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Risk Management in Dual Banking Systems: Islamic Ethical and Conventional Banking

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Abstract

The author makes comments on the state of the problem in part of the English-speaking scientific thought. The authors present a comparative analysis of risk management conducted in countries where the dual banking system is practised — Islamic (ethical) banking and conventional (western) banking. The study showed that a risk profile of an Islamic bank is not significantly different from the one of the conventional banks in practices. In the beginning, they point out the central thesis and prospects for the development of conventional and Islamic banking. The central part of the comments begins with the historical aspect of the comparison. According to him, despite the differences, they are based on the priority of financial and human values. Further, the authors carefully discuss the risk profile of Islamic banks and the unique risks facing Islamic banks. It was confronted with conventional risk management of banks based on the Basel Committee on Banking Supervision (BCBS). Today, the regulation applies to credit risk, market risk, operational risk and liquidity risk (Basel II and Basel III). After all, the author reaches two essential conclusions for his research.

Keywords: Islamic (ethical) banking; conventional (Western) banking; risk profile of Islamic banks; concept and principles of banking
JEL Classification: C 14, G11, G21, G24, G32.

Instead of an Introduction

The scientific paper attempts to compare the elements of Islamic (ethical) banking and conventional banking in Western countries. Some points of view are discussed, discussing the advantages and disadvantages of each type of banking. It emphasises some of the key points of the various author's opinions. We also showed the peculiarities of commented viewpoints.

In the Islamic world, Islamic finance is emerging as a fast-growing component of the financial sector. However, it is not restricted to Islamic countries but is spreading in communities where there is a substantial number of Muslims.

We defend the thesis that, despite the differences between conventional and Islamic banking, each one is based on specific financial and human values. The flexibility and resilience of financial crises will show which of the two banking systems is more promising.

Basic Part

To fully appreciate the phenomenon of Islamic finance, it is necessary to understand the historical evolution of the foundations of the global banking system, i.e. the historical aspect of comparison (Grimarenko, 2015).

The traditional banking system originated in the Middle Ages in Europe in countries with the Christian religion. In the XVI–XVII centuries, merchant guilds of several cities (Venice, Amsterdam, Hamburg) created specialised giro banks for cashless settlements between their clients. *Therefore the activity of commercial banks in the modern sense was developed with the beginning of the industrial revolution in the West*.

But there is another type of banking model based on the religious principles of Islam. Since the advent of Islamic civilisation, there have been such operations as currency exchange, money transfers and the use of checks. As a result of colonial expansion, Muslim countries assimilated the Western banking model, and Islamic banking, which emerged in the early period of Islam, ceased to exist. Significant changes occurred only in the early twentieth century (Naaма, 2001, 2006).

The first ideas for creating independent Islamic banks appeared much later in the late '40s of the 20th century. Practical steps were taken only in the early '60s with the first successful experiment to set up a financial institution working without interest through the Mit-Ghamr project. In 1963, the first local Savings Bank "Mit-Ghamr Islamic Savings Bank" was established in the Egyptian town of Mit Ghamr based on interest-free financing.

Therefore, autonomous Banking in Muslim countries is developing significantly later. The turbulent development of trade and colonialism is likely to force Muslim countries to adopt the traditional banking system.

According to the research "*A Modern Comparison of Western Banking to Islamic Banking*" Western and Islamic banks structure their financial products differently. The highlights we placed on the following elements:

(a) Shariah law prohibits charging or paying interest, called riba in Arabic. It also discourages investments or banking that is connected to products or industries that Islam considers sinful or haram. Credit card services and any situation where interest is paid and/or charged to benefit one party and not the other are not permitted.

(b) Islamic banking resembles conventional Western banking with its overall objective of making money by lending capital. Like conventional banking, it focuses on ethical investment and non-predatory lending.

(c) Shariah-compliant finance creates its financial products based on Islamic contracts and profit-sharing. Islamic banks offer loans based on a project's viability and contracts signed by both parties. Islamic financial products include investment accounts, portfolio management, commodity and equity-based fund management facilities and mortgages as well as investment banking and corporate finance.

(d) Islamic banking, in comparison with Western banking, conveys an intent to accomplish moral purposes through financial services. The goal of the Institute of Islamic Banking and Insurance is "a financial system based on Islamic belief that truly embodies the concept of socio-economic justice in commercial dealings".

