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Islamic finance: complement or substitute to conventional finance?

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Abstract:

Emerged in the early 1970s, Islamic finance has seen its rise on the world stage after the last financial crisis. This crisis has seen the rise of several channels claiming the importance of Islamic finance as preventive weapon against the outbreak of any crisis while others reject this idea and see in Islamic finance as a complement to conventional finance in terms of collecting savings and improvement of banking services. The update of this debate is the goal of this article. Through the experience of Iran and the Maghreb countries in the Islamization of the banking sector we will try to reveal whether Islamic finance could be a substitute for conventional finance and how this would be possible?

Key words: banking, Islamic banking, conventional finance

JEL Classification: G21, G32

Introduction

Since the 1970s, Islamic finance has grown remarkably in several Muslim countries namely Iran and Saudi Arabia, while in other countries it has seen a slight rise that is the case for Tunisia, Algeria and Morocco and other Western countries namely France.

Islamic finance has experienced remarkable integration into the global economy. In 2008, the size of the industry is 700 billion US dollars in the world with 500 billion US dollars are captured by airlines and banks takafuls and US $ 200 billion in funds. It grows very quickly at a growth rate of 30-35% per year. This "globalization" of Islamic finance is fueled by several factors. The first is related to the influx of petrodollars generated by the increase in oil prices that blew investment demand in the Gulf. The second factor is a sense of disappointment that results from the inability of Western financial capitalism to prevent and deal with the succession of financial crises and especially the last global financial crisis. The third factor is related to the increase in the number of Muslims in the world representing 1,4milliards in 2008 and especially in Western countries which has entre13 and 15 million Muslims. It is in this sense that several countries are open to Islamic finance to drain global savings and especially the Muslims who live in these countries.

In order to diversify the range of banking services to meet the needs of certain segments of the population and improve the deepening of the economy, several Western countries and North Africa have turned to Islamic finance.

After the last global financial crisis, Islamic finance has been considered by many economists as an alternative to conventional finance; while for another it cannot be him further. The debate on this question is the goal of this article.

This work is as follows: we will first identify the differences between Islamic finance and conventional finance, then we will try to answer the question is what Islamic finance is a substitute or a complement to conventional finance?

I- Islamic finance and conventional finance: what are the differences?

Currently the debate on Islamic finance is booming which leads us to better understand the foundations and principles of such finance.

Islamic finance represents a number of ethical principles, which differ from those of conventional finance. It draws its principles from five sources of Shariah which are: the Koran, the Sunna, the qyas the ijtihed and ijma. In fact, there is an Islamic financial institution the "Shariah Board" which includes competent, having a great knowledge of Islamic law, finance, financial engineering and therefore ensures compliance of Islamic financial products standards of Shariah.

Islamic finance is based on some fundamental principles:

- The First fundamental principle is the prohibition of any practical interest, "riba" considered usurious and blamed by the Quran in Sura II, verse 275: "God has permitted trade and forbidden usury" and also by Hadith "God has cursed the one who eats wear, the giver, the one who testifies and the one that establishes the contract." According to sharia, the "riba" is considered illegal and immoral income.
- The Second corollary of the first principle is the sharing of profits and losses between the bank and customers. This sharing must be fair between the lender (investor) and the contractor (the borrower), whatever the type of financing used.
- The Third principle is that any financial transaction is backed by a tangible asset.
- The Fourth concerns the prohibition of illegal economic activities considered in Islam (haram), namely the arms, alcohol, pornography, the gaming industry etc.
- The fifth principle is the prohibition of hoarding by the Qur'an in Sura 9, verse 34: "those who hoard gold and silver and do not spend it in the path of God, proclaim a grievous penalty». As hoarding diverts funds from productive activities.

- The Final principle is related to the prohibition of speculation or "Gharar" according to Muslim ethics or as situations of uncertainty (maysir).

The result is the importance of the integration of Islamic finance in most countries saw their populations increase the number of Muslims.

Islamic finance has several financing instruments that are approved by the scholars, Muslim scholars and experts in sharia have the ability to decide on the conformity of a financial product with the financial law. The most important Islamic financial products are:

The Musharaka

It is an operation of association between the investor and the bank. In this sense, both parties are responsible and investment managers. In addition, profits and losses are shared in proportion to the capital between the bank and the investor. The sharing of profits and losses agreed in advance between the two parties. This is similar to a joint venture.

