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COMPARATIVE BUSINESS CHARACTERISTICS OF ISLAMIC FINANCIAL INSTITUTIONS AND TRADITIONAL BANKS

Magomed Tashtamirov (a)*, Razet Yushaeva (b), Zulai Tavbulatova (c) Zarina Aylarova (d) Zarina Tarkhanova (e)
*Corresponding author

(a) Chechen State University, Chechen Republic, Grozny, Russia, basxo@yandex.ru,
(b) Chechen State Pedagogical University, Chechen Republic, Grozny, Russia, adlan0476@bk.ru,
(c) Chechen State University, Chechen Republic, Grozny, Russia, eva_didi@inbox.ru,
(d) North Ossetian State University after K.L. Khetagurov, Vladikavkaz, Russia, zaya1982@mail.ru,
(e) North Ossetian State University after K.L. Khetagurov, Vladikavkaz, Russia, zarinka1982-82@mail.ru

Abstract

This paper identifies the distinctive features of Islamic financial institutions and traditional secular banks based on loan interest. The relevance of this study is caused by the need to assess the integration of the Islamic financial model into the financial system of national economies with the non-Muslim population. In recent years, Western European countries have taken an active interest in increasing cooperation with Islamic banks from the Persian Gulf countries thus expanding their activities and transforming their financial relations. Such cooperation is based on the complementarity of two financial models of banking. This issue is particularly acute given the increase in sanctions pressure and the ban on Russia's largest banks to attract funding from many Western countries for more than 30 days. But in order to achieve effective synergy between the two models it is important to make a comparative analysis thus providing theoretical and methodological integration. The paper presents a brief description of the development of the Islamic financial activity model. The concept of activities of Islamic financial institutions in the classification of transactions carried out by Islamic banks and other organizations engaged in insurance, trade and settlement activities is considered. The approaches of the scientific community to assessing the efficiency of Islamic financial institutions are reviewed. The main differences between Islamic financial institutions and secular commercial banks are systematized and grouped by classification criterion with identification of their peculiarities. The main structural, standard, regulatory, and infrastructure problems in the development of the Islamic financial model are defined.

Keywords: Islamic banks, Islamic finance, commercial banks, financial instruments, banking.

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1. Introduction

The global financial crisis and the post-crisis development of the global financial system have called into question the advantages of the Western banking model. However, traditional financial institutions and instruments are still prevailing. It is worth noting that even in the financial markets of Muslim countries the share of Islamic banks is on average relatively small (less than 20 % of the banking assets of Muslim countries (Beck et al., 2010) and about 1 % of global banking assets (IDBank, 2011).

The importance of the Islamic financial services market in general and Islamic banks in particular is quite ambiguous. The opponents of the Islamic financial system note not only its competitive disadvantages (Mirkin, 2002), but also potential social danger (Kuran, 2008). The apologists of Islamic financial principles, on the contrary, view the institution of loan interest as a source of social injustice, concentration of capital, reduction of demand, imbalance of the economy (Amlot, 2011). As an alternative, it is proposed to utilize the profit-and-loss sharing mode (PLS), which, according to them, creates conditions for more balanced distribution of profits and thereby reduces income differentiation in the society, contributes to more efficient allocation of resources, implies more integrated control over business by a financial intermediary – the Islamic bank, which assumes most financial, investment and business risks, which, in turn, reduces the risk of financial crises and creates prerequisites for sustained economic growth.

The Islamic Bank is a financial institution that accepts deposits and places raised funds in accordance with the principles expressed in the ban on loan interest, speculations and contractual conditions, which lead to uncertainty and/or one party receives excessive advantages at the expense of the other. These principles are consistent with the fact that the Muslims perceive a fair (non-exploitative) distribution of income within the society: a person receiving income must take part in a labor process and/or risk his/her property (Ivanov et al., 2007), and it is unacceptable to earn money from money. From an organizational and legal point of view, the necessary conditions for Islamic banks are the following: Sharia-based Supervisory Board to ensure that all transactions comply with the requirements of the Sharia; ability to conduct banking operations on the basis of Islamic financial principles (including compliance with the loan interest ban); lack of legal restrictions on banks' participation in trading and on the distribution of profit (loss) with clients.

It is obvious that such conditions require a special approach to the regulation of Islamic banks – three models are implemented in practice, where:

1) banking legislation is built in accordance with Sharia requirements (Sudan and formally Iran and Pakistan);

2) activities of traditional banks are regulated by general banking legislation, and Islamic – by special laws (similar banking systems operate in Malaysia, Bahrain, Turkey, Kyrgyzstan, Kazakhstan, etc.);

3) activities of Islamic banks are regulated within the framework of the general banking legislation (this model is typical for most Western countries where Islamic banks are present, for example, Great Britain, Switzerland, the USA).