(e) Companies considered to be dealing in haram, or sinful products, services or sectors include those that produce, use or deal with alcohol, pork or pork by-products, pornography, gambling or interest-based finance.

In our opinion, the foremost stand out:

First, *Islamic Business Ethics*.

Shariah-compliant banking ideals derive directly from the Quran and from the life and statements of the Prophet Muhammad, sources that also drive Islamic law regarding diverse issues. Ethics, justice, equity and truth, are mentioned frequently in the Quran. Muhammad proclaimed extensive rulings and laws regarding business ethics, trade, pricing and financial transactions, as well as warnings to avoid debt.

Secondly, *Cross-Cultural Influence*.

Islamic banking is not limited to Muslim-owned companies. Western banks have been responding to the demands of many Muslim clients by incorporating and offering Shariah-compliant services. Indeed, Islamic banking is influenced by Western banking.

Third, *Research in Islamic banking incorporates lessons and successful components from Western financial systems*. Shariah banking organisations review and adopt Western techniques focused on business ethics and codes of conduct. For example, they use the U.S. Department of Commerce's Model Business Principles and research produced by The International Society of Business Economics and Ethics (Lake, 2017).

It is considered that, but the major twist in the story came with the advent of Islamic Banking. Before, Capitalism and Marxism were two main Giant concepts. Then the middle of the road concept came what almost astonished Western World and Encouraged Eastern World to contribute to the banking industry.

Gearing up at fast pace, grabbing the market share of Conventional banking and now leadingly called as Ethical Banking in Western World, Islamic Banking has changed the shape of Industry as a whole.

The main difference between the Conventional and Islamic Financing is of Interest, called "Riba" in Islam. Conventional Financing asks lenders to charge a profit from borrowers on the principal amount, and this profit is termed as "Interest". The rate of interest can be fixed, or it can vary with the inflation rate. (Floating rate, i.e. Base

Lending Rate, Karachi Interbank Offered Rate or London Interbank Offered Rate.) On the other hand, Islamic Banking defines Profit on some different dimensions. Here, the borrower and lender decide on a contract where the lender purchases something on borrower's behalf initially and then selling it back to the borrower with some amount charges as "Profit".

The second main difference is the Payments procedure. Conventional Financing defines payments in a decided time frame in terms of instalments with the determined rate of interest. In each instalment, a portion carries the interest amount, whereas the remaining adjusts the principal amount.

The third significant difference between both financing systems is the time frame. Conventional Financing defines complete instalment system, interest payment and principal amount to be paid within a certain time frame. On the contrary, Islamic Financing believes in one-time contract system. In Islamic Banking, no one party can gain benefit over the loss of another and this why it is far more superior to the conventional banking system. (*Islamic Finance…*, 2019)

Therefore, of course, it is necessary:

(i) More than 75 countries have Islamic banks, of which only 45 are Muslim countries, the rest being non-Muslim nations

(ii) Although, there are some advantages and disadvantages of both systems, it depends on the nature of the country a bank or any financial institutions are operating as well as the current position of the economy of particular Region. Conventional Banking is somewhat the pioneer of the financial world, and we can not ignore its importance, and it still imposes large footprints in the Financial Corporate World.

Clearly, the conclusion is that, World is moving towards this new interface, and Financial World is now seeing a totally new form of Financing.

According to Jessica Margolin, the major conceptual differences are:

- Islamic finance fundamentally rejects business that is considered bad for (a religious) society
- You can not decouple risk and revenue; in other words, you must share risk, rather than transfer it (Margolin, 2014).

The main differences are concentrated in the following several directions:

(a) Deposit/Liabilities CASA[1] & Term Deposit.

Islamic Banks offers deposit products based on the following structures:

- "*Oard*" — Current accounts are provided under this contract where the risk of the funds lies with the bank, and no added benefits are provided to the client solely based on this facility. However, clients may be allowed to avail those facilities which are offered across the board;
- "*Mudarabah*" — a type of partnership where client funds are invested in various businesses, and returns are shared between the bank and client as per the agreed profit sharing ratio whereas, the loss is shared as per the investment ratio. Term Deposit and Savings Accounts are offered based on Mudarabah.