The Mudaraba

This is a partnership between the bank "rab el mal" provider of financial aid and "mudarib" borrower. One - is solely responsible for the investment management that must be lawful "halal" while the bank supports only the loss in case of failure of this investment, in the opposite case, the profits will be distributed according to a key sharing agreed in advance between the bank and the investor.

Both financial products (Mudaraba and Musharaka) have profits to equity transactions and losses and therefore compensation results achieved downstream of the financing transaction.

L'Ijara
This is a similar operation -bail credit. The bank buys goods leased to the client. It agrees to pay rent and the opportunity to purchase the property, in this case we speak of a lease or selling of "Ijara wa iktinâa".

The Murabaha
This is a transaction operation of a commodity by the bank in favor of the account of his client. The price of the goods plus a profit margin determined by the bank and negotiated in advance.

The Sukuk or "Islamic duty"
It is a title created in the 1970s in Malaysia and which is analogous to an obligation but not bearing interest rates and mainly used for real estate financing. In 2002, the total value of sukuk did not exceed one billion dollars while in 2005 it is 10 billion.

L'istisna
This is a construction contract in which the client requests a builder to build a structure payable through a financial, advance, forward or in installments, in accordance with specifications.

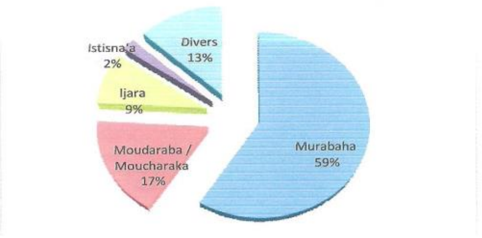
Quard Hassan
This is an interest free loan granted under certain considerations in case of difficulty of an individual or a business, or to promote the development of emerging industries.

Salam
This is a forward sale that is to say the payment is made in cash when the delivery is made in the future. Islamic finance prohibits the sale of a non-existent good but in some operations, especially in agriculture, exceptions may be granted.

Salam contract is therefore used to replace some products namely futures or options as these products reflect gharar elements that make them incompatible with Islamic law.

These financial products (Murabaha, Ijarah the, salam and istisna) are sales transactions of merchandise or service credit and lead to debt for the party purchasing these goods and services. The remuneration of the bank is therefore part of the selling price.

Figure 1: Breakdown of Islamic assets by product type



Source: Moral report on the money in the world (2005), Financial Economics Association.

The following table summarizes its Islamic financial products and analogues for conventional banks.

Table 1: Islamic and conventional financial products

Islamic banking	Conventional Bank
Mudaraba	Capital-investment
Musharaka	Capital-investment
Murabaha	Microcredit
Ijara	leasing
Qard -hassen	Ready mutual
Bay'mu'ajjal	forward sale or forward
Bay'salam	bail Sale
Sukuk	Bonds

Source: Errico & Farahbaksh, 1998.

Islamic banking makes the same services as conventional banks. It is an intermediary between borrowers and owners of capital. It collects deposits (demand, time and savings) and uses it in provides banking operations, but by banning the interest which the Crown is participation.

The following table reflects the results of an Islamic bank.

Table 2: Summary of an Islamic bank

A. Actif	**B. Passif**
1. *Capital* **2.** *Currency* **3.** *Islamic financing receivables*	**4.** Share Capital **5.** *Current deposits:* deposits no interest similar to those of conventional banks in exchange for the service and checks overdraft privilege. capital guaranteed **6.** *Savings deposits*: opportunity not guarantees to be paid by the profit of the bank. Capital secured or unsecured, according to bank. Finance especially for low-risk short-term projects **7.** *Investment deposits:* finance • mu of Araba and araka mush. Share of profit (and loss). Unsecured capitals as before enable sharing of loss in the case of mush araka. **8.** *Zakat funds*: powered by legal alms collected from shareholders, depositors and employees **9.** *Net worth* (total A-4-8)

Total A = Total B

Source: Adapted from Haqiqi and Pomeranz (1987) and Abdul Gafoor (2000, chapter 4).

