

Investigation on Functions and Product Structure of Islamic Banking vs. Conventional Banking in Sri Lanka: a Case Study

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Abstract - Islamic banks (IBs) were originated to satisfy the financial needs of Muslim community by rejecting interest and following Profit-Loss sharing paradigm while conforming to Shariah principles. IB is increasingly gaining attention across the global financial environment due to its unique framework relative to Conventional banks (CBs). But the public still lack the comprehensive knowledge about how actually IBs differ from CBs. Hence, there is a lack of participation of the public with the IBs for banking transactions. The objective of the study is to explore 'how' and 'why' IBs differ from CBs with giving special reference to the functions and products. Hence, this research would fill the knowledge and empirical gap in the Sri Lankan context.

The study adopts interpretative methodology and multiple case study strategy. Primary and secondary data were collected through interviews, observations, reports and websites.

Major findings of the study concluded that IBs and CBs enclose differences as well as similarities in their framework. The major differences were identified connecting to the framework of IBs as they need to follow interest free paradigm, Profit and Loss Sharing (PLS) paradigm and Shariah principles in performing the banking functions comparing to interest based CBs. However, still both IBs and CBs function as financial intermediary carrying out similar functions. Similarly in terms of product and services, IBs offer similar saving and financing solutions to banking customers as of CBs, but still their products tend to be unique as they adhere to above principles and variety of Shariah product concepts such as Mudharaba in forming savings accounts and Mudarabah, Musyarakah, etc in offering financing products. Likewise similarities and differences can be observed in investments and financing structure between two systems.

Thus it is evident that IBs and CBs enclose differences as well as similarities in their product and working structure. Accordingly the major

principles of interest free paradigm, Profit and Loss Sharing paradigm and Shariah principles have influenced for the emergence of unique structure that differentiate an IB from general CBs though few similarities can be observed between two systems. Thus these results are consistent with the findings of other researchers in the similar areas.

Keywords: Islamic bank, Conventional bank, Functions, product structure

I. INTRODUCTION

Islamic Banking was originated to satisfy the financial needs of Muslim community. This has gained much attention with its unprecedented growth and expansion in last decades. With its growing awareness and success, Islamic bank made its entry to the Sri Lankan banking industry in 2009. Islamic banks (IBs) deem to be very unique than conventional banks (CBs) since they reject interest and follow interest free framework while conforming to Shariah principles. This case study was carried out with an objective to comprehensively understand the Islamic banking system and its concepts. The study attempts to ascertain to what extent Islamic banks differ from conventional banks and its application of Shariah principles in Sri Lankan context with especial reference to functions and products of the two banking systems.

II. METHODOLOGY

This study has selected two banks, selected Islamic Bank (IB1) and selected Conventional Bank (CB1) accordingly, each representing IBs and CBs. Interpretative methodology and multiple case study strategy have been employed to analyze the data. Primary and secondary data were collected through interviews, observations, reports and websites. This study was conducted in a structured way to ensure the validity and the reliability of the findings.

A. Research Purpose and Research Approach

The purpose of the current research is to gain a better understanding of the concept IB and its application in the Sri Lankan context as well as to identify how and to what extent it differs from CBs. As IB is a new concept to the financial market of Sri Lanka, it requires comprehensive understanding about the subject. Therefore, the qualitative approach has been used in this study to go profound into the research area and to achieve the objectives of the present study. Hence the study will be an exploratory research.

B. Research Philosophy and the Strategy

The research philosophy the study adopts is interpretative methodology and multiple case study strategy. Accordingly, two case studies are conducted to address the research questions as it allows an easy foundation to compare and validate the results as well as to conduct a cross-case analysis (Yin, 1994; Merriam, 1998).

Two banks were selected from the banking sector as the study focuses on the banking system of the county.

C. Data Collection

Data are primarily collected by following in-depth face to face focused interviews employing an interview guide. Further, within the scope of research, the current study has further used internet and observation as sources of data collection. The documentation was also used in order to supplement evidences from other sources. For example, data available in bank information materials as annual reports, articles and brochures were collected to acquire an overall view of the present situation of banks.

III. RESULTS AND DISCUSSION

A. Functions

CB1 as well as IB1 perform multiple functions such as deposit mobilization, agency services and general utility services to meet the needs of banking customers. The primary function of CB1 is to accept deposits and advance loans on the basis of different interest rates. Hence, CB1 highly depends on interest rates. As to the informant, CB1 continually adopts low cost deposit mobilization strategies in order to continue their growth. Additionally they perform variety of other functions based on agency services and general utility services by facilitating various fee based products and services to them.

