Islamic Banking and Conventional Banking- The Difference

Unit

3

Unit 3

Islamic Banking and Conventional Banking- The Difference

Learning outcomes

By the end of this unit the learner will be able to:

- **Discuss the "Islamic Banking Model"**
- **Identify the difference between Islamic and Conventional Banking**

What is Islamic banking: the model?

Islam fully recognizes the useful role that financial intermediation can play. It was not entirely unknown to Islamic society in its early centuries. Direct finance was no doubt the dominant mode of finance, but the practice of someone obtaining finance on the basis of profit-sharing and then giving it to another person, the actual user of the funds, on the basis of profit-sharing is also recognized. This is known as the principle of *al-mudarib udarib* and it can be expressed as, '*the one who mobilizes funds, on a profit-sharing basis, extends these funds to the users on the same basis*'. In the early Islamic period, most caravan trades were financed by *mudarabah* and *suftaja* (money transfer). Islamic scholars consider the earning of profits from an intermediary role as a genuine occupation. It is, however, noticeable that this concept of financial intermediation is interwoven with the production and exchange of real goods and services.

The functions of Islamic banks and other financial intermediaries are similar to their conventional counterparts. Muslim economists have shown that there are alternative Islamic modes and models through which these functions can be performed. In fact, they have shown that Islamic models can perform these functions in a better way. These models are briefly described below:

Two-tier *mudarabah*

Under this model, a bank is organized as a joint stock company with the shareholders supplying the initial capital. It is managed by the shareholders through their representatives on the board of directors. Its main business is to obtain funds from the public on the basis of *mudarabah* and to supply funds to businessmen on the same basis. Its gross income comprises the share in the actual profits of the fund users, in accordance with an agreed ratio of profit-sharing. That income, after deducting the expenses incurred in managing the funds, is distributed pro rata on share capital as well as deposits. The bank retains, in favour of its shareholders, part of the profits accruing to deposits in accordance with the predetermined profit-sharing ratio.

In addition to the general investment deposits mentioned above, there could also be specific investment accounts in which deposits are made for investments in particular projects. It is also possible to conceive of special investment accounts in which deposits are made on condition that they be invested in particular business activities (for example, trade financing on a *murabahah* (mark-up) basis, or leasing, and so on). Then, there could be current accounts in which deposits are made to be withdrawn at any time. These are current accounts on which banks pay no profit, but they are allowed to use these deposits profitably at their own risk. Demand deposits are regarded as loans to banks whose repayment is guaranteed. In sum, bank funds could comprise share capital, demand deposits, and various types of investment deposit.

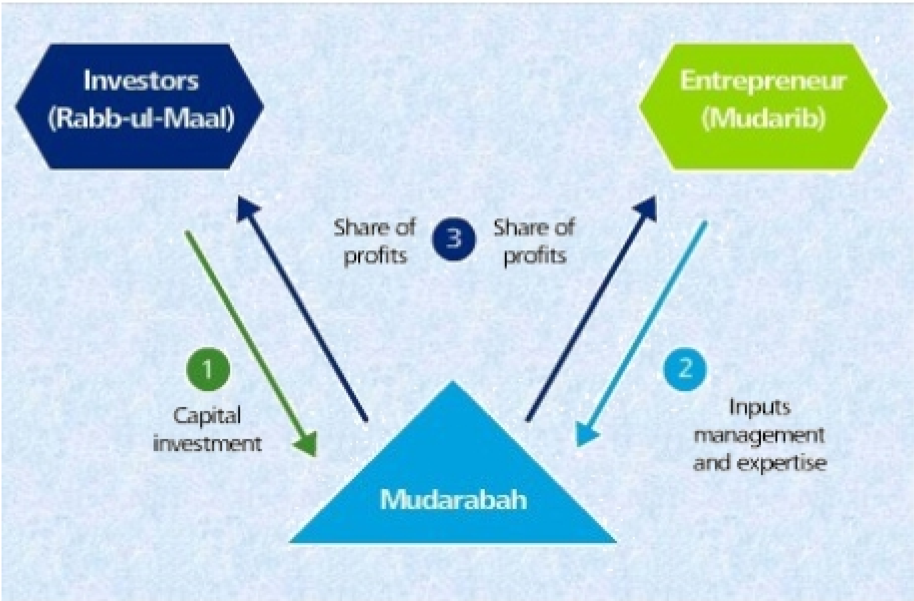

Fig: 3.1: How does Mudarabah work?

