

# The difference between islamic loans and conventional loans essay example

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## **Executive Summary**

Conventional banking is based on the issue of interest. However, most religious teachings, including Islam, are for the opinion that charging of interest is wrong and should not be prohibited. However, most of the modern banking systems are based on this principle. To steer away from this, the Islamic banking has derived ways of avoiding interest charges. One of these is the use of Murabaha. The essay below looks at the differences between the Murabaha and conventional loans.

## **Introduction**

According to Hanif (2011, p. 170), the trend in the modern banking system in which interests are charged is unacceptable to most religious institutions, including Islam, Judaism and Christianity. For the Christians, the Bible instructs them that, "Thou shalt not lend upon usury to they brother; usury of money, usury of victuals, usury of anything that is lent upon usury" (Deuteronomy 23: 19). The Quran, in the part of Surah Al-i-' Imran 3: 130, it clearly states that "O those who believe do not eat up riba doubled and redoubled." Riba is taken in the Islamic terms as a synonym for interest. Hanif (2011, p. 169) also illustrates that the use of interests was also prohibited among the Jews.

With such a strong belief against the use of interests, the Islam religion holds that taking of interest is Haram; which means something that is prohibited by the religion, or a taboo. Being very strict with their religion, the Islam seeks out ways of making sure that they do not comply with the wrong

financial strategies that are in existence today. Rather, they seek out their own ways of financing which are compliant to the Shariah laws. There are different modes of payment that are acceptable in Islam.

## **Islamic Finance**

Usmani (2012, p. 1) posits that there are different forms of payment that are acceptable in the Islamic sector because they do not incorporate the aspect of interests. One of these is the Murabaha. In its original meaning, the Murabaha is not a form of financing (Ansar Group, 2007, p. 1). Rather, it is a term of sale where the seller discloses the amount of money with which he has bought an asset, then adds some profit on it. This profit can be in terms of percentages or as a lump sum. Here, the main point to note is that the initial cost is disclosed to the buyer, which is not common in most transactions involving profits. Bai'Mu'Ajjal is another form of Islamic payment in which the parties agree that the payment of the price shall be deferred. This is also very closely related to the Bay'Bithaman Ajil (uob. edu. bh, n. d., p. 2) which is a form of payment where the goods are delivered upfront and the payments are made at a later date. Joudeh (2012, p. 3) concludes that all these forms of Islamic payments are based on the issue of profit and loss sharing. The burden is not left to the buyer. Rather, the seller and the buyer both hold a relative form of risk for the asset. There are different guidelines as to how the Islamic Financing strategies should be carried out (Goud, 2012, p. 1). However, this essay will just focus on Murabaha.

## **Murabaha**

The Ahli United Bank (2003, p. 1) posits that Murabaha, in the economic sense, is a cost-plus sale with deferred repayment. It is a form of financing that is compliant with the Shariah laws. However, Usmani (2012, p. 1) indicates that the original meaning of Murabaha was just a point of sale. The involvement of financing into the same has revolutionized the meaning to what is known today. In shedding some light on the issue, Ahmed (2007, p. 5) observes that there are some rules that govern how a Murabaha should be carried out. First of all, it is clear that Murabaha is not a kind of financing. Rather, it is a form of deferred payment where an individual pays for the goods bought at a cost plus. When the purchase has to include the assistance of a bank, the bank has to stipulate the form of goods that will be sold to the buyer in kind. This is in a way of avoiding any form of ambiguity in the contract. The bank also states the benefit it will get from the sale, and the duration in which the amount will be paid. Usmani (2012, p. 1) further indicates that the subject of the sale must be in existence at the time of sale, in its physical form, and must be in possession of the seller at the time of purchase. This possession of the asset must be either physical or constructive possession. The main aim of making sure that the seller has ownership of the subject is so as to make sure that there is risk distribution between the buyer and the seller. Furthermore, for Murabaha to hold, the sale must be instant and absolute and the subject of property must be of property value, not cash. Furthermore, the property should not be used for haram purposes, and must be specifically known and identifiable to the buyer. From these explanations, it can be seen that Murabaha is a form of

sale of property. As such, confusion arises as to how financing for the same can occur given that banks do not sell property. In dealing with this, Asmani (2012, p. 1) explains how Murabah financing can take place.

## **Murabaha Financing**

As already explained above, the sale cannot take place unless the item is in the possession of the seller at the time of transaction. In order to facilitate the Murabaha financing, Islamic banks have several features which ensure that the transaction takes place. This involves five major steps.

First of all, the buyer and the institution sign an agreement in which the institution makes a promise to sell the goods to the buyer at an agreed profit ratio on top of the cost. This is just a promise-promisor relationship that exists between the two.

Secondly, the institution appoints the buyer as the agent for the institution, signing agreement forms between the two. The client then purchase the commodity, but not as his own. Rather, he acts as an agent to the institution. The fourth step is where the client informs the institution of the purchase, and then offers an interest to buy the same property. This leads to the fifth and final stage where the institution accepts the offer and the ownership as well as risks associated with the property are transferred to the owner. These steps are just a formality of making sure that the terms of Murabaha are fulfilled, where the risk of the property has to be in the hands of the institution for sometime.

A similar scenario occurs when a client needs a mortgage (Ahli United Bank, 2012, p. 1). The client identifies the house, and then the bank buys it and immediately sells to the buyer at a higher price. The property is registered in the name of the client as a trustee of the bank, and then pays the bank in the agreed duration. As the client pays, the shares of the bank reduce, and go down to zero with the last installment. The idea here is to make sure that the risks of real estate are not borne by the client alone, but by the client and the bank.

