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**A STUDY ON CONVENTIONAL BANKING, ISLAMIC BANKING AND IT'S TREATMENT OF PROFIT AND LOSS**

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**OMAN**

**ABSTRACT**

*The purpose of this study is to understand conventional banking and Islamic banking transaction with interest and without interest. In Islam interest is prohibited. Allah also said in Quran taking, giving and writing interest transaction is also prohibited. It is also said by Prophet Muhammed(PBUH) in many hadies that help poor by giving loan but don't take extra over the principal amount. Give loan to the needy in the form of qard al-hasan (interest free loan) but do not charge interest over it. In conventional banking loan is given on interest where as in Islamic banks without interest. In Islam interest taking and giving is treated as sin. Allah said interest is prohibited but inspire people to invest in business and earn profit from such business. Such profit is treated as halal so many Muslim scholars have found the financial transaction. Such financial transaction is totally interest free based. The effective profit and loss sharing mechanism will drastically erase unfair sharing of income and wealth which leads to well organized allocation of optimal resources as compared to conventional banking. The basic objective of this paper is to enlighten how profit and loss shared mechanism work without interest in the presence of conventional banking scenario.*

**KEYWORDS**

Conventional banking, Islamic banking, prohibition of interest (Riba), Partnership (mudarabah, Musharakah and Murabaha ) Profit and Loss Sharing (Treatment).

**INTRODUCTION**

Islamic banking is the new phenomenon which runs on the principles of Shariah (Islamic rulings) it's practically applications is to develop the economy. Shariah refers to a code of law or divine injunctions that regulates the conduct of human being. The banks were run on the principle of interest but in Islamic banking it is complete a free interest basis business. Shariah principle prohibits the acceptance of interest (RIBA) in lending as well in trade and other activities. RIBA means surplus, excess or increased. In shariah riba is predetermined surplus.

The extra money which received by the creditor during the specified period of time.

A number of verses of the Holy Quran say about prohibition of riba. From the holy Quran, verses on Riba are given below

**SURA AL –RUM, VERSES 39**

"That which you give as Riba to increase the people's wealth increases not with God; but that which you give in charity, seeking the goodwill of god, multiplies manifold."(30:39) (Ayub, 2007)

**SURAH AL NISA, VERSES 161**

"And for their taking Riba although it was forbidden for them and their wrong ful appropriation of others people's property. We have prepared for those among them who reject faith a grievous punishment."(4:161)(Ayub, 2007)

**Surah AL – IMRAN, VERSES 130**

"O believers, take not doubled and redoubled Riba, and fear Allah so that you may prosper. Fears the fire which has been prepared for those who reject faith, and obey Allah and the prophet (pbuh) so that you may get mercy."(Ayub, 2007)

**SURAH AL-BAQARAH, VERSES 280**

"And if the debtor is in misery, let him have respite until it is easier, but if you forego it as charity, it is better for you if you realize."(Ayub,2007)

**CONVENTIONAL BANKING**

There are two types of bank one conventional banks and another one is Islamic bank. Conventional bank run on the objectives of interest and Islamic bank run on the objective of without interest. Present conventional banks and Islamic banks have created competition to meet the needs of customer for long term benefits. The basic difference objective of Islamic and conventional banks is interest (Riba) and risk sharing. Islamic banking was in practice since 1970's later it started spreading to many countries in the world.

The conventional banks like HSBC, Standard Chartered Bank, Deutsche Bank, Citibank, etc, have started new windows to offer Islamic products to their muslim and non muslim customer. The customers who are interested in profit and loss sharing mechanism.

Demand for Islamic banking is high in Muslim as well in non Muslim countries. In UK there were seven full fledged Islamic bank till 2006 and planned to increase 12 by the end of 2007. Beside this, the European Islamic Investment bank, HSBC Amanah, Alburaq, Lloyds TSB, ABC international bank Bristol etc are also offering services to non muslim clients. In Malaysia 40% of Islamic banks offering services to non Muslim clients also. In US and North America, Many institutions are providing Islamic financial services to the Muslim clients.