The main feature of the model described above is that it replaces interest by profit-sharing on both the liabilities and the assets side of the bank's balance sheet. This change brings about a number of positive effects for the efficiency, equity and stability of the banking system.

One-tier *mudarabah* combined with multiple investment instruments

This model visualizes the mobilization of savings on the basis of *mudarabah* and the use of funds so acquired to earn profits through trade, commerce and industry. When academic work on Islamic banking as an alternative to interest-based banking first started, discussion essentially focused on the traditional forms of Islamic modes of finance such as *mudarabah* and *musharakah*.

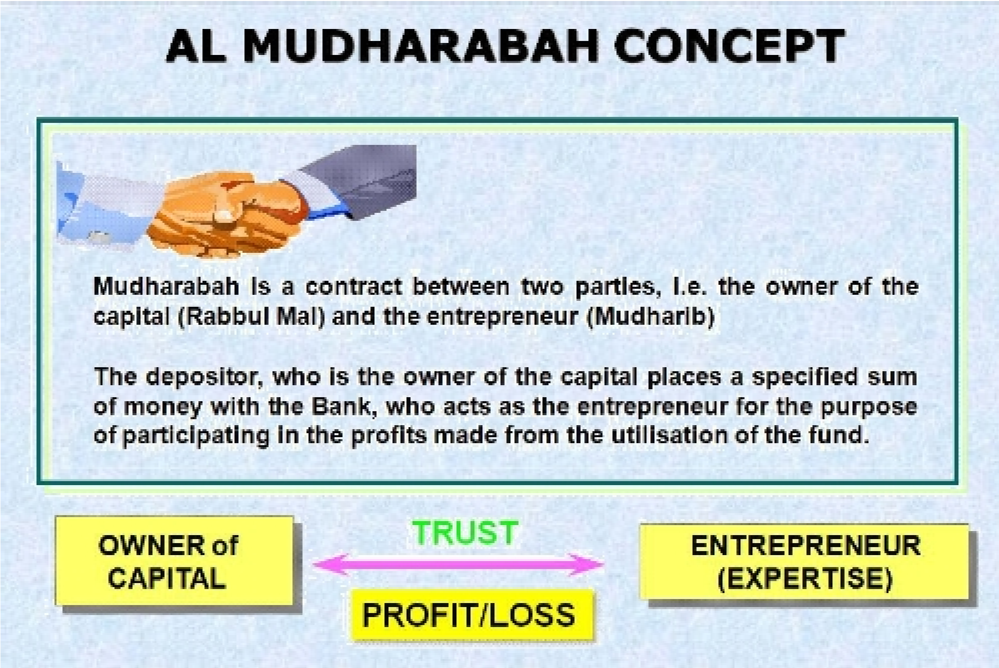

Fig: 3. 2

Subsequent writings, as well as the practice of Islamic banking, have made important contributions both to the evolution of new forms of Islamic business enterprises and also to the conceptual development of Islamic modes and financial instruments. The traditional modes of finance were based on either partnerships or the principle of deferred trading of goods and services.

The practice of Islamic financial institutions has led to the evolution of different types of permanent, temporary as well as gradually diminishing partnerships based on the principles of *musharakah* and *mudarabah*, incorporating easily adaptable arrangements with respect to managerial responsibilities. Islamic banks have also developed various forms of price and object deferred sales, such as short-term *murabahah* (declared cost-plus-profit based financing), instalment sales (long- and medium-term *murabahah*); pre-paid or price-deferred manufacturing orders (*istisnaj*); and pre-paid or rent-deferred leasing (*ijarah*).