Similarly, IB1 also performs variety of functions to provide diversity of unique financial solutions to its customers. Their main function is also to ensure deposit mobilization by pooling funds from savers and lending them to investors to invest in productive ventures to generate profits. Additionally IB1 is identified to perform functions to provide agency services and general utility services to its customers.

However, though IB1 perform identical functions as CB1 (Table 1) , their functions are unique than CB1 as IB1 function in accordance with Shariah principles and interest free framework, whilst CB1 operate within the framework of interest and they do not follow religious laws as Shariah.

This argument was brought in to light by the informant of IB1:

“As a Shariah compliant bank, we also offer the same functions as CBs but by following the principles of Shariah. Therefore our functions are unique and designed based on the stipulated Shariah guidelines and principles than other CBs”.

Therefore, IB1 functions are designed under interest free framework to mutually share risk as well as rewards with customers, with an aim to avoid speculation and to ensure ethical investments. However, both the banks place a major emphasis on deposit mobilization than the other functions as they earn higher income by advancing loans. Hence, these findings of the study are consistent with the findings of Ahamad et al. (2010), Al-Jarhi and Iqbal (2001), Ahmad et al. (2010) and Bahari (2009) as they also have identified that the main functions of IBs and CBs involve deposit mobilization, agency function and utility functions.

Table1.Main Functions of IB1 and CB1

Main Functions	IB1	CB1
Deposit mobilization	Accept deposits Advancing Loans	Accept deposits Advancing Loans
Agency functions	Collection of cheques Execution of standing orders	Collection of cheques Execution of standing orders
Offer general utility services	Collection of utility bills	Collection of utility bills

	Foreign exchange and treasury services ATM card services	Foreign exchange and treasury services ATM and credit card services
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Source: Researcher's own construction (based on the functions of two banks)

Therefore, the findings confirm that IBs perform identical functions as CBs, but still their functions are unique than of CBs, as IBs are required to follow Shariah principles and Islamic law as a Shariah compliant bank. Very interestingly these findings are supported by Paino et al. (2011), Mouawad (2009), Hanif (2011) and Benamraou (2008) as they have also discovered that the functions of IBs are similar to that of CBs, but differences can be foreseen in the operation of two systems as IBs are Shariah followers and function within interest free, when CBs are interest based and not operate under religious laws as Shariah

IB1 exists to achieve the objectives such as socio-economic justice, fairness and equality, whereas main consideration of CB1 is to maximize returns. As a result, IB1 functions are designed by adhering to Islam values and Shariah principles in order to meet these goals unlike CBs. These results are consistent with Paino et al. (2011), Ahmed (1987), Uzair (1976) and Hanif (2011). But the the study contradicts with the findings of Mouawad (2009) as he has emphasized that IBs and CBs have exact same operations, as the practices of IB is also driven towards profit maximization than social benefits as CBs.

Furthermore, IB1 is required to develop a customized information system that supports interest free products, Profit and Loss Sharing (PLS) paradigm and Shariah principles in performing these functions. Hence, they do not adopt the current banking software systems as CB1, as those softwares' are developed based on interest products.

B. Product Structure

CB1 offers current accounts, savings accounts and investment accounts to the banking customers based on interest. On the other, IB1 offer savings accounts and investment accounts based on PLS ratios, while current accounts are offered with a guarantee for principal deposit amount and it is not covered by PLS paradigm. However unlike CB1, IB1

follows Shariah product concepts Mudharaba in forming savings accounts and investment accounts. The PLS ratio for the deposit accounts in IB1 is pre-decided. But the actual profits and loss shared with customers depend on the monthly earnings of IB1. Therefore, the profit rates to customers of IB1 are subject to change according to the monthly profits of the bank and thus monthly rewards to customers depend on that calculated monthly rate. Further when compared to CB1, IB1 offers more profit rates to saving accounts depositors and less profit rates to investment account holders than CB1.