It is important to know how Islamic banking is emerging in the existence of conventional banking. Islamic banking and conventional banking varies in the basis of objectives, the objective of Islamic banking is interest free and risk sharing. Islamic banking follows the principles of which Shariah is given by almighty Allah but whereas conventional banks' follows the man made principles. In Islamic banking income is generated in income which is variable while in conventional banking income is generated from interest which is fixed. In Islamic banking risk is shared among Rabbul mal and Mudarib whereas in conventional banking risks are shared with others. Islamic banking is trade oriented and conventional banking is a purely based on the interest basis transaction.

The basic aim of this paper is to enlighten what is Islamic banking, conventional banking, and prohibition of interest and how profit and loss are shared among partners. In Islamic banking there are three kinds of partnership Mudarabah Musharakah and Murabahah

In mudarabah contract the bank act as mudarib and customer acts as Rabbul mal. The customer deposite the money with the bank and bank will invest the fixed deposited money in productive business. If they occur profit then it will be shared between customer ( Rabbul mal)and bank( mudarib) in ratio agreed by them.

There are two types of mudarabah business, one is restricted and another is unrestricted. In restricted mudarabah business a financer specifies a particular business; the mudarib (bank) should undertake only that business which is there in agreement where as in unrestricted business the mudarib (bank) is opened to undertake any kind of business.

**REVIEW OF LITERATURE**

Awan(2009) analyzed the vertical growth of Islamic banking and compared it with its counterpart conventional banking. Six newly formed Islamic banks in Pakistan and six conventional banks of the same size were selected for the purpose of comparison. Data relating to their performance and profitability were collected from primary and secondary sources from 2006 to 2008. The ratio analysis technique was applied to measure the performance of key indicators of both Islamic and conventional banks.

The results of the study are very encouraging because the performance and profitability of Islamic banks are far better than selected conventional banks. Islamic banks outperform conventional banks in assets, deposits, financing, investments, efficiency, and quality of services and recovery of loans. It predicts the bright future of Islamic banking in Pakistan.

**Willison(2009)** evaluated the development of Islamic banking in the GCC since then, an industry which now encompasses Islamic *takaful* (insurance) and *shariah*-compliant asset management, as well as retail and investment banking. An examination is made of the extent to which government policy, through both legislation and regulation, has facilitated the development of Islamic finance. *Shariah* governance systems are appraised, in particular the workings of the devolved form of self-governance by Islamic financial institutions. The deposit facilities offered by Islamic banks in the GCC are discussed, as well as the financing provided, notably trade finance, consumer credit and mortgages for real estate, which are the dominant types of funding by Islamic banks. The issuance and trading of Islamic *sukuk* securities is also considered, as well as the role of their region's financial centers.

**Ahmad & Rehman and Saif(2010)** study on the relationship between service regarding Islamic banks and as conventional banks in Pakistan. It also investigated how service quality affects customer satisfaction by assessing the magnitude of the relationship between selected variables. This study is important due to an emerging trend of Islamic banking practices in Pakistan in the existence of conventional banking system. Data were collected from 720 bank customers by using stratified random sampling. SPSS 15.0 version is applied for data analysis. The results reflect that there is strong positive relationship between service quality and customer satisfaction in case of Islamic banks as well as in case of conventional banks. Findings showed that there is stronger positive relationship between service quality and customer satisfaction in Islamic banks as compared to Conventional banks in Pakistan. The study has a number of implications for bankers, policy makers and academicians.

**Jalil and Rehman(2010)** have discussed in their study the prohibition of interest (*riba*) on loan given. When a lender lends money to another person, he is allowed to get back the capital amount only and not any additional amount which is usually fixed interest on the capital. Taking interest on loan given caused cruelty and injustice to poor people in the society during Prophet Muhammad time that was unable to pay back the capital and the interest? So, Prophet Muhammad encouraged the rich people to give *qard al-hasan* (interest free loan) to the poor and needy people to help them to solve their problems. That's why Allah (the Creator) prohibited taking interest but encouraged people who have money to invest the money in business. The profit obtained from business is permitted (*halal*) but fixed rate interest taken on loan given to a person is *riba* (interest) and it is prohibited. As Allah (the Creator) has prohibited interest, Muslims are prohibited to give interest, to take interest and to write down the interest transaction. Hence, Muslim scholars have invented some Islamic transactions which do not involve interest and Islamic banks are adopting these Islamic transactions.