These developments have led to the emergence of a different model of Islamic banking. Under this model, the relationship between savers and the bank is organized on the basis of *mudarabah*. However, in its relationship with the entrepreneurs, the bank uses a number of other financial instruments permissible from a *Shari'a* point of view, none of which involves interest. A wide variety of Islamic modes of financing is possible, and is now available. Some of these are described below.

Musharakah (partnership)

Musharakah literally means sharing. In the Islamic finance literature it refers to a joint enterprise in which all the partners share the profit or loss of the joint venture. The financial term is derived from the Islamic legal term *shirkah* with the same literal meaning but having a broader application. In the Islamic *fiqh* literature *shirkah* is of two kinds: the first is *shirkat-*

ul-milk, which means joint ownership of two or more persons of a particular property which may come into existence either through inheritance or joint purchase.

The second kind of *shirkah* is *shirkat-ul-jaqd*, which means a partnership established through a contract. Such contractual partnerships are usually established for commercial purposes and take several forms such as partnership in the capital of the enterprise, partnership in labour and management, common goodwill or a combination of these elements.

Musharakah as a financial contract refers to an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss is shared strictly according to capital contributions. The basic rules governing the *musharakah* contract include the following:

1. Profits of the enterprise can be distributed in any proportion by mutual consent. However, it is not permissible to fix a lump sum profit for anyone.
2. In case of loss, it has to be shared strictly in proportion to the capital contributions.
3. As a general rule all partners contribute both capital and management. However, it is possible for any partner to be exempted from contributing labour/management. In that case, the share of profit of the sleeping partner has to be in strict proportion to his capital contribution.
4. The liability of all the partners is unlimited.

As a mode of finance, an Islamic bank can advance money to a client using the contract of *musharakah*. Normally the bank will use the option of being a sleeping partner. The contract can be more widely used by Islamic funds with unit holders assuming the role of sleeping partners. The contract can also be used in securitized assets.

Mudarabah (passive partnership)

Mudarabah is a special type of partnership. This is a contract between two parties: a capital owner (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in accordance with the ratio that they agreed upon at the time of the contract. Financial loss is borne by the capital owner, the loss to the manager being the opportunity cost of his own labour which failed to generate any income. Except in the case of a violation of the agreement or default, the investment manager does not guarantee either the capital extended to him or any profit generation. Some other important features of the *mudarabah* contract include the following:

1. While the provider of capital can impose certain mutually agreed conditions on the manager, he has no right to interfere in the day-to-day work of the manager.
2. Mudarabah is one of the fiduciary contracts (juqud al-amanah). The mudarib is expected to act with utmost honesty, otherwise he is considered to have committed a grave sin (in addition to worldly penalties). This has important implications for the moral hazard problem.

3. The liability of the rabb al-mal is limited to the extent of his contribution to the capital.
4. The mudarib is not allowed to commit the mudarabah business for any sum greater than the capital contributed by the rabb al-mal.
5. All normal expenses related to mudarabah business, but not the personal expenses of the mudarib, can be charged to the mudarabah account.
6. The contract of mudarabah can be terminated at any time by either of the two parties on giving a reasonable notice. (This condition may create serious problems in the context of modern commercial enterprises. However, using the Golden Principle of Free Choice, the parties can agree on any conditions in the contract that will regulate the termination so as not to cause any damage to the enterprise.)
7. No profit distribution can take place (except as an ad hoc arrangement, and subject to final settlement), unless all liabilities have been settled and the equity of the rabb al-mal restored.

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-mal* and the bank as the *mudarib. Mudarabah* deposits can be either general, which enter into a common pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the *rabb-al-mal* and the businessman as the *mudarib* (manager). However the manager is often allowed to mix the *mudarabah* capital with his own funds.

In this case profit may be distributed in accordance with any ratio agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.

Diminishing partnership

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

Bay al-murabahah (sales contract at a profit mark-up)

In the classical *fiqh* literature, there is a sales contract called *bay mu'ajjal* which refers to sale of goods or property against deferred payment (either by lump sum or instalments). *Bay mu'ajjal* need not have any reference to the profit margin that the supplier may earn. Its essential element that distinguishes it from cash sales is that the payment is deferred. Strictly speaking, the deferred payment can be higher than, equal to or lower than the cash price.

