

## 1. ISLAMIC VS CONVENTIONAL BANK

In Conventional System	In Islamic System
Borrows funds from the depositors paying interest on the liability side of its balance sheet.	Partnership (Mudarabah) or profit and loss sharing arrangement between the bank and the depositors
Lends the funds to the borrowers, charging higher interest on the asset or investment side.	Profit and loss sharing (Musharaka) or trade based financing arrangement (Mubadalah) between the bank and its investment clients
Between the depositors and the bank, there is an iron wall.	Islamic bank entitles the depositors, (a). To be informed of what the bank does with their money (b). To have a say in where their money would be invested (Mudarabah-e-Muqayyidah)
The interest or the return is predetermined or fixed in advance	The profit or the return is based on the actual investment outcome
Transactions are financial asset based	Transactions are real asset based

## 2. PERMANENT SOURCES OF ISLAMIC BANKS:

### Permanent Sources of Funds - Internal

Accumulated Profits (Retained Earnings)

- ▶ Capital Reserves
- ▶ Revenue Reserves

## **Permanent Sources of Funds - External**

### **Bank Accounts:**

- ▶ Non-Profit Accounts or Current Accounts (Demand Deposits) Qard-e-Hassanah Deposits
- ▶ Profit Bearing (on Mudarabah basis)
  - Savings Accounts
  - Investments Accounts

### **External Qard-Hassan Deposits**

- ▶ Like current account in conventional banks
- ▶ Kept for safekeeping and convenience in payments (transfers)
- ▶ No return or profit offered
- ▶ Checkable
- ▶ Face value guaranteed by the bank

## **Permanent Sources – Profit Bearing :**

### **Savings Accounts**

- ▶ Checkable just like conventional saving accounts
- ▶ The term to maturity is not fixed as in the case of term or fixed deposits
- ▶ Can be assigned by the depositor to participate in productive activities, thus becoming PLS accounts (Mudarabah-based)

### **Investments Accounts**

- ▶ Investor committed for a certain time period
- ▶ Usually not checkable
- ▶ Early withdrawal may be denied by the bank, but usually allowed as per the norms
- ▶ Usually there is a minimum period before which the withdrawal would result in denial of all profits
- ▶ For the withdrawals made after the minimum period, the weightage is reduced accordingly

### 3. TEMPORARY SOURCES OF FUNDS (Liquidity Management)

#### Special Mudarabah Portfolio

- ▶ Islamic alternative to overnight lending and borrowing
- ▶ A separate portfolio is created by several banks jointly

#### Securitization

- ▶ Islamic banks can securitize their assets (like real estate, Ijarah assets etc.) and raise the required funds

#### Salam

- ▶ Islamic bank enters a contract with another financial institution agreeing to provide specified commodity to that institution in future and get the money now.

#### Tawarruq

- ▶ Islamic bank purchases marketable (real) assets from the Financial Institution and sells it in the market to get funds

#### Back-to-back Financing

- ▶ If the bank has tight liquidity position it can direct the financing of a specific transaction to another bank

#### 4. FEE-BASED OPERATIONS:

##### Charge Fee:

Islamic banks can charge fee for providing following services:

- ▶ Checking account
- ▶ Money transfers
- ▶ L/C (Non-funded)
- ▶ Lockers (safe-keeping)
- ▶ Online services
- ▶ Debit Card and ATM services
- ▶ Collections
- ▶ Investment banking services
- ▶ Cash and Portfolio management advice
- ▶ Brokerage services

##### Letter of Guarantee

Fee for issuing Letter of Guarantee disallowed

- ▶ But the bank has the right to be reimbursed for expenses incurred in providing the Letter of Guarantee
- ▶ The amount charged should be uniform if the expenses incurred are same across various guarantees provided

#### 5. Musharaka in Bank Accounts

##### Musharakah in Bank Accounts

- ▶ Musharika = Mudarabah + Shirkah
- ▶ The relationship between the Bank and its depositors is essentially of Mudarabah
- ▶ Depositor = Rabb-ul-Maal
- ▶ Bank = Mudarib
- ▶ Restricted Deposits (Mudarabah-e-Mutlaqa) vs. Unrestricted (Mudarabah-e-Muqayyidah)

## Differences from Traditional Mudarabah

### (a). Commingling or Mixing:

The depositors' funds are mixed together in a big pool with their permission

### (b). Profit Sharing Ratio:

- ▶ should be fixed at the time of account opening
- ▶ can be different for different investors or depositors

### (c). Different Weights for Different Deposits

- ▶ Profit distribution weightage is usually higher for the long term customer funds
- ▶ Sharia allows variation in the profit distribution weights based on the principle that each Mudarabah contract between the bank and the depositor is separate and independent from the other

### (d). Weightage and Profit Sharing Ratio

It can be changed, but with 2 conditions:

- ▶ At the time of opening the account, an initial weightage should be agreed upon and,
- ▶ The schedule of revision of weightage scheme should be disclosed alongwith the outcome of actual revisions

## Profit Distribution:

(a). Actual liquidation is not necessary for computation of profit

(b). Profit can be ascertained periodically on the basis of the assessed market value of the assets

(c). Therefore, Mudarabah assets are valued at defined intervals to arrive at the profit/loss figure

(d). The bank deducts the management fee which is an agreed upon percentage of the Mudarabah profit

(e). The residual amount is distributed to the depositors' pool

(f). Within the pool, the distribution to individual depositors is made on the daily product basis

(g). The actual share of an individual depositor in these profits, thus, depend on:

- ▶ the average amount of his overall investment
- ▶ the period of investment measured in days
- ▶ the weightage assigned to the category in which he invested