Hypothesis, Operation Target, Risk Management: A Comparative Study of Islamic and Conventional Commercial Banks

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ABSTRACT
Based on modern financial intermediary theory, this paper examines the similarities and differences between Islamic banks and conventional commercial banks in the aspects of hypothesis about human nature, operation target, financial standardization and disclosure. The paper points out that Islamic banks have diverged from the ideal PSL model to lease and sales-based contracts in last 20 years, and moreover, the development and growth of Islamic banking was the result of reconciling conventional banking system with the sharia. In future, Islamic banks and conventional commercial banks will get more compatible in financial inclusion, risk management and theories on modern enterprise management.

Keywords: *Islamic bank, conventional commercial bank, difference, compatible*

1. INTRODUCTION

Islamic banking has its special principles and foundational theory. A pioneering experiment of putting the principles of Islamic banking into practice began in 1963 with the establishment of the Mit-Ghamr Islamic Saving Associations in Egypt (World Bank and Islamic Development Bank Group, 2017).[1] At that time, some similar Islamic financial institutions were established in Islamic countries, such as Malaysia and Pakistan.

In 1970s, many Islamic Banks were established (Dusuki, 2012)[2]: the Islamic Development Bank was established in Saudi Arabia in 1974; Dubai Islamic Bank was established in 1975; the success of early Islamic banks led to the establishment of a series of similar banks, Faisal Islamic Bank of the Sudan in 1977, Faisal Islamic Bank of Egypt in 1977, Kuwait Finance House in 1977, the Islamic Investment Company— Bahamas in 1977, the Islamic Investment Company of the Gulf— Sharjah in 1978, the Jordanian Islamic Bank in 1978, Bahrain Islamic Bank in 1979, and the Islamic Investment Company of Pakistan in 1979.

In 1980s, more Islamic banks were established and developed rapidly in the Middle East, Northern Africa, the Persian Gulf and Southeast Asia. IMF issued the first batch of papers about Islamic banking and finance in 1980s (Haque and Mirakhor, 1986; Karsten, 1982; Khan, 1986).[3]

Singapore was considered to be one of the pioneers of Islamic finance because of the Mendaki Growth Fund launched in 1991. Now Singapore is developing into a hub for Islamic finance. The United Kingdom is home to a number of Islamic Banks, and is positioned as the leading Western Hub for Islamic Finance. The scramble of Islamic financial hub between Singapore and U.K. indicates that Islamic Bank has a space in non-Islamic countries (Riazet al. 2017; Xiaomeng Ren, Jinchuan Shi 2017).[4][5].

From 1990 to 2010, Islamic Banks made great success on deepening the capital market, improving financial service, innovating new products, and managing banking assets. In 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established and issued accounting, auditing, and sharia standards for financial reporting at Islamic financial institutions. In 2002, the Islamic Financial Services Board (IFSB), and the International Islamic Financial Market (IIFM) were established. In 2010, IMF agreed to officially recognize the core principles of

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Islamic Financial regulation for banking as part of their standard and codes initiatives (Hassan and Aliyu 2017).[6]

2. THE DIFFERENCE BETWEEN ISLAMIC BANK AND CONVENTIONAL COMMERCIAL BANK

2.1.Hypothesis about human nature

Human nature is a bundle of fundamental characteristics—including ways of thinking, feeling, and acting. The concepts about human nature are not always the same because it depends on traditions, cultures, and religions. So, different people may have different hypothesis about human nature.

2.1.1. Hypothesis about human nature in Islamic Banking

Islamic Banking is based on two fundamental principles: justice and legality. Justice is achieved mainly through the sharing of risk. Legality means that all activities must be compliant with the sharia. The operation motive of Islamic banks is to pursuit harmonious development of the whole society, not maximization benefits.