There is another sale contract known as *bay al-murabahah*, which refers to a sale in which the seller declares his actual cost and the parties agree on adding a specific profit margin. Basically, this is a two-party buying and selling contract; no financial intermediation is involved. The Islamic banks have created a mode of finance by combining the concepts of *bay mu'ajjal* and *bayal-murabahah*. They use this contract as a mode of finance in the following manner.

The client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such a commodity from the bank once it has been bought, but at a deferred price, which includes an agreed-upon profit margin (called a mark-up) in favour of the bank. Thus, the transaction involves an order accompanied by a promise to purchase and two sales contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price which includes a mark-up. The deferred price may be paid as a lump sum or in instalments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the bank. The basic rules governing the *murabahah* contract are shown below:

1. The subject of the sale must exist at the time of sale.
2. The subject of the sale must be in the ownership of the seller at the time of sale.
3. The subject of the sale must be in the physical or constructive possession of the seller.
4. The delivery of the commodity sold to the buyer must be certain and should not depend on contingency or chance.
5. As in any sales contract the price must be specified and, once specified, it cannot be increased in case of default.
6. The time of delivery must be specified.
7. The payment schedule must be specified.

Ijarah (leasing)

In the simple lease contract the usufruct generated over time by an asset, such as machinery, aircraft, ships or trains, is sold to the lessee at a predetermined price. This is called an operating lease, as opposed to a financial lease. The operating lease has a number of features that distinguish it from other forms of leasing. First, the lessor is himself the real owner of the leased asset and therefore bears all the risks and responsibilities of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Second, the lease is not for the entire useful life of the leased asset but rather for a specified short-term period (for a month, a quarter, or a year) unless renewed by mutual consent of both the parties.

A lease ending in the purchase of the leased asset

Since the entire risk is borne by the lessor in the operating lease, there is a danger of misuse of the leased asset by the lessee. The financial lease helps take care of this problem by making the lease period long enough (usually the entire useful life of the leased asset) to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option of purchasing the asset from the lessor at its market value at that

time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.
A financial lease has other advantages too. The leased asset serves as security and, in the case of default on the part of the lessee, the lessor can take possession of the equipment without a court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the *Shari'a* allows the sale of physical assets, it does not allow the sale of monetary debts except at their nominal value.

Some of the jurists have expressed doubts about the permissibility of financial leases. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. A financial lease has thus the potential of becoming more exploitative than an outright purchase. Suppose the lease contract is for five years. The lessee would have to continue making lease payments even if he does not need the asset, say, after two years.

In the case of a purchase through an interest-bearing loan, the purchaser can sell the asset in the market and repay the loan, thus reducing his loss. This cannot be done in a financial lease. If someone is unable to make lease payments, that person may lose his stake in the asset even though part payment of the asset price has been made beyond the rental charge he would normally pay in an operating lease.

However, there are jurists who consider financial leases to be permissible if certain conditions are satisfied. First, the lessor must bear the risks of leasing by being the real owner of the leased asset. The lessor cannot lease what he does not own and possess, and should be responsible for all the risks and responsibilities related to ownership. Therefore, a leasing contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying and taking possession and gets a reward without bearing any risk. Second, lease payments cannot start until the lessee has actually received possession of the leased asset and can continue only as long as it remains usable by him. Third, all manufacturing defects (and later damages which are beyond the control of the lessee) should be the lessor's responsibility. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset.

As a form of financing used by Islamic banks in practice, the contract takes the form of an order by a client to the bank, requesting the bank to purchase a piece of equipment and promising, at the same time, to lease it from the bank after it has been purchased. Rent instalments are calculated in such a manner as to include, in reality, recovery of the cost of the asset plus the desired profit margin. Thus this mode of financing includes a purchase order, a promise to lease, and a leasing contract with a provision to transfer ownership of the leased asset to the lessee at the end of the lease agreement. This transfer of ownership is made through a new contract, in which the leased asset is either given to the lessee as a gift or is sold to him at a nominal price at the end of the lease agreement. According to a decision of the OIC Fiqh Academy, this second transfer-of-ownership contract should be signed only after termination of the lease term, on the basis of an advance promise to affect such a transfer of ownership to the lessee.