The structure of the Islamic banking system consists of two levels:

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1) inter-ethnic non-profit organizations promoting the development of Islamic banks (the key institution of this level is the Islamic Development Bank (IDB), which provides various support to Islamic financial institutions, and acts as a financial intermediary accepting deposits and placing funds in accordance with Sharia requirements);

2) commercial organizations, which in turn are represented by:

a) commercial Islamic banks with the primary purpose of profiting from Sharia-compliant banking services;

b) specialized Islamic banks established for specific tasks (agricultural, industrial banks, etc.);

c) Islamic windows in traditional banks (an important condition for such units is “self-sufficiency as an Islamic financial intermediary”: managed funds are invested in sharia-compliant assets) (Bekkin, 2008).

Unlike traditional banks, the financial intermediation of Islamic banks is based on a share in profit (loss) from transactions with real assets. The Islamic Bank provides and attracts funds on specific terms: interest rates on loans and deposits are not allowed.

2. Problem Statement

The increasing frequency and duration of economic and financial crises requires an improved approach to financial performance and a reconsideration of financial institutions, which today serve the main catalyst for instability and risk. On the other hand, the strengthening of “sanctions wars” (Tashtamirov, 2015), trade restrictions, world political contradictions create an unfavorable environment for effective development of national economies, which depend on the conditions of the world financial system and investment flows. This issue is particularly acute for the Russian Federation, which belongs to developing countries. It is attractive to investors due to the high yield rate on government bonds, and at the same time is facing some difficulties with external funding due to sanctions pressure. Such conditions create the need to explore the possibilities of using the potential of Islamic financial institutions as an additional source of financial capital for the development of the national economy.

3. Research Questions

The solution to this problem is to identify the nature of Islamic financial institutions, to define the peculiarities of transactions under the Islamic financial model, to determine the fundamental differences between Islamic financial institutions and traditional banks, whose activities are based on loan interest.

4. Purpose of the Study

The purpose of this study is to identify fundamental differences between Islamic financial institutions and traditional commercial loan banks.

5. Research Methods

To the greatest extent, the concepts of profit and loss participation correspond to the equity project financing instruments – mudaraba and musharaka, the urgent nature of which does not allow them to be classified as equity financial instruments in the strict sense of this word. Active transactions of Islamic banks on debt interest-free financing are formalized by such basic financial instruments as murabaha, salam, istisna. They are not directly related to the concept of profit and loss participation, but are based on transactions with real assets and therefore exclude the exchange of money for money.

Let us describe the peculiarities of the main financial instruments used in active transactions of Islamic banks in more detail.

Mudaraba: a trust financing contract under which an Islamic bank finances an investment project, but does not have the right to participate in project management; receives the due share of the profits from the project, with the profits divided in predetermined proportions between it and the partner managing the raised funds; bears all risks of no profit on the project.

Musharaka: a joint activity contract under which a joint company is created for the implementation of an investment project, and an Islamic bank acts as one of its owners. Unlike mudaraba, in this case the bank has the right to participate in project management along with another partner (partners), which partly reduces its risks. The financial result (both profit and loss on the project) is distributed according to the ownership interest.

Murabaha: a commercial credit contract under which an Islamic bank, acting as an intermediary, at its own expense, but on behalf of a client, acquires a certain asset (commodity) according to the description provided by the client in the application. The description indicates the essential characteristics of an asset, its price, availability on the market. The contract becomes effective after the goods are transferred to the property of the intermediary. The item is then sold to the customer at a price that includes a margin, usually on the basis of deferred or instalment payment.

Salam: a commercial credit contract providing for the purchase and sale of an asset (goods) on prepayment terms. According to the contract, the Islamic bank provides the executor with some amount equal to the value of goods, and the executor undertakes to deliver the goods by the agreed date. Salam is concluded simultaneously with another contract. As a rule, it is a parallel salam, when the Islamic bank, in turn, acts as a performer, profiting from the difference in prices at which it buys and sells goods.

Istisna: a pre-paid contract under which the Islamic bank provides the contractor with a certain amount equal to the manufacturing cost, and the contractor undertakes to perform the works by the fixed date. It is concluded in combination with another contract under which the Islamic bank sells the goods to the client. The profit of the bank, acting as an intermediary between the manufacturer and the end buyer of goods, is formed at the expense of a predetermined difference in purchase and sale prices: the price at which it pays for the performance of works is known to be lower than the price at which it sells the received goods. Most often istisna is used for financing large projects, as well as for mortgage lending.

Passive operations of Islamic banks are mainly carried out on the basis of contracts of equity project financing and interest-free loan. The most popular financial instruments are mudaraba, kard hassan.

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Mudaraba: a contract that results in the depositor's funds going to an investment account of an Islamic bank used to finance an investment project (projects). The contributor's share in project financing is substantial (up to 90 %), and its profits depend on the financial result of the project. Mudaraba can be limited (related to a specific project) and unlimited (the bank itself determines where to invest).

Kard Hassan: the interest-free loan contract under which the Islamic bank attracts money free of charge, can use it at its own discretion, but is obliged to return on first demand. The funds received in this way go to savings accounts. At the same time, Islamic banks try to encourage customers, for example, by giving them discounts on their services. Other mechanisms for the formation of savings accounts include the following: a) a bank has the right to use the funds raised thus guaranteeing their return within the specified time limit, but at its discretion can pay the depositor additional income; b) the attracted funds can be invested by a bank, and the received profit – divided with the depositor in predetermined proportions.