Maslow's (1943, 1954) hierarchy of needs theory is a motivational theory in psychology. Every person is capable and has the desire to move up the hierarchy toward a level of self-actualization. In self-actualization, a person comes to find a meaning to life that is important to them. In *the Human Side of Enterprise*, McGregor (1960) talked about two theories called Theory X and Theory Y. He identified a participative style of management which "assumes that people will exercise self-direction and self-control in achievement organizational objective to the degree that they are committed to those objectives". This is the development of motivational theory.

Islam grants substantial freedom in almost every aspect of life. For any transaction, the parties in contract are free in deciding their terms and conditions. However, some activities are prohibited, such as gambling, speculations, excessive uncertainty, and any other activities to be detrimental to society (Maha-Hanaan,2011).[7] Islamic banking assumes that the human nature seems to be a multi-dimensional combination of self-actualization and self-control. Based on the assumption of self-actualization, Islamic banks make all stakeholders develop together, and finally realize harmonious development of the whole society. Meanwhile, based on the assumption of self-control, as a medium of finance and investment, Islamic banks must be with the idea of bounded rationality for attaining social justice.

2.1.2.Hypothesis about human nature in Conventional Commercial Banking

Hypothesis about human nature in conventional commercial banking conforms with the basic concept of Economic Man. By studying the behavior of individuals and firms, the western micro-economics assume that human beings are motivated by self-interest, and seek their benefit maximization. In 18 century, Adam Smith pointed in his book of *The Wealth of Nations* (1776) that every individual "...... led by an invisible hand to promote an end which was no part of his intention. …… By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it." Later, John Stuart Mill (1884) explicitly brought up the term of economic man in accordance with the theories of Smith and Senior. Specifically, economic man is an individual who is creative, acts rationally, and can seek to maximize his benefits. In fact, economic man implies the assumption of rational man, that means he could use the principle of cost-benefit analysis or "profit and avoid loss" principle to compare all possibilities, goals, and ways to achieve a goal while making an economic decision in order to work out or choose one strategy to maximize his benefits.

In fact, the principle of maximizing the shareholder value in conventional commercial bank is the duplicate of the assumption of economic man. The basic meaning is how to choose the best composition of input-output, and maximize the benefits under a specified condition of technology and resources.

2.1.3.Interpersonal Relationship in different hypothesis about human nature

Under different hypothesis about human nature, interpersonal relationship in Islamic banks and conventional commercial banks present different pictures. In Islamic banks, every stakeholder is equal in dignity, and the difference between them is social division of labor. Islamic banks take into consideration different capability, different responsibility, and different requirement. Some act as leaders, some act as executors; some need help, some offer help. In different situations, an individual may play different roles. An individual is a specializing person with high or low capability, and has his own job.

In conventional commercial banks, the relationship between bank and stakeholders is equal value exchange under equal condition, and every individual seeks to maximize his benefits.

2.2. Operation Target and Operations

2.2.1.Operation Target

On the base of different assumption about human nature, the operation target is significantly different between Islamic banks and conventional commercial banks. For operation target, Islamic banks attach importance to social responsibility more than business benefit, but inversely conventional commercial banks attach importance to business benefit more than social responsibility. The operation target of Islamic banks is to prompt social justice, improve social welfare, strengthen financial inclusion, prevent any illegal activities which are not compliant with sharia, such as the use of interest, gambling, speculations, excessive uncertainty (gharar), and any illegitimate transactions that are related to pornography, tobacco, short-selling, alcohol, and any other activities considered to be detrimental to society. However, the principles of safety, profitability and liquidity are regarded as the basic principles of conventional commercial bank, and benefit maximization is the test criterion for all activities.

2.2.2.Operations

Due to different hypothesis about human nature and basic principles, some typical operations of Islamic banking are obviously different from conventional commercial banking. The transaction in Islam banks must be compliant with the sharia, while conventional commercial banks need not. Islamic banks developed some distinctive products mainly including Musharaka, Mudharaba, Murabaha, Ijara(Leasing), and Sukuk(Islamic bonds).