Salam

Salam is a sales contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a *salam* contract. It is usually applied only to fungible commodities. Some basic rules governing the *salam* sale are given below.

1. The price should be paid in full at the time of the contract.
2. Goods whose quality or quantity cannot be determined by specification cannot be sold through the contract of salam. An example is precious stones.
3. Goods can be sold only by specifying the attributes. They cannot be particularized to a given farm, factory or area.
4. The exact date and place of delivery must also be specified.

Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an instalment sales contract. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a *salam* or sale by instalments basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description and so on as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *Shari'a* point of view, the second contract must be independent (i.e., not linked to the delivery in the first contract).
Should the second contract consist of a sale by instalments, its date should be subsequent to the date on which the bank would receive the commodity.

Al-istisna (Contract of Manufacture) and al-istisna al-tamwili (financing by way of istisna)

Al-Istisna is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. Any party can cancel the contract after giving notice to the other before the manufacturing work starts. However, after the manufacturing work has started, the contract cannot be cancelled unilaterally.

Istisna is similar to *salam* in the sense that both are exceptions to some general conditions of sale which prohibit the selling of something which is not owned and is not in the possession of the seller at the time of sale. However, there are some differences between the two which are summarized below.

1. The subject of *istisna* is always a thing which needs manufacturing, while *salam* can also be effected on things that do not involve manufacturing.
2. In the case of *salam* full payment of price is necessary, whereas in the case of *istisna* the payment can be delayed.
3. The time of delivery in case of *salam* must be specified at the time of the contract. In the case of *istisna* this is not necessary.

Al-Istisna al-tamwili, which is used by Islamic banks, consists of two separate *istisna* contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed instalments, and the bank undertakes to deliver the requested manufactured commodity at an agreed time. The second *istisna* contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in instalments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istisna* contract. The original purchaser (i.e., the bank's client) may be authorized to receive the manufactured commodity directly from the manufacturer.

An Islamic bank working as an agent (*wakil*)

It is also possible that Islamic banking is arranged on a basis of *wakalah* (agency) principle. *Wakalah* is a contract whereby somebody (the principal) hires someone else to act on his behalf (i.e., as his agent) for a specific task. The agent is entitled to receive a predetermined fee irrespective of whether or not he is able to accomplish the assigned task to the satisfaction of the principal as long as he acts in a trustworthy manner. He would be liable to penalties only if it can be proved that he violated the terms of the trust or acted dishonestly.

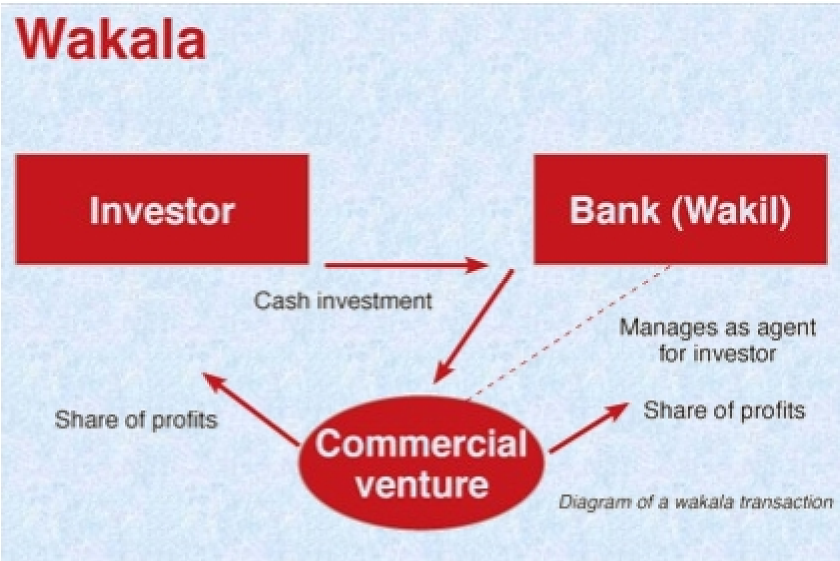

Fig:3.3

In the case of a financial *wakalah* contract, clients give funds to the bank/ company that serves as their investment manager. The bank/company charges a predetermined fee for its managerial services. The entire profit or loss is passed back to the fund providers after deducting such a fee.