### **Differences between Murabaha and Conventional Loans**

After looking at how the Murabaha functions and with a deep understanding of the same, it is possible to look at how it differs with the conventional loans lent by other banks. Right on the onset, it is worth noting that there are some criticisms about Murabaha, with some people arguing that it functions just the same as the conventional loans, only that it employs some logistics which make it look a little different (DIFC, 2010, P. 5). Irfan (2008, p. 1) also airs the same views, noting that the functionality of Muranaha and conventional loans does not make any difference to a banker. Nevertheless, it cannot be denied that there are innate differences between the two. These are as highlighted in the paragraphs below.

The first and obvious difference is that in Murabaha, the seller – the bank in this case – discloses the actual cost that it went through in acquiring the property. It then informs the buyer the profit margin to be charged. This does not happen with the conventional banks. They set the interest rates at a fixed margin and do not have to inform the client on the initial cost of

whichever product they have to sell. In conventional banking, the aim is to make the profits. Another obvious difference is that the conventional banks offer their financing in terms of cash. All that the client needs to do is to show the ability to pay back the principle amount as well as the interest charged. This does not happen in the Islamic banking as no cash is given. The financing has to be in kind; in terms of a tangible, physical property.

Besides the obvious differences, there are other complex differences which might not be very obvious. Hanif (2011, p. 169) looks at these differences in a broader perspective. The first difference arises in terms of deposits. He observes that depositing is similar in both institutions. However, the reward schemes tend to be different. In the conventional system, the reward is pre-determined and the client knows that the deposits can earn him a given reward after a given time duration. However, the Islamic banking does not have a fixed rate. The risks and rewards are shared equally between the depositor and the institution. The same comes in when there is the issue of financing and investment. The conventional banks and the Islamic financing allow for credit facilities in terms of investment. However, their modes of interest are very different. The conventional banks offer a loan on which there is a fixed rate of interest. This is not determined by whether the client makes profits or losses. The bank has to get back the principle amount and the interest. However, the Islamic banks offer the assistance in form of Murabaha. They offer the assistance in kind, helping the client to purchase the goods for trade. The interest is not charged on the amount lent but on the goods sold to the client.

In the issues of overdraft and credit cards, the conventional banks offer the service where a customer can overdraw from his account on interest. This goes well with the credit cards where the customer can buy the products using a credit card or plastic money. Well, the same services are available to the Islamic faithful, but on Murabaha terms. As already explained above, the risk of the product has to be borne by the lending institution for some time before it finally falls in the hands of the client. The conventional banks charge the interest on such services immediately they avail such a service to the customer. However, the Murabaha laws have it that the customer is charged the interest once the goods are in his possession. This underlines the difference between the two.

Conventional banks as well as Islamic banking also do offer the agricultural loans. The conventional banks offer this service in cash. They give the money to the clients so that they can buy the farm inputs and everything else that they need for agricultural practices. The main point is that the client must return the principle amount and the interest, even if the money is not a direct product of the agricultural activities. Again, the Islamic Financing takes the Murabaha perspective. The loan is given to the individual in kind, such as seeds and fertilizers for the agricultural practices. The purchase is done as stipulated earlier in the Murabaha rules of purchase. The loan given to the client is taken as a form of purchase for the agricultural produce. As payment, the farmer will have to deliver the produce to the lending institution.



Housing financing is another area in which the conventional banking and the murabaha differ. As explained by the Ahli United Bank (2003, p. 1), the Islamic banking allows for the assistance in purchasing a house. However, the client identifies the house and fills a form indicating the interest in the house. The bank goes ahead and purchases the house, but in the name of the client as a corporate partner or a trustee. The house is then given to the client immediately after the purchase. The agreement is such that the client pays the bank the amount paid in installments. Every installment paid reduces the claim of the institution on the house. Eventually, the client pays the entire amount due as well as the profit that was pre-determined at the point of purchase. The house is, thus, left in possession of the client. The main aim as to why the bank has to retain a share in the house is to make sure that should the real-estate sector experience some problems, the client would not shoulder the risk alone. The risk would be shared between the two, as stipulated in the murabaha provisions. This is not the case in conventional banking. The conventional banks do have affixed interest rate on mortgages. They also do not have any shareholding in the property. As such, the client bears all the risks associated with real estate and also have to pay more interests to the banks.

In a summative manner, it can be seen that the main difference between Murabaha and conventional banking is that the conventional banks are bent on making profits through elevated profit margins. However, the Islamic banks, through Murabaha, are not concerned with taking of riba or interests.

## **The Future Prospects**

Goud (2012, p. 1) observes that the Islamic finance has made an impact in the business world and is no longer seen an outsider in the same. He, therefore, suggests that the system should do away with some of the conservative ways and try to take advantage of the current economic growth. These views are propagated by the fact that the Islamic banks have become more involved in the trade finance after the European banks withdraw due to the debt crisis. The Islamic banking could take advantage of this. DIFC (2010, p. 3) also airs the same views. They liken the Islamic banking sector to a 40 years old man who still lives in the fears of the 10 year old boy he once was. The idea here is that the banks should stop being so conservative. They should spread their wings and explore other areas beyond their Islamic boundaries. Well, this could be a long shot, considering that the Islamic banks are bound to the Islam religion, which is very strict on its rules and regulations.

## **Conclusion**

The above account has laid a great emphasis on the Islamic banking, with the main focus being the Murabaha. The main aim of the essay was to bring out the differences between the Murabaha and the loans offered by the conventional banks. In order to build the case, it was important to look at the definition of Murabaha and how it functions. Once this was understood, the essay then went on to look at the areas in which the Murabaha differs with the conventional loans. Literature has revealed that the differences arise in the manner in which the two institutions charge their interests. The

Murabaha is not focused on the interests the institution can gain from the clients. On the other hand, the conventional loans are focused on earning much interest to the lending institution. This brings out the main difference between the two.

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