**Muda & Ismail** (2010) demonstrated theoretically Profit-Loss Sharing (PLS) contracts in the financial intermediation theory. The aim is to propose optimal conditions of the PLS contracts to minimize the problems of asymmetric information and transaction costs. Three propositions are presented to achieve the optimal conditions of Profit-Loss Sharing contracts in Islamic banks. For *mudharaba* contract, Islamic bank as *rabbul maal* gives incentives of  $\phi^*(Rpb')$  to entrepreneurs, if a positive value of Islamic bank's expected net profit is obtained. If Islamic bank, as *mudharib* is appointed as *wakeel*,  $c^*(m)$  is imposed to the depositors of *mudharaba* investment account for cost of processing information. For *musyaraka* contract, Islamic bank is proposed to incur monitoring cost of  $c^*(y)$ . With these conditions take place, then, Islamic banks can maximize the net profit and create value to their shareholders.

## OBJECTIVES OF STUDY

1. The objective of the study is to know how Islamic banking is operating in the presence of conventional banking.
2. To study on conventional banking and Islamic banking and also the treatment of profit and loss in Islamic banking. In order to draw conclusion how Islamic banks competitive with conventional bank and meet the demand of depositors in the absence of interest

## RESEARCH METHODOLOGY

Descriptive research design has been used for this Research.

### DATA COLLECTION METHOD

Secondary data has been used through various sources like books, journals and Internet.

### DATA ANALYSIS METHOD

#### SECONDARY ANALYSIS

From the overall study the conventional banking when fails to run after some decades then the conventional bank found such banking windows where losses of conventional commercial banks can be compensated by opening of Islamic banks windows. as it mention in the paper that it is that kind of banking business where a business is done without any extra i.e. interest. Islamic banking is another (finance) investment industry of conventional banking and that investment is growing at rapid speed. The fact of growing of Islamic banks is because the conventional banks could not operate because of heavy losses. A loss is the major cause of recession.

The alternative industry Islamic banking is at rapid speed because of its unique characteristics. This unique characteristics which motivating Muslim as well non Muslim to do business in the principle of Islamic law (*shariah*). The justice is the unique law of Islamic banking, which is an indispensably require for all sort of Islamic financing. The financed project of profit sharing, share the actual net profit/loss with the investor and receiver rather than dumping the risk burden only on the entrepreneur. In order to have a fair distribution of output between the two parties (investor and receiver) the principle of fairness and justice is essential. When the investor is sharing the profit then he has to bear loss of the project in accordance with proportional share.

Another important feature of Islamic banking is that they developed the relationship with the customer (depositors). The relationship begins on the basis of investment but not on fixed interest rate. Islamic bank pool the deposits of their customer and invest in high profitable project after going through strategic analysis to give substantial returns to the depositors.

Islamic banks are offering their products which are structured under the contract of *Mudharabah*. Islamic Banks gives higher rate of returns on deposits because of the profit sharing ratio whereas conventional banking will give the fixed return to the depositors irrespective of the performance of banks.

The other advantage of depositors of Islamic banks is that the depositors can withdraw their deposits on demand before maturity of the contract. A distinguished advantage of Islamic Banks is that the Islamic banks will pay the returns on the depositors' investment for the actual period whereas conventional banks which normally pays half the agreed fixed rate.

The important limitation of Islamic banking is that the depositors of Islamic banks are still not aware of profit sharing applications under the *Mudharabah* contract. The return on investment cannot be quantified unless they said profit is identified, Islamic banks will not intimate the depositors about the profit sharing ratio at the time of deposits. Islamic banks estimates the rate of return on investment based on previous months profit rates. This previous profit rates acts as an indicative rates. This indicative rate helps the Islamic banks in deciding the rate of return of depositors. The depositors will receive higher or lower returns on the deposit and may vary depending on the actual returns of investments obtained by the Islamic Banks. Therefore the depositors have to keen in profit sharing rates of Islamic Banks to ascertain how the banks are fairing in terms of returns.