This contract is used by some Islamic banks to manage funds on an off balance sheet basis. The contract is more widely used by Islamic mutual funds and finance companies.

How Islamic banking works in practice

An Islamic bank, like other banks, is a company whose main business is to mobilize funds from savers and supply these funds to businessmen/entrepreneurs. It is organized as a joint stock company with the shareholders supplying the initial capital. It is managed by shareholders through their representatives on the Board of Directors. While a conventional bank uses the rate of interest for both obtaining funds from savers and supplying these funds to businessmen and others, an Islamic bank performs these functions using various financial modes described above.

The bank and the investment deposit holders share the realized profit in accordance with the ratios agreed upon between the parties at the time of contracting. The deposits in the current account are treated as if they are loans from the clients to the bank, and therefore they bear no yield to the account holders. However, being loans to the bank, their principal is guaranteed by the bank. Islamic banks have achieved significant success in attracting resources on the basis of the *mudarabah* contract.

When utilizing these resources for income generation, Islamic banks use both fixed return modes (such as *murabahah*) and leasing and variable return modes (such as *mudarabah* and *musharakah*). While, on the liabilities side, Islamic banks have made significant progress in using profit-sharing, this is not the case on the assets side. The share of profit-sharing modes in the total financing provided by Islamic banks is very small. Most of the financing is provided on a *murabahah* basis.

How Is Islamic Banking Different From Conventional Banking

While Islamic banks perform mostly the same functions as conventional banks, they do this in distinctly different ways. Some of the distinguishing features of Islamic banking are given below:

Risk-sharing

The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) and the user of funds (entrepreneur). By contrast, under conventional banking, the investor is assured of a predetermined rate of interest. Since the nature of this world is uncertain, the results of any project are not known with certainty *ex ante*, and so there is always some risk involved. In conventional banking, all this risk is borne by the entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital gets away with a predetermined return.6 In Islam, this kind of unjust distribution is not allowed.

In Islamic banking both the investor and the entrepreneur share the results of the project in an equitable way. In the case of profit, both share this in pre-agreed proportions. In the case of loss, all financial loss is borne by the capitalist and the entrepreneur loses his labour.

Emphasis on productivity as compared to credit-worthiness

Under conventional banking, almost all that matters to a bank is that its loan and the interest thereon are paid on time. Therefore, in granting loans, the dominant consideration is the credit-worthiness of the borrower. Under profit-and-loss sharing (PLS) banking, the bank will receive a return only if the project succeeds and produces a profit. Therefore, an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur. This feature has important implications for the distribution of credit as well as the stability of the system.

Moral dimension

Conventional banking is secular in its orientation. In contrast, in the Islamic system all economic agents have to work within the moral value system of Islam. Islamic banks are no exception. As such, they cannot finance any project which conflicts with the moral value system of Islam. For example, they will not finance a wine factory, a casino, a night club or any other activity which is prohibited by Islam or is *known* to be harmful to society. In this respect Islamic banks are somewhat similar to the ‘ethical funds’ now becoming popular in the Western world.

Wider set of products

An important point to be noted in the way Islamic banking works is that it offers a wider choice of products. In addition to some fixed-return modes that can serve necessarily the same functions that interest serves in conventional banking, Islamic banks can use a variety of innovative profit-sharing financing techniques. The addition of various profit-sharing modes to the available menu of available financial products renders several advantages, including those listed below:

1. The allocation of financial resources on the basis of profit-and-loss sharing gives maximum weight to the profitability of the investment, whereas an interest-based allocation prioritizes credit-worthiness. We can expect that the allocation of resources made on the basis of profitability is likely to be more efficient than that made on the basis of interest and the ability to repay.

