fair incentives for all lifestyles.

It proved that due to symmetrically matching structure of assets and liabilities through the concept of profit & loss sharing basis the Islamic banking systems are more stable than the conventional banking systems because therein fixed interest cost, hence the

refinancing is not possible through debt and there is no preventions if rates fluctuated. That is why in the times of recent crises due to profit and loss sharing advantages the depositors / investors shared the risk automatically and because of this, the Islamic Banking Systems less affected. In the Islamic banking, contribution in risk is prime factor and the investors have *(to some extent)* an option to be a part of investment decisions with the institutions while making decisions to invest. These practices permit investors to be involved or be a part of economic activities and ethically try to supports to each other's instead of only making profits. The businesses should never be harmful for anyone in the societies.

I would like to further elaborated here that the risk coverage is extremely important for both banking systems but this could be reduced by due diligence on the part of the management competencies and social norms. Hence, the issues discussed in earlier Chapter(s) must be ascertained before investing the investors / public moneys:

1. The requirement of the businesses for the society.
2. The businesses won't be harmful for any one.
3. The proposed businesses have capability to flourish in the market.
4. The Management of the businesses have skills to run or if they are new in these businesses, they have enough capabilities to overcome the hurdles if occurs.
5. The businesses that are suggested will help / support to the needy for the development of their own and that will ultimately beneficial for the Society without harming dignity of every one.

In addition to all these, the possibility of the stability of Islamic banking systems being undermined by a tendency on the part of users of bank funds to conceal their true profits has been the subject matter of extended discussion. Research reveals that the basic reason for charging fixed rates of interests or higher than the nominal rates of interests is to cover the default risks. Hence this is the duty of the partners morally (*lenders or investors and entrepreneurs or borrowers*) to do the task with due diligence up to the entire satisfaction of both partners and fulfilled the commitments as agreed in advance.

However this is without any double barreled argument (*means never ever two meanings*) acceptable to all faiths that no any religions favors doing wrong with any one or any other religion(s) with or without any consideration. Every religion promulgates very clearly that right is right and wrong is wrong for everyone means right and wrong does not affect by religions, casts, clans, colors, regions and favors doing right for everyone. So the goals of both the Banking systems are the same to develops and harmonizes the societies as a whole without any discrimination. However, experiences proved that the environment wherein the competitive markets are available for any trades the benefits for the consumers would increase. And this is ultimately the main goal of every religion to provide help, support to the peoples for their promotion that obviously entails the development of the societies.

Therefore, I extracted from this research and concluded that the basic themes of both the systems are to serve the humanity for the development of the societies economically as a whole but, emerging new trends like sharing risks leads and steering Banking Industry towards more stability / maturity.

The concept of help, supports, to the needy and discontinuation of fixed rate interest based financial systems by profit and loss sharing or risk sharing will definitely provokes and harmonizes the overall businesses. In addition to this the freedom to invest in varied businesses that will ultimately cause the betterment of individuals, vicinities, societies economically and proud to be contributors in the businesses could make more than enough satisfaction to the investors through the banking systems.

However, patronizing one or the other banking systems relates to the social and religious faith / behavior of the societies. It is proved by all the previous researches that the increasing trends which inducing the customers / investors towards Islamic banking systems are the regions where population of Muslims much higher but exceptionally it is proven that the approach of sharing the risk given maturity to the banking Industry as a whole. We can relate all these with the concept of peaceful societies wherein everyone have the responsibility to take care of others for which every religion emphasized. Nevertheless, in the Islamic doctrine along with the peace for everyone and take care of everyone *“The Tolerance”* is fundamentally proven from the practical life of the last prophet (*MUHAMMAD S.A.W.W PEACE BE UPON HIM*).

According to the Muslim believers, at first, the Muslim caliphs (rulers) who assumed their first and foremost duty to take care of their people in all respects give this vision of the peaceful and welfare societies. They do not want to take rests until and unless everyone in their jurisdiction sleeps peacefully. Hence, if we create the societies wherein no one is above the law and everyone has due respects without any discrimination of casts or clans (*religiously or others*) or without hurting their dignity by social justice, we could enable to reduce the elements of charging super normal

interests / profits or fixed rates of interests / profits (*which is inevitable for the Banks to charge due to rationalizing the risks factors among the societies*)& by employing the resources (*land, labor, raw materials, capital, funds*) on the entire satisfaction of both (*lenders or investors and entrepreneurs or borrowers*) with the concept of supporters / contributors in all economic activities, the banking Industry will prosper with the ideology of sharing based partnerships and take their full boom in all the societies.

Therefore the debate about the banking systems (*Islamic and Conventional*) will disappear automatically in the days to come. Because the default risks will be eliminated and utilization of pooled funds would be very easy, everyone may do every task with their full justification, devotion, energy and capability. Further the concept of ownerships / partnerships will provide leverage to the trades that will accelerate the performance without hurting self-dignity of anyone.

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