## DISCUSSION

### TREATMENT OF PROFIT AND LOSS

In *mudharabah* partnership *Rabbul mal* and *mudharib* are at liberty to agree on the proportion or ratio of profit sharing between them with mutual consent. The profit ratio has to decide at the time of contract. Even the *Rabbul mal* or *Mudharib* can agree on equal sharing or allocate different proportions. For example, 50, 40 or 60% of the profit is going too shared by *Rabbul mal* and the remaining 50, 60 or 40 % is going to *Mudharib*. Different proportions can be agreed up on for different situations. For example, *Rabbul mal* (financier) can say *Mudharib*. "If you deal in wheat, you will get 50%, but if you deal in cloth, you will be given 40% of the profit. Or if you do business in your town you will get 40% and if in another town you will be getting 50% of profit. In case if loss occur then the entire loss will be bear by financier. A lump sum amount as a profit cannot be allowed to one party, the parties has to show their mutual consent that if profit goes beyond

particular ceiling then one party can share larger amount of profit. Incase if profit is below or equal to the stipulated ceiling then the distribution has to be done according to the agreed ratio.

As a principle, in Mudarabah partnership the financiers only bear loss. However, if Mudarib has also contributes capital, with mutual consent he can also bear the Pro Rata loss. (Ayub,2007)

**MUSHARAKAH PARTNERSHIP**

In Musharakah partnership, it is a partnership between two or more partners who contributes capital in the business. All partners will not contribute in the management of the business but they direct follow up the business for the effective and efficient progress of the business. Profit and loss are shared between partners according to the share of capital invested. The partner who works actively in business is called active partner and the partner who does not participate in business is called sleeping partner. The active partner not only participates in profit of the business but also receive monthly salary. The word musharakah also means company business. The bank pools the deposits from investors and invests in company business or partnership. The profit which is arising from that investment is treated as income. This profit is not interest. Therefore it is approved shariah transaction.

**TEATMENT OF PROFIT AND LOSS**

According to " Imam Abu Hanifa and Imam Ahmad" the profit ratio can differ from the investment ratio on the basis of the amount of work to be done by the partners, because along with capital, labour and work are also factors for accrual of profit. Thus any partner make a condition that he will get more than the ratio of his investment as compensation for the work he will be doing for the shirkah (partnership).According to all jurist a loss must be shared exactly in accordance with the ratio of capital invested by partners. The fourth pious caliph of Islam, Ali (Gbpwh):"profit is based on agreement of the parties, but loss is always subject to the ratio of investment". The rational of this principle is that earning profit is legitimized by engaging in an economic activity and thereby contributing to the socio economic welfare of society. It encompasses equitable risk sharing between provider of capital and the entrepreneur. According to this principle no partner is entitled to have any lump sum amount of the profit. (Ayub, 2007)

**DEPOSIT MANAGEMENT IN ISLAMIC BANKS ON MUDARABAH BASIS**

The profit and loss sharing mechanism of Islamic banks are also known as Mudarabah plus Musharakah model or simply the Mudarabah model. For Example: The bank will create an investment pool having categories based on different tenors of deposits. The bank has launches three tenors: three months, six months and one year. Each depositors of the bank will deposit its funds in specific category of the investment pool that will be assigned a specific weight age. Weight age can only be amended at the beginning of the accounting period. Assuming that the depositors are invested the investment in the following investment pool A.

TABLE 1

| Category     | Amount in \$ | Weight age |
|--------------|--------------|------------|
| Three months | 5000         | 0.60       |
| Six months   | 2285         | 0.70       |
| One year     | 3000         | 1.00       |

All members of the pool will have a musharakah relationship with each other.ie. They are partners in the pool with the above mentioned weight ages. The bank also invests in the pool as depositors.

Now all partners of the pool collectively enter into a mudarabah contract. Under this pool A acts as a Rabbul Mal and the bank will be Mudarib.The bank undertakes the business with funds from the pool and earned profit would be share between the parties in an agreed ratio. Assuming that the profit sharing ratio is equal (50:50).

The bank deploys \$10285 of the pool for a period of one month and earns a profit of \$1000 at the end of the month. The profit would be share among the bank\$500 and the pool \$500.The Mudarabah contract completed at this stage.

**PROFIT SHARING AMONG THE POOL MEMBERS**

\$500 earned by the pool will be disturbed as per the weight age assigned at the beginning of the month. The relationship within pool will be governed by the rules of Musharakah. The total profit earned for one month \$1000.The following are the calculation for the disturbitation of profit among the member of the pool.