2. A system based on profit-sharing would be more stable compared to one based on a guaranteed interest rate on capital. In the case of conventional banking, the bank is obliged to pay a guaranteed return on its obligations (deposits) regardless of their fate, should economic conditions deteriorate.

In profit-sharing, the return paid on the bank's obligations depends directly on the returns of its portfolio of assets. Consequently, the cost of capital would adjust itself automatically to suit changes in production and in other business conditions. Furthermore, any shock which might befall the obligations side of the balance sheet would be automatically absorbed. This flexibility not only prevents the failure of the enterprises seeking funds, but also ensures the existence of a necessary harmony between the firm's cash flow and its repayment obligations, an element which enables the financial system to work smoothly.

3. Since depositors of Islamic banks, except demand deposit holders, share in the actual performance of the banks, they are expected to remain more vigilant about the performance of banks. That will also contribute to financial stability.

4. Since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) become the prime movers of the rates of return to the financial sector.

5. The transformation of an interest-based system into one based on profit sharing helps achieve economic growth as this results in increasing the supply of venture or risk capital and, consequently, encourages new project owners to enter the realm of production as a result of more participation in the risk-taking process.

Closer links between the monetary and real sectors

Another important feature of Islamic banking is that even in the case of fixed return modes that create debt, such as interest-based financing, there is a crucial difference. Debt creation in Islamic finance is generally not possible without the backing of goods and services, and the resultant debt instruments are not tradable except against goods and services. Monetary flows through Islamic financial modes are tied directly to the flow of goods and services, so there is little room for a sudden and mass movement of such funds as compared to the flow of interest-based short-term funds. Hence destabilizing speculation is expected to be significantly curtailed.

Conventional Banks	Islamic Banks
1. The functions and operating modes of conventional banks are based on fully manmade principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic*Shariah*.
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3. It aims at maximizing profit without any restriction.	3. It also aims at maximizing profit but subject to *Shariah* restrictions.
4. It does not deal with *Zakat*.	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a *Zakat* Collection Centre and they also pay out their *Zakat*.
5. Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks. So we have to understand our customer's business very well.
6. It can charge additional money (penalty and compounded interest) in case of defaulters.	6. The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are give for early settlement at the Bank's discretion.

What does the Islamic banking model promise?

Economists usually evaluate any scheme on the basis of its allocative efficiency, equity, stability and growth implications. In this section we evaluate the Islamic banking model described in the previous section on these criteria.

Fig: 3.4

More equitable

Islam is a religion which emphasizes justice to all parties. A contract based on interest involves injustice to one of the parties, sometimes to the lender and sometimes to the borrower. The *riba* contract is unjust to the borrower because if somebody takes a loan and uses it in his business, he may earn a profit or he may end up with a loss. Now, in the case of loss, the person using that money, let us call him the entrepreneur, loses his labour. In addition to this loss, he has to pay interest and the capital to the lender. The lender, or the financier, in spite of the fact that the business of the enterprise has ended up making a loss, gets his money as well as his interest. Consequently it is unjust. Now, let us see how sometimes an interest contract can be unjust to the depositor. Many people do not realize that a *riba* contract can be unjust to the depositor and not always so to the borrower. In most of the underdeveloped countries perhaps it is more unjust to the lender. This is because depositors may be paid a rate of interest that is in fact generating negative real returns if inflation is greater than the rate charged. If borrowers take out loans and invest these in successful projects that yield returns substantially greater than the rate of inflation then they benefit as they only have to make modest loan repayments that are not linked to the performance of the investment. In fact, they could be repaying at a rate that relates to negative levels of real interest while generating substantial positive real returns from their investment. In contrast, depositors may be rewarded with negative real return on their deposits. This would mean that depositors became relatively poorer and borrowers relatively richer in real terms, which contributes to greater financial and economic inequality in the system. On the basis of economic reasoning, Islamic banking is superior to an interest-based arrangement because it ensures equity between the borrower and the lender. Both parties share the accrued return which the project generates.