The above confirms that the most fundamental differences in the activities of Islamic and traditional banks are related to the concept of risk management and methods of raising and placing funds (Table 01).

The activities of Islamic banks are clearly characterized by specific principles. Therefore, the results of empirical studies, according to which the differences between Islamic and traditional banks are not that critical, seem to be quite intriguing. Thus, having analyzed the activities of 2,857 traditional and 99 Islamic banks from 141 countries of the world during the period 1995–2007 T. Bek, A. Demirguch-Kunt and O. Merrosh did not reveal any significant peculiarities of Islamic banks either in terms of their business model, efficiency, asset quality or stability level (as cited in Ariff, 2001). At the same time, the participation of Islamic banks in trade transactions makes it possible to classify them as financial companies rather than deposit-type institutions. However, it shall be noted that the concept of "traditional (ordinary, secular) bank", in turn, is quite ambiguous.

6. Findings

If the differences between the two models of financial and banking activity under consideration by classifying characteristics and features of activity are considered structurally, the results can be presented in the form of the following table (Table 01).

Table 01. Key differences between Islamic and traditional banks

Performance characteristic	**Banks**	
	Islamic	**Traditional**
Risk management concept	Risk mutualisation concept	Risk sharing concept
Fundraising features	As a rule, investors (depositors) share risks and profits with the bank. The financial result of depositors is not guaranteed and depends on financial results of a bank.	Investors (depositors) generally pass on risks to the bank receiving a certain and guaranteed interest. At the same time, the interest rate does not directly depend on the return on investments of a bank.
Participation of contributors in	Available	Almost not available

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profit and loss		
Guaranteed payments of deposits on demand	Available	Available
Guaranteed payments of investment deposits	Not available	Available
Investment features	Risk sharing mechanisms are used in the investment process. The main volume of active transactions is related to equity financing of investment projects, financing of purchase and sale of products, goods and services.	Investment is predominantly done on a debt basis. Borrowers pay interest regardless of the result of the investment of received funds. Risk transfer tools are used.
Banks' right to grant a credit depending on charged security	Most often there is no right to discriminate against clients depending on their security.	Always available

Among the most significant problems that constrain the development of Islamic banks are their competitive disadvantages, underdeveloped infrastructure of the Islamic financial services market, high degree of regional fragmentation, and imperfect system of banking supervision and regulation.

The competitive disadvantages of Islamic banks are usually studied in the context of peculiarities of the development of the Islamic financial services market, as well as in comparison with traditional financial institutions. According to Mirkin (2002), "within the framework of Islamic finance (taking into account the hierarchy inherent in Islamic society) it is difficult to expect a mass retail investor in securities, taking high risks, oriented to large-scale and liquid stock markets" (p. 472). As a result, the structure of the market becomes simplified, the share of banks – excessive, there is a dominance of large family investors in equity. Kuran (2004) is even more categorical arguing that at this stage of development – in the conditions of weak organization and lack of corresponding skills – the Islamic banking model is in general not viable.

7. Conclusion

How much criticism of Islamic banks is consistent with empirical research? The analysis of the competitiveness of Islamic banks conducted by Ernst & Young in 2012 led to the conclusions on a relatively more significant decline in the profitability of their business against the background of global financial instability and the insufficient level of "risk appetite" compared to traditional banks. Besides, it is highlighted that the risk management practices of Islamic banks require major improvement. The first conclusion is quite unexpected: in the context of the global financial crisis, Islamic banks have generally been more resilient than traditional ones demonstrating higher lending growth and more substantial asset growth. Between 2007 and 2009, the average growth rate of assets of Islamic banks was twice higher than that of traditional banks (as cited in Hasan & Driddi, 2010).

Poor market infrastructure impedes effective liquidity management of Islamic banks. Their liquidity is higher than that of traditional banks by 40 % owing both to the small depth of the money market caused by the small number of participants and the insufficient number of tools that could be used in relevant transactions with the central bank.

The imperfection of banking supervision and regulation are noted as one of the most serious challenges for the Islamic banking industry (Hasan & Driddi, 2010). The most significant work in this direction is carried out by the Islamic Financial Services Boards (IFSB), which develops general standards for the activities of Islamic financial institutions, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which approves general standards for the activities of Islamic financial institutions. However, the introduction of international standards for Islamic financial institutions raises serious concerns among many experts, as the Islamic financial market is very uneven in different countries (Shayerah, 2010).

In summary, it is worth noting the social role of Islamic banks in financing low-value infrastructure projects that promote the development of small and medium-sized enterprises, increase the availability of financial resources, including for the poorest groups, through special microcredit programs (IDBank, 2011). Finally, we can't fail to see that the Islamic banking model is initially based on and solves the task of overcoming a number of social problems.

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