For Islamic finance, three main objectives in terms of monetary policy used to cancel the interest rate, namely the stability of the value of the currency, economic well-being with full employment and the growth rate optimum economy and equitable distribution of wealth.

Like the conventional banking, Islamic banking is also made up of an Islamic central bank that performs the same functions as a conventional central bank. In addition, the Islamic bank uses the various instruments of monetary policy that does not conflict with Sharia with the exception of the discount rate that does not exist.

The need of an interbank market was largely defended by several Muslim economists such as Iqbal and Mirakhor

(1987) who saw that this market allows increasing the liquidity of the banking system.

Islamic finance and conventional finance are characterized by several points mainly in risk, structuring of financial products and skills required. Thus Unlike conventional finance, Islamic finance provides funding directly to the real economy and to prohibit financial intermediation.

However, some authors believe that there is no fundamental difference between the two financial systems and that the religious argument is just a "marketing" argument used to attract Muslim customers. The result is that Islamic finance has the same purpose as conventional finance: the mobilization of financial resources and their allocation to investment projects and that it is not a system based solely on bans and restrictions.

II-Islamic finance: complement or substitute to conventional finance?

With the recent global financial crisis, several economists have seen in Islamic finance an alternative to the current international financial system, while others have questioned this idea.

Islamic finance can provide a credible alternative since it is based on the principle of direct participation in the risk of investment and the prohibition to sell products that do not exist, in addition, all transactions are conducted on a sphere real do not encourage excessive debt economic unlike conventional finance which is largely cut from the real economy and is based on financial products and services. Islamic finance is thus based on sounder and less speculative banking practices.

In addition, Islamic financial institutions are less exposed to the crisis than conventional banks. The recent financial crisis has its origins in an increased mortgages called subprime risk (subprime mortgage meltdown), granted at variable interest rates and weak early in high-risk borrowers. Then, these loans were converted as the financial market including: "Investor confidence has faltered due to the development of securitization not mastered." It follows that for monetary policy purposes, the Federal Reserve raised interest rates which put these borrowers in default. This results in a failure of funding and liquidity in the interbank market failure.

By contagion, this crisis has led to the deterioration of the international financial markets. Hence, the fragility of the international financial system and the bankruptcy of a large number of financial institutions.

Islamic banks prohibit interest (riba), and therefore they are not exposed to the US mortgage market, a market rate, and consequently we will not have the thousands of people who have access to credit and real estate. In this sense, we can say that if the US financial system was Islamic to the base, we would not have had the outbreak of the crisis "subprime".

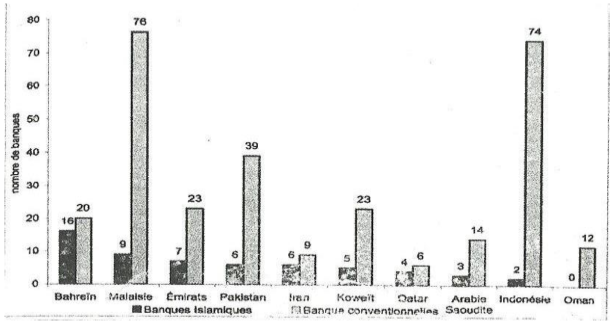
However, Islamic banks as conventional banks may be affected by the international financial crisis. The Islamic financial system is not quite perfect since it is in an unstable global environment and consequently the Islamic financial system is not immune to any turbulence affecting the international financial system.

In addition, Islamic finance is considered a "simple" finance and devoid of financial products that can meet the needs of the market.

1-A Case Study of Iran

Islamic finance is concentrated mainly in Malaysia, Iran and the Gulf countries. The so-called Islamic countries do not practice 100% Islamic finance. The following graph shows the coexistence of Islamic banks and conventional banks in these countries.

Figure 2: The number of purely Islamic and conventional financial institutions in the Gulf countries and Asia (2006 data and 2007)



Source: Saidane D. (2009) "Islamic finance in the era of globalization", Edition Review Bank, p27.

In fact, all countries in South Asia and the Middle East-is the Sultanate of Oman exception practicing Islamic finance while in Egypt, the University of Al-Azhar issued a fatwa authorizing interest rate.