Conventional banks accept deposits based on a loan for all types of deposit accounts including Term Deposit, Savings and Currents accounts. Interest-based returns are provided for the Savings accounts and Term Deposits, whereas Current Accounts may offer free banking facilities. In addition to this, the conventional bank invests the deposits in non-shariah compliant avenues and subsequently earns non-shariah compliant returns.

(b) Lending/Financing.

Islamic banks offer financing/leasing facilities to their clients to fulfil their business requirements based on the following contracts depending on the requirements of the client:

Islamic Banks Financing Transactions Characteristics:

Islamic bank takes the risk of the asset;

Income is earned through sale or leasing contracts

Share profit & bear Loss as the case may be

In case of late payment or default by the client, there will be no penal charges. However, to instil a payment discipline, Bank is authorised to recover an amount at a predetermined percentage as compulsory contribution to Charity Fund constituted by the bank approved Shariah Board. This contribution to Charity Fund shall not constitute income of the bank

[1] CASA is the acronym for Current and Savings account, which is commonly used in the banking industry across West Asia and South-East Asia. CASA deposit is the amount of money that gets deposited in the Current and Savings Accounts of bank customers. The bank pays very low or no interest for deposits in current accounts whereas the deposits in Savings Accounts receives slightly higher interest rates.

The bank will deploy the Islamic Funds in only Shariah Compliant avenues.

Where the relationship between the Bank and client is that of lender and borrower respectively, conventional banks offer lending facilities to their clients to fulfil their cash requirement based on loan contracts. Conventional Banking Loan Contracts Characteristics are as follows:

No risk of underlying assets

Income through Interest

Late Payment charges on delayed payments and shall constitute the bank's income.

(c) Trade Finance.

Islamic banks offer trade finance related operations under the concepts of services, guarantee and financing with the following conditions:

Islamic Banks Trade Transactions Characteristics:

Commission based Income as per the guidelines of Shariah

Income through payment and documents facilitation services

Income through sale or lease of assets

Share Profit & bear Loss as the case may be

In case of late payment or default by the client. There will be no penal charges.

Conventional banks offer trade finance related operations under the concepts of services, guarantee and lending. Conventional Banks Trade Transactions Characteristics:

Commission based Income

Income through guaranteeing payments

Income through Interest on loan payments

Additional interest income on delayed payments.

According to Faleel Jamaldeen, "Islam is more than a religion; it's also a code of life that deals with social, economic, and political matters. Every Muslim is expected to live according to the Islamic code, or sharia. Each issue addressed by sharia is entwined with all other issues; therefore, economic matters are related to religion, culture, ethics, and politics" (Jamaldeen, 2019).

Islamic finance, then, is a financial system that operates according to sharia. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. Notwithstanding this, these entities are governed both by Islamic laws and by the finance industry rules and regulations that apply to their conventional counterparts.

The central vision of Islam is that Allah is the owner of all wealth in the world, and humans are merely its trustees. Therefore, humans need to manage wealth according to Allah's commands, which promote justice and prohibit certain activities. At the same time, Islam allows for a free-market economy where supply and demand are decided in the market — not dictated by a government. But at the same time, Islam directs the function of the mechanism by imposing specific laws and ethics.

Consequently, *Islam and social justice are inseparable, and it's a key concept of the Islamic finance industry*.

In this regards, by reminding Muslims of their obligations, Islam seeks to promote stronger relationships between each person and Allah, between people and the earth, and among individuals.

Emphasis is placed on:

Requiring zakat: To promote justice related to the distribution of wealth, Islam imposes a property tax called zakat. Every Muslim who meets specific criteria regarding the accumulation of wealth must pay zakat, which is distributed to people in need

Prohibiting usury (interest): For the sake of social justice, Islam prohibits interest-based transactions. No individual or business entity should hoard money to earn interest (or riba); instead, that money should be used to support productive economic activities

Encouraging shared risk: Islam encourages risk-sharing in economic transactions. When a risk is shared among two or more parties, the burden of the risk faced by each party is reduced.

Avoiding gambling: Two Arabic words refer to transactions that involve gambling:

"Maysir" — The acquisition of wealth by chance and not by effort

"Qimar" — In modern gambling, any game of chance.