Table 1. Main financial instruments of Islamic

Model	name	Main Feature
PLS	Musharakah	Musharaka is a profit-and-loss sharing partnership, which underlines all partners to share losses and distribute profits in proportion to capital contribution. Generally, the investment is to own real estate (the real estate must not violate the Islamic banking principles. The same below).
PLS	Mudharaba	Mudharaba is a profit-sharing and loss-bearing contract. One party (financier) supplies funding, and another party provides skill, management expertise or the necessary experience for making a profit. The profit will be shared between the partners according to a pre-determined profit sharing ratio (not interest), but the losses are borne entirely by the financier. A number of Islamic banks have formed funds applying the rules of mudharaba to buy real estate assets.
Non-PLS	Murabaha	Essentially, murabaha is similar to collateral loans. The Islamic bank purchases a specific commodity upon the request of a client, and then the client purchases the commodity from the bank on a deferred payment basis at an agreed mark-up. The mark-up covers the cost of purchasing the commodity, the risk of the transaction, and a profit margin.
Non-PLS	Ijara(Leasing)	Ijara is essentially a lease contract. The Islamic bank purchases an asset, and rent it to a lessee for a specific time period at an agreed rental. One type of Ijara is a longer-time lease like a hire-purchase contract by the end of which the leaser will sell the asset to the lessee with the price of the residual asset. A second type is short time, which is similar to an operating lease. By the end of the contract, the asset will be returned to the bank.
Between PLS and Non-PLS	Sukuk(Islamic bonds)	Sukuk is a type of Islamic investment certificates. In 2003, AAOIFI defined it as "Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the

		ownership of) the assets of particular projects or special investment the assets of particular projects or special investment activity". Generally, the income from it must be related to the purpose for which the funding is used, it must be backed by real underlying assets, rather than being financial derivatives. Sukuk has been identified as one of the key financial instrument for the further development of the Islamic banking and finance industry.

Dubai Islamic bank (the largest Islamic bank in the world), which has made great progress at about 15% speed since 1990(see the balance sheets from bloomberg,2019), for instance, have all the financial instruments in Table 1, and some special operations, such as no interest loans, zakat, est.. Most investments are tangible assets including real estate, land, properties held for development and sale.

Besides regular financial products including all types of loans, investment, deposits, and lending, conventional commercial banks have developed various financial derivatives such as exchange rate derivatives, interest rate derivatives, equity derivatives. These financial derivatives have played very important roles in the operations of conventional commercial banks since 1980s. It was well known that financial derivatives directly led to a serial of main financial events, such as Bahrain Bank falling in 1995, SocGen falling in 2008, especially the global financial crisis from 2007 to 2009. However, Islamic banks could avoid the disaster of the global financial crisis from 2007 to 2009 because they scrupulously abided by their basic financial principles and operation target.

2.3.Price of Money

For conventional commercial bank, interest rates are the prices of borrowing (and lending) currency. This rate of interest is the price of money. For all types of savings in conventional commercial banks, interest payable will occur even though the deposits are not be used. The interest margin (the difference between the interest income generated by banks and the amount of interest paid out to their lenders) is the main source of profit of conventional commercial banks.

However, unlike conventional commercial banks, there are not interest payable for current account deposits and other funding in Islamic banks because interest is definitely prohibited. This is a distinct feature of Islamic banks. Interest-free deposits are held in safe-keeping, and the bank is deemed as a keeper and trustee of funds and has right to use the funds for its financing operations and share the profits with the depositors. Islamic banks are discouraged to create leverage, which makes Islamic banking system less risky compared to conventional commercial banks (Van Greuning and Iqbal, 2008).[8] In brief, operations backed by physical assets make Islamic banks stable.