TABLE 2

| Deposits(\$)<br>A | Weightage<br>B | Weighted average(\$)<br>C=A*B | Profit(\$)<br>D | Rate<br>E |
|-------------------|----------------|-------------------------------|-----------------|-----------|
| 5000              | 0.6            | 3000                          | 197.3           | 3.94%     |
| 2285              | 0.7            | 1600                          | 105.2           | 4.60%     |
| 3000              | 1              | 3000                          | 197.3           | 6.57%     |
| 10285             |                | 7600                          | 500             |           |

Profit=C\*500/7600

Rate=D\*100/A

The profit is shared according to agreed ratio among Rabul mal and Mudarib (50:50). \$500 has to be distributed among three depositors (rabul mal). Each depositor has to share profit according to the weightage assign. The three depositors had contribute 5000, 2285, and 3000.There weightage is 0.6, 0.7 and 1.According to weighage each depositor get 3000, 1600, 3000 like (5000\*.6), (2285\*.7), (3000\*1) that is weighted average(C=A\*B).The total Weighted Average is 7600.Inorder to derive at each depositors profit, the total profit\$500 is divided by total Weighted average 7600 and multiplied by each depositor Weighted average like 500/7600\*3000=197.3,500/7600\*1600=105.2,500/7600\*3000=197.3.The percentage rate is calculated as Profit multiplied by hundred and divided by each depositor deposits like 197.3\*100/5000=3.94%,105.2\*100/2285=4.60% and 197.3\*100/3000=6.56%.

**SHARING OF LOSS AMONG THE DEPOSITORS**

As per the rules of Musharakah loss to the pool would be distributed among the pool members (Rabbul Mal) according to their investment ratio. For example, if loss to pool \$500, it will be distributed in the following manner: (Ayub, 2008)

TABLE 3

|              |        |     |
|--------------|--------|-----|
| Three months | \$5000 | 250 |
| Six months   | \$2285 | 100 |
| One year     | \$3000 | 150 |
| Total loss   |        | 500 |

The losses are shared among the depositors (Rabul Ma) according to their investment ratio (5:2:3) like \$500\*5/10=250, \$500\*2/10=200, \$500\*3/10=150.

**MURABAHAH**

Murabahah contract is the last type of contract. In order to be a part of this contract a customer and bank has to enter in to agreement. In this type of transaction the bank will not deal with cash but deal with commodities. Here bank will ask the customer to select the goods of type and bank will purchase the goods on behalf of customer later sell the goods to customer after mentioning the profit margin .Thereafter the customer will pay the money to bank in installments. Suppose a customer want to purchase house but he does not have enough money so the customer will go the Islamic bank to purchase House. The Islamic bank will ask the customer to bring all detailed specification of the House like Flat no, price, location, area and Square yard etc. After receiving the specification the bank will enter in to contract with the customer. The bank will purchase the house and will sell to customer with mark up profit and customer will have a chance to pay that by installments for a period of 2years or five years. Once this contract gets signed by customer then bank will purchase the House

and sell it to customer and allow customer to pay that amount in installments. This type of transaction is absolutely free from interest and it is acceptable by Shariah principles.

## CONCLUSION

In Holy book Quran. In Quran many times it mentions about the prohibition of interest (riba) that giving and taking interest is prohibited. Prophet Mohammed (pbuh) also narrated in many hadies regarding giving and taking of interest. Hence many Muslim scholars have made their attempt to bring such bank or financial transaction which is not purely based on interest.

It is not easy to find such bank transaction without interest based because conventional banks has occupied well place in the minds of people ,who furnished the needs of people by giving and taking interest. In 1970s and 1980s many Muslim scholars found a solution for interested based business to be replaced by Islamic banks which runs on the principle of Shariah(Islamic laws).Muslim scholars in different countries has shown the business transaction which can be done without interest. Now in many countries of the world the conventional commercial banks are opening windows of Islamic banking for their Muslim and non Muslim customer.

The Islamic bank is doing more good on universal principle of profit and loss sharing mechanism.Thus to conclude that Islamic bank need improvement because it is in its earlier stage in some countries so that it will be easy for the people to understand and accept it. In order to improve the efficiency of Islamic banks need continues research and development for overall success of Islamic banks.

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