Improved allocative efficiency

A profit-sharing system is also more efficient. It is more efficient because Islamic bank financing is solely based on the productivity of the project. In an interest-based system the sole criterion for the distribution of credit is the credit-worthiness of the borrower. In Islamic banking, the productivity of the project is more important, and so the finances will go to more productive projects. In this way the resources, instead of going to low-return projects belonging to credit-worthy clients, will flow to high-return projects even if the credibility of the borrower is lower. Therefore, the system is more efficient in its allocation of resources. It is also more efficient because the bank's return is now linked to the project.

In case of interest-based systems, banks need not care much about project evaluation and may focus more on collateral and security. Their interest is with the borrower. In the case of profit-sharing, they have a much greater interest in the project itself so they will evaluate the project very carefully and allocate funds to more efficient projects. Third, since the return of Islamic banks depends on the success of the project, they may also contribute to the management of the project. Since they specialize in the area of finance and investment, their expertise will improve the profitability of the project.

Stability of the banking system

From the stability point of view also, the Islamic banking model is more stable than the conventional banking model. (Here, we are talking about the stability of the banking system and not of the economy.) In an interest-based system, there is a lack of symmetry in the cash flow of the banks and the cash flow of the enterprise. The entrepreneurs or the businessmen have to return a stipulated interest repayment to the banks that bear no relationship to the actual return of the project. Therefore, if the project is not going well in some stages of the project or in the entire life of the project, there develops an asymmetry between the cash inflow and cash outflow. That creates instability in the entire business sector. From the other side, the bankers also lack equilibrium in their assets and liabilities because their liabilities are fixed while their assets are variable. When there is any external shock, there is no automatic mechanism which can restore equilibrium between the assets and liabilities of the bank. In the case of an Islamic system, the liabilities of the bank are on the basis of *mudarabah* and hence are also variable. If there is any shock, it affects the assets side as well as the liability side of the banks' balance sheet. For example, if recession occurs, banks' assets will go down, but, at the same time, their liabilities will also go down since they do not have to pay a fixed or guaranteed rate of return to the depositors. Even the principal is not guaranteed. Thus their liabilities are related to the actual performance of the projects they finance. The assets and liabilities are mutually linked and this mechanism restores equilibrium between the assets and liabilities of the Islamic banks, so there is a smaller likelihood of bank failure.

Promotion of growth

Another criterion on which economists usually judge a scheme is that of growth. From the growth point of view also the Islamic banking system is preferable to the conventional banking system for the following reasons.

First, the Islamic banking model promotes innovation. Innovation is not something on which the big industrialists have a monopoly: anybody can be enterprising, and anybody can have a good idea. In Islamic banking, if a small or middle-class entrepreneur has a better project, he has (i) a possibility of getting it financed, and (ii) he will not be held back by the fear of tremendous risks. We know that innovations involve risks. Since risk is shared between the financier and entrepreneur, the Islamic banking system results in a better distribution of risk. Business risk is spread over a larger number of people.

The entrepreneur is risking only his labour and the bank is risking its capital. Therefore, ingenious entrepreneurs will be forthcoming and innovation will be promoted. Second, conditions which dictate the cost of capital, one of the determinants of the rate of investment in any economy, are more favourable under the Islamic system. The cost of capital in an interest based system, which is the rate of interest, is fixed in that the rate of interest paid or charged does not vary with the productivity of the projects which banks finance. In an Islamic economy, the cost of capital varies with productivity. There is no fixed cost of capital.

In the periods when there is a recessionary trend in the economy, productivity goes down but, at the same time, the cost of capital for the clients of Islamic banks also goes down. Thus it does not have that deterrent effect on investment which a fixed cost of capital has. As a result, even in that period, relatively speaking, there will be greater investment in an Islamic economy or in the profit-sharing economy as compared to an interest-based economy. So, for these reasons, from the growth point of view the Islamic banking system fares better.