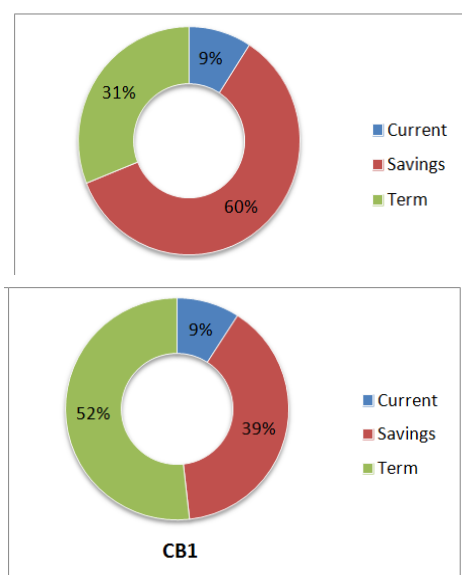
When looking at savings, It is identified that resident customers of IB1 get more percentage of profits, while IB1 gets more profit ratio than customers pertaining to foreign accounts. However, the resident customers get higher interest than foreign account holders in CB1. Generally the customers of IB1 as well as CB1 get higher returns when the period of investment increases than the bank pertaining to investment accounts. Additionally, the term deposits tend to dominate in CB1 while savings deposits dominate in IB1. Hence, these results are confirmed by Alam (2000), Al-Shami (2009), Karim (1996), Hanif (2011), Haron (1998), Chong and Liu (2009), Olson and Zoubi (2008), Benamraoui (2008) and Ariff (1995). They found that IBs offer current, savings and investment accounts as CBs, but with subject to Islam law and Shariah principles. They further discovered that IBs follow the Mudharaba in forming deposit accounts

The two banking streams offer identical financing options, term financing, trade financing, house financing and lease financing options against collateral. But still many differences have been identified between two banks with regard to financing options as IB1 follows Shariah product concepts such as Mudarabah, Musyarakah, Murabaha, DiminsihingMusharaka, Ijara, Wakala, Import Murabaha and Import Musawamma as well as PLS paradigm in offering financing solutions to its customers. Hence under PLS ratio, IB1 and its borrowers share the profits on an agreed ratio and the losses are shared according to their capital contribution. On the other hand CB1 offers financing options based on interest.

Further, IB1 does not offer financing solution or invest in organizations that operate in unethical or socially harmful industries such as liquor, gambling and tobacco irrespective of their profitability. In the case of CB1, they do not face such restrictions and

hence lend to borrowers who have the creditworthiness. In a case of default or delaying the loan instalments, CB1 charges an extra interest from the borrowers and this charge is considered as an income for them. But in the case of IB system, IB1 does not charge an extra amount for the delay but they have the opportunity to charge a penalty if only it is stated in the agreement. But IB1 cannot include it as income and instead the amount is transferred to a separate charitable fund. Mostly, term financing facilities tend to dominate in two banks among other financial options. (Figure 1) These findings are consistent with the findings of Alam (2000), Karim (1996), Wilson (1987) and Haron (1998)

Figure 1. Deposit Composition – IB1 and CB1



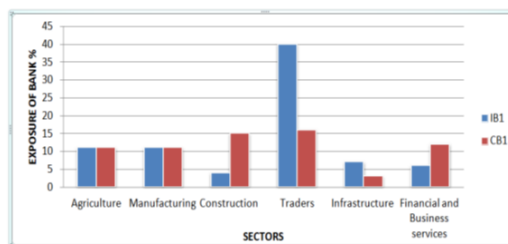
Source: Researcher’s own construction (based on the annual reports of 2011 of two banks)

As CB1, IB1 offers other fee based products such as treasury products to customers but following Shariah principles. Further, CB1 tends to offer fund transfers, pay and standing orders, safe deposits lockers and pawing facilities while IB1 only offers fund transfers, pay and standing orders and they do not offer safe deposits lockers and pawing facilities to its customers at present.

When considering the investment in two streams, IB1 only invest in the securities and the organizations that are ethical and interest free. However, CB1 is not subject to such restrictions and they have the opportunity to invest in the sectors and securities that they intend to invest. Further,

IB1 holds deposits with other CBs, but under its Islamic window. Thus IB1 only places deposits with Islamic financial institutions and they cannot invest as intended like CB1. Investment sectors of the two banks are tending to differ, but they both cater to agriculture, manufacturing, construction, traders, infrastructure as well as financial and business services sectors. Traders dominate CB1 followed by construction sector, while traders dominate in IB1, followed by manufacturing and agriculture sector. (Figure 2)

Figure 2. Exposure of Financing of Banks in Common Sectors – IB1 and CB1



Source: Researcher’s own construction (based on the annual reports of 2011 of the two banks)

It is evident that IB1 and CB1 offer identical products to customers, but still there are differences among two systems due to the fact that unlike to CB1, IB1 follow Shariah principles, Islamic law and Shariah product concepts in providing these products. As a result though the products and services of IB1 have identical features as of CB1, the philosophy and the operations of two banks are deemed to be different from one another.