Currently, Iranian banks are the first in terms of total assets in the world, followed by Saudi banks and the Malaysian banks.

The banking system of Iran has turned into Islamic model in the Islamic revolution of 1979. The application of the law on banking-wear in 1984 and therefore reflects the abolition of the use of rates of interest.

Units' purely Islamic banks in the banking system of the country account for 67% of total banks in 2006 and 2007.

Deposits authorized by these banks are: the so-called deposits gharz-ol-Hassan is savings accounts with no annuity interest. Futures investment banks who are paid on a percentage fixed in advance of profits made by these banks with these funds.

The credits are allowed in the financing of direct investment projects, lease-purchase, purchase and short-term resale, purchase term production and interest free loan.

In addition, all lending rates and deposit of public banks are determined by the central bank. Officially, the banking system is Islamic; these rates are the rate of profit. In reality, these are interest rates.

Table 3: deposit interest rates and bank loans public banks in 2008

%	**Short term**	**1 year**	**2 years**	**3 years**	**4 years**	**5 years**
The deposit rate	7-8	12-16	13-15,8	13,7-15,8	13,8-16	16
%	Manufacture and mines	Housing	Agriculture	Trade	Exports	
Taux d'intérêt des crédits bancaires	12	11	12	12	12	

Source: Thierry Coville (2009), op cit, p12.

The study by Thierry Coville (2009) showed that the financial system and the banking system mainly Iran is not affected by the recent global crisis and this is due to the weak integration into the international financial system and not because of the Islamization of its financial system.

2-A case study of the Maghreb countries

Islamic finance to the Maghreb countries dates back to the 1980s, the banking system in these countries has been the opening of some branches of banks specializing in Islamic finance and thus become a mixed banking system (conventional and Islamic).

In Tunisia, the first Islamic bank offshore was founded in 1983 is Al -Tunisi Ettamwil Beit Al Saudi which has become Al-Barka Bank from 1 January 2010. It is a subsidiary of Al Barka Banking Group, 20% of the capital of the bank is owned by the Tunisian state. The activity of individuals is limited to deposit and savings paid by a halal profit.

The second Islamic bank offshore, Noor Islamic Bank was established in 2008. It is a subsidiary of Dubai Investment Group but the bank has made its own closed due to the recent financial crisis that has hit hard.

The third Islamic bank is the Zitouna bank created in September 2009. Several branches were opened in all governorates of the country from March, 2010.

For Algeria, the first Islamic bank Al Baraka offshore was created in 1991 with the capital is held 50% by the former public -Bank of Agriculture and Rural Development and 50% by the Saudi group Al Baraka. The second Islamic bank Al Salam Bank Algeria was created in 2006.

Morocco has seen the creation of two banks: International Financial Services Board in 2006 and BAM in 2007.

The financial system in the Maghreb countries is largely dominated by conventional finance, inherited from the colonial period and remains firmly rooted in these countries, which explains the low presence of Islamic finance. This limited presence may also be explained by the refusal of the political authorities to practice Islamic finance and the existence of a less conservative majority population of Islamic law.

Open to Islamic finance to drain more savings for the benefit of the economies of the Maghreb countries has become a necessity in order to contribute to a better banking services of these economies remained still under-banked. According to D. Plank (2007), the banking rate is 25% in Morocco, 20% in Algeria and almost 33% in Tunisia.

In addition, this recourse to Islamic finance comes to meet the needs of a certain category of the population in remarkable growth. The development of Islamic finance, as it exists today in these countries is an opportunity to improve the competitiveness of the financial center of the country.

In fact, the banking sectors of the Maghreb countries are far from being affected by the recent financial crisis. The banks of these countries are weakly related to the international financial market and have few assets abroad; similarly, the currency is not fully convertible and financial institutions do not use techniques that have been the cause of the financial crisis, namely securitization. It shows that the financial systems of these countries are not strongly integrated into the international financial system.

Conclusion

Islamic finance is ultimately the same purpose as conventional finance but the form of operation is different. However, Islamic finance must evolve to adapt to the needs of the international financial market. In this sense, it cannot be a substitute for conventional finance but a complement.

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