2.4.Financial Regulation

In principle, no matter conventional commercial bank or Islamic bank, must abide by the laws and rules promulgated by government or international groups. In contrast to conventional commercial banking, sharia supervisory board (SSB) is the super authority of Islamic banks, and makes sure that Islamic banks operate within sharia principles. The standards issued by the AAOIFI have some special features, such as the treatment of Zakat distributions, reserve funds for profit smoothing, and protection unrestricted investment account holders. Moreover, the IFSB serves as an international standard-setting body of regulatory and supervisory agencies for ensuring the soundness and stability of the Islamic financial services industry.

3. BEING COMPATIBLE WITH EACH OTHER

Islamic banks have some significant differences from convention commercial banks, but, by studying the operations of Islamic banks in last 60 years, and viewing the standards for international conventional commercial banks, we find that Islamic banks and conventional commercial banks are increasingly compatible in some aspects such as the projects inside financial reporting, financial standardization, financial disclosure and so on.

3.1. Projects inside financial reporting

3.1.1.Assets

The history of conventional commercial banks is over 300 years, while the history of Islamic banks is only about 60 years, so Islamic banks need to learn from and catch up conventional commercial banks.

In the beginning, Islamic banks attached importance to social responsibilities more than the motive of business profits, but they gradually diverged from the basic principles (Hassan and Aliyu, 2018).[9] The transactions of Islamic banks are dominated by Murabahah and Ijarah, which are regarded as sale and sales-based contracts. Essentially, Murabahah is a special type of collateral loans. Ijarah has two types (operating lease and finance lease). Some aspects of Ijarah are similar to conventional commercial banking, such as leased object (fixed assets), way of repayment (installment payment), end of the lease (ownership of the asset shifts or not), and profit sharing (price premium or pre-determined profit sharing ratio).

In addition, in the balance sheets of Islamic banks some subjects of assets are similar to those of conventional commercial banks, including cash, cash equivalents, investments in bonds (Islamic sukuk), investments in associates and joint ventures, and other investment in fixed assets.

3.1.2.Liabilities

In the financial statement of Islamic banks, the liabilities mainly include customers' deposits, due to bank and financial institutions, sukuk issued. These subjects are similar to those of conventional commercial banks. Take Sukuk (Islamic bonds) as an example. Islamic banks are the issuer and the main purchaser of sukuk. Generally, the sukuk more 10 years is part of Tier 2 capital of Islamic banks. This is basically close to the standards for bonds of international conventional commercial banks.

3.2.Financial standardization and financial disclosure

In principle, the financial regulations for Islamic banks are totally different from that for conventional commercial banks. Although Islamic banks are restricted to some special operations, there are some ordinary sharia-compliant transactions both Islamic banks and conventional commercial banks can do.

Islamic banks actively comply with the international framework and standards for conventional commercial banks. Dubai Islamic Bank, for instance, revealed equity in financial statement of 2017 as per the relative regulations in Basel II and Basel III [i]. The IMF has recognized the growth of Islamic banking, and emphasizes the framework and standards that will enhance best practice, and has advised the Islamic standard-setters to provide guidelines on deposit insurance schemes, the LORD, money laundering, and a resolution framework (Hassan and Aliyu, 2018).[9]

4. CONCLUSIONS

The current study shows that there are mutual influence and competition between Islamic banks and conventional commercial banks, some Islam countries have a dual banking system, and some multinational Islamic banks established branches in London and Singapore and went into the competitive system of the western developed commercial banks.

As Shusong Ba, Xianfeng Liu, Zheng Cui (2009) [10]pointed out, the development of Islamic finance is a process to reconcile conventional finance with sharia. Most of the studies on Islamic banking practice in last 20 years find that Islamic banks have diverged from the ideal PSL model to lease and sales-based contracts. Some studies find that interest rate is one of the key factors influencing the activities of Islamic banks.[11][12][13][14].

In future, Islamic banking and conventional commercial banking will be more compatible in the aspects of financial inclusion, financial risk management, and theories on modern enterprise management. The developing tendency, to some extent, is that Islamic banks will learn the latest development result and research methods from conventional commercial banks in order to bridge the gap between both sides.

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