IV. CONCLUSION

Findings concluded that the Islamic banks and the conventional banks enclose differences as well as similarities in their framework specifically pertaining to the aspects functions and products structure. This is mainly driven by the major principles of interest free paradigm, Profit and Loss Sharing paradigm and Shariah principles for the emergence of unique structure that differentiate an IB from general CBs. Differences have been highlighted more than similarities between these two systems which confirmed that Islamic banking is not a mere copy of conventional banking as follows.

Functions: CBs as well as IBs perform multiple functions such as deposit mobilization, agency services and general utility services to meet the needs of banking customers. Though IBs perform

identical functions as CBs, their functions are unique than CBs as IBs function in accordance with Shariah principles and interest free framework, whilst CBs operate within the framework of interest and they do not follow any religious law as Shariah. However, both systems place a major emphasis on deposit mobilization than other functions as they earn higher income by advancing loans. IBs exist to achieve the objectives such as socio-economic justice, fairness and equality, whereas CBs main consideration is to maximize returns. Furthermore, IBs are required to develop a customized information system that supports interest free products, PLS paradigm and Shariah principles in performing these functions. Hence, they do not adopt current banking software systems as CBs, as those softwares' are developed based on interest products.

Products and services: Both CBs as well as IBs offer current, savings and investment accounts to banking customers based on interest and latter on PLS ratios which are pre-decided. But the actual profits and loss shared depend on the monthly earnings of IBs. Therefore, profit rates to customers of IBs are subject to change according to its monthly profits. Unlike CBs, IBs follow Shariah product concepts Mudharaba in forming savings and investment accounts. Thus IBs offer more profits rates to saving account holders and less profit to investment account holders. Further, the term deposits tend to dominate in CB sector, while savings deposits dominate in IB sector.

The two banking streams offer identical financing options, term financing, trade financing, house financing and lease financing options against collateral. But still many differences have been identified between two banks as IB follows Shariah product concepts such as *Mudarabah*, *Musarakah*, *Murabaha*, *Diminsihing Musharaka*, *Ijara*, *Wakala*, *Import Murabaha* and *Import Musawamma* as well as PLS paradigm in offering financing solutions to its customers. Hence, under PLS ratio, IBs and borrowers share the profits on an agreed ratio and the losses according to capital contribution. In contrast CBs offer financing options based on interest.

Further, IBs do not offer financing solution or invest in organizations that operate in unethical or socially harmful industries such as liquor, gambling and tobacco irrespective of their profitability. In the case of CBs, they do not face such restrictions and

lend to borrowers who have creditworthiness. In a case of default or delaying the loan instalments, CBs charge an extra interest from the borrowers and it will be an income for them. But in IB system, they cannot charge an extra amount for the delay but they have the opportunity to charge a penalty if only it is stated in the agreement. But IBs cannot include it as income and instead it is transferred to a separate charitable fund. Mostly, term financing tend to dominate in two banking systems among other financial options.

When considering the investment in two streams, IBs only invest in the organizations that are ethical and interest free. However, CBs are not subject to such restrictions and have the opportunity to invest in the sectors that they intend to invest. Further IBs only place deposits with Islamic FIs and they cannot invest as intended like CBs. Investment sectors of two streams are tend to differ, but they both cater to agriculture, manufacturing, construction, traders, infrastructure as well as financial and business services sectors. Traders dominate CB sector followed by construction sector, while traders dominate in IBs, followed by manufacturing and agriculture sector.

The explanations for differences between two banking systems have been majorly driven by the Islam law and the application of Shariah principles. Islamic banks adhere to Islamic laws and Shariah principles in addition to standard banking rules in performing banking activities while conventional banks only follow standard banking regulations.

At present, Islamic banking system is still in its initial stage in Sri Lanka and is required to take steps in developing the system parallel to conventional banking system as it is beneficial to the customers as well as to the economy in a way of employment and earning generation. This study suggests important implications to academicians, researchers, policy makers, bankers, and customers to explore the potential benefits of Islamic Banking.

Based on the findings, this study indicates the following avenues for further research. First since the present study focus on only on functions and product structure, the future researchers can extend the study by adding more variables of their interest and carryout a comparison between IBs and CBs. Another opportunity for future research exists as a similar study can be conducted in other

financial sectors to identify the similarities and the differences in their operations such as comparing conventional and Islamic leasing companies, insurance companies etc. This study is conducted based only one IB and only one CB. However it would be more worthwhile if a comparison is made with more IBs and CBs in SL. Hence future researchers can undertake a study to compare IBs with Islamic windows of CBs. On the other hand they can carry out similar research by including Islamic windows of CBs too.

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