Both types of transactions are prohibited because they are based on uncertainty (gharar). So, the Islamic prohibition against transactions that involve gambling prevents Muslims from purchasing conventional insurance products because those products are a gamble. Instead, Islamic insurance, called "takaful", is based on a very different model of risk management that involves shared risk and mutual responsibility.

The predominant part of Islamic financial facilities is Islamic banking. From this general status quo, more accurate data is available to us from the Islamic Financial Services Board in 2018, namely:

Firstly, after two years of marginal increases, the Islamic financial services industry (IFSI) returned to healthy (8.3 per cent) growth, and its total worth slightly surpassed the USD 2 trillion. The main growth drivers were "sukuk" issuances by sovereigns and multilateral institutions. The volume of "sukuk" outstanding grew by 25.6 per cent, and assets of Islamic funds grew by almost 19%. Islamic banking assets grew by only 4.3 per cent, reducing the share of Islamic banking in the total value of the IFSI to 76 per cent.

Secondly, the market shares of Islamic banks (i.e. shares in the total domestic banking assets) increased in at least 19 jurisdictions and remained constant in seven other ones. Six jurisdictions reported declines of market shares. Islamic banking is categorised as systemically important in 12 jurisdictions where the market shares have reached 15 per cent. Collectively, they account for 92 per cent of the global Islamic banking assets. Apart from two jurisdictions with market shares of 100 per cent (Iran, Sudan), the shares in most of the ten jurisdictions with dual banking systems increased, while it decreased in only one country (Qatar). Collectively, these 12 jurisdictions account for 92 per cent of the global Islamic banking assets. The largest are Iran (34.4 per cent of global Islamic banking assets), Saudi Arabia (20.4 per cent), United Arab Emirates (UAE) (9.3 per cent), Malaysia (9.1 per cent), Kuwait (6.0 per cent) and Qatar (6.0 per cent). (Islamic.., 2018)

Ayman Abdal-Majeed Ahmad Al-smadi, Faizul Hamdan and Mahmoud Khalid Almsafir (Ahmad Al-smadi, Hamdan, & Almsafir, 2013) highlight nine differences that include:

Islamic Banks

The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah

promotes risk-sharing between the provider of capital (investor) and the user of funds (entrepreneur)

It also aims at maximising profit but subject to Shariah restrictions

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

Participation in partnership business is the fundamental function of the Islamic banks. The customers' business has to be understood

Islamic banks have no provision for charging any extra money from the defaulters. The only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion

It gives importance to the public interest. Its ultimate aim is to ensure growth with equity

The status of Islamic bank concerning its clients is that of partners, investors and trader, buyer and seller

Islamic bank can only guarantee deposits for a deposit account, which is based on the principle of al-wadiah; thus the depositors are guaranteed repayment of their funds, however, if the account is based on the mudarabah concept, clients have to share. A loss if it occurs.

Conventional Banks

The functions and operating modes of traditional banks are based on wholly humanmade principles

The investor is assured of a predetermined rate of interest

It aims at maximising profit without any restriction

It does not deal with Zakat

Lending money and getting it back with compounding interest is the fundamental function of the conventional banks

It can charge additional money (penalty and compounded interest) in case of defaulters

Very often it results in the bank's interest becoming prominent. It makes no effort to ensure growth with equity

The status of a conventional bank, concerning its clients, is that of creditor and debtors

A conventional bank has to guarantee all its deposits.

We could highlight the following two findings:

First, Islamic banking is more humanising than conventional banking (Confirmed and by Shamsher Mohamad, Taufiq Hassan, & Mohamed Khaled I. Bader, 2008).

Secondly, Islamic banking provides a more human approach. It had been proven that many consumers choose Islamic banking rather than conventional.

In a more detailed and detailed scientific study "*The Hundred Differences Between Islamic and Conventional Banking Systems*" (2017) outline the concepts and principles of Islamic banking. It focuses on differences between the conventional and the Islamic banking system (Basha, 2017).

Islamic Banking can be described as a system of banking that adheres to the principles of Sharia, i.e. the Islamic Law. In other words, it can be viewed as a financial system which identifies itself with the spirit of Sharia (The Islamic Law), as laid down by the Holy Qur'an and Sunnah (the practices of Prophet Mohammed, as regards its objectives, principles, practices and operations).

There are the following differences between the conventional and the Islamic banking system, including:

(a) Differences in the Assumptions

(b) Differences in the Operations

- Financing
  - Long Term Loans
  - Leasing
  - Short Term Loans
  - Overdraft
  - Personal Consumption Loans
  - Short-term Agricultural Loans
- Investments
  - Investments in Central Banks and Other Banks
  - Investment in Shares
  - Investment in Bonds
  - Investment in Derivatives
  - Liquidity Management Practices

(c) Impact of the Banking System.

Unlike conventional banking, Islamic, also called ethical banking, is based on the following principles of its activity:

Prohibition of receipt and payment of Interest

Emphasis is on profit and loss sharing

Prohibition of "Qimar" (gambling), "Iktinaz" (hoarding), "Ihtikar" (monopoly), "Israf" (extravagance), "Fasad" (corruption), "Mujazafah" (speculation), "Ghish" (deception), "Tadlees" (fraud), "Kathib" (lying) etc.

Prohibition of contracts involving "Gharar" (excessive risk)

Prohibition of financing socially detrimental projects that deals with "Khamr" (intoxicants), "Khinzir" (Pork), and all unethical dealings such as prostitution, stealing etc.

Prohibition on selling what is not owned or possessed

Prohibition on selling fruits before they are ripe

Prohibition on selling debts

Asset Backing Principle: It is required that financial transactions should be unpinned by an identifiable and tangible underlying asset. It means financial transactions must be accompanied by an underlying productive economic activity that generates legitimate wealth.

Conventional banking is governed by all the human-made principles, and these banks have followed no divine guidance. The capitalist economy supports traditional banking. It allows all type of transactions for the purpose of earning a higher profit. It may be riba, hoarding, gambling, dealing in illicit goods and services, short sales, in short, all the speculative transactions can be deal in this banking system. The purpose of conventional banking is to maximise profit only.

According to the capitalist theory, capital and enterprise are factors of production. Capital gains fixed returns in the shape of interest, and the enterprise receives its return in the shape of profit or loss as the case may be. In the conventional banking system, only the guidelines or rules are followed, which are made to earn a profit.

Therefore, the conventional banking system provides loans to every business and earns a profit. Thus, in the business model of the conventional banking system, the aim is receiving money from people who have it in excess and lend the same money to the people who need money for the establishment and enhancement of their businesses.

Conclusion

From the comments presented, the following more essential conclusions can be made:

First, Conventional banking system considers economic methods of wealth creation but ignores social, ethical and moral practices. Islamic banking system gives first priority to social, ethical and moral methods of wealth creation; economic attractiveness of business is the next priority. Islamic banking is not a mere copy of conventional banks. It has its way of doing business, and all operations are duly certified by Sharia experts Islamic Fiqh Academy (IFA).

Secondly, In conventional financing, lenders lend to borrowers to make a profit from interest charged on the principal amount. At the other pole — at the very heart of Islamic Finance is the prohibition of collection and issuance of interest/riba. The ban on interest in all economic activities is so explicitly defined and remains non-compromising in Islamic literature as Allah divinely forbids it. The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah. In other words, it can be viewed as a financial system which identifies itself with the spirit of Sharia (The Islamic Law), as laid down by the Holy Qur'an and Sunnah.

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Управление рисками в двойных банковских системах: исламской этики и традиционного (западного) банкинга

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Аннотация. Сравнивая особенности риск-менеджмента, проводимого в странах с двойной банковской системой — исламской (этической) и традиционной (западной), авторы констатируют: профили риска исламского банка и обычных банков практически существенно не отличаются. Авторы констатируют: несмотря на некоторые различия, обе системы основаны на приоритете финансовых и человеческих ценностей. Сравнивая профили традиционных и уникальных рисков исламских банков с традиционным управлением рисками банков на основе Базельского комитета по банковскому надзору (БКБС), авторы приходят к выводу, что принципы регулирования кредитных, рыночных, операционных рисков и риска ликвидности (Базель II и Базель III) используются в той или иной мере исламской банковской системой.

Ключевые слова: исламский (этический) банкинг; традиционный (западный) банкинг; профили риска исламских банков; концепция и принципы банкинга