

## **Shariah and Western Banking Compared: A Contractual Assessment<sup>1, 2</sup>**

**By Sarah Bennani Kemmoun**

### **Abstract**

This paper explains and analyses the main differences between western and Islamic banking in terms of revenue stream generation, risk, approach and ethics. The financial crisis in 2008 disturbed the western banking as households and organizations are seeking for alternatives. This paper will try to answer all the possible questions in order to help choosing a financial institution over another.

To do so, we compared the steps of both methods based on experts' speeches, official bank services and MADM (Multi-Attributes decision making) tool to assess the risk from the customer perspective.

The results showed that in terms of risks the Islamic banking is more keen to assist customers in their financial decisions and choices as both parties hold a partnership as opposed to the western banking which is more of a borrower/lender relationship. Therefore, in case of absence of payments both parties are put in risk while for the western banking all the risk is transferred to the customer regardless of the level of difficulty he might be in.

Even though the Islamic banking is the risky for customers it has still some work to do to gain in credibility and affirm itself in the market. With 1% of the global financial activities, Islamic banking is still weak when compared to the western banking that has been around for centuries.

**Key words:** Islamic banking, western banking, Shariah law, Haram- halal, Interests based activity, ethics

---

<sup>1</sup> Editor's note: Student papers are authored by graduate or undergraduate students based on coursework at accredited universities or training programs. This paper was prepared as a deliverable for the course "International Contract Management" facilitated by Dr Paul D. Giammalvo of PT Mitratata Citragraha, Jakarta, Indonesia as an Adjunct Professor under contract to SKEMA Business School for the program Master of Science in Project and Programme Management and Business Development. <http://www.skema.edu/programmes/masters-of-science>. For more information on this global program (Lille and Paris in France; Belo Horizonte in Brazil), contact Dr Paul Gardiner, Global Programme Director, at [paul.gardiner@skema.edu](mailto:paul.gardiner@skema.edu).

<sup>2</sup> How to cite this paper: Kemmoun, S. B. (2018). Shariah and Western Banking Compared: A Contractual Assessment, *PM World Journal*, Volume VII, Issue VI (June).

## **Introduction**

After the 2008 financial crisis, the world of finance has been disturbed as the conventional banking, that has been around for centuries, has shown some weaknesses. This left room for another type of financial structure which is referred to as Islamic banking. In fact, it offers customers a new way of seeking financial help.

The western and Islamic banking both have fundamental similarities and differences with a common objective which is to provide a financial solution to households, small ecosystems, but also organizations, large ecosystems.

The core DNA of Islamic banking is related to the Shariah law that prohibits paying interests, called Riba in Arabic, and also prohibits getting involved with organizations that deal with sinful or haram products and activities such as pork or pornography. Western and Islamic banks structure their financial products differently as, unlike Islamic banking, western finances don't filter the industries they provide help to. In fact, as long as there is a profitability with an assurance that the other party will pay the settlements, there is no reason to reject the financial help request.

This paper has been undertaken to identify the core differences and similarities of both banking systems regarding a home ownership plan. In fact, it will explain the different attitudes towards risks, the responsibilities of both parties when there is a failure to payments and also it will identify the revenue stream of both financial systems in order to highlight their differences and similarities.

In addition, this paper will also provide clarifications regarding the offers each institution has for large organizations that need finance for entrepreneurial investments. In fact, it will explain the relationship both parties have, how it is implemented and when does it end. It will also clarify the procedures and explain how they are different from one type of banking to the other.

Finally, ethics and cultural influences will also be discussed in order to show how both financial systems have evolved within the same environment and how they have affected each other.

The mission of this paper is to provide the reader with a clear idea of the methodologies and procedures undertaken by each banking types, highlighting their main differences and similarities. It will provide sufficient information to enable the reader to identify its banking interests and conveniences.

This will result in a clear idea of the objectives and targets of the western and Islamic banking insisting on their ethics and success factors.

To summarize, this research paper has been undertaken to answer the following questions:

1. How do Western and Islamic banking differ?

2. What is the ethic behind each banking type?
3. How are both types of contracts legally represented?

## **Methodology**

In order to understand both concepts of banking and analyze their differences and resemblances, I had to watch videos on professionals speaking about the subject and explaining in details the topic. I also used official banks websites to understand their formalities, rules and offers for customers. These tools enabled me to have different points of views on the matter as well as different perspectives as the Islamic banking is a recurrent subject in the world of finance and has a number of defenders as well as critics.

## **Multi- Attribute Decision Making (MADM)**

This tool is considered to be the most well-known branch of decision making. In fact, it concerns decision problems with a number of decision criteria. Solving a MADM problem involves sorting and ranking. In the context of this paper, the decision making is able to indicate preference information between two feasible alternatives.

The two alternatives here are the western and Islamic banking. As financial institutions involve “people”, we will base the assessment on one criterion which is the level of risk people face regarding each attribute. As a matter of fact, financing for households and organizations is always a risky step to make as it involves engagement with an institution that is enforced by the law. It is in fact an external help; however, it comes with inconvenient as well.

## **Application**

In the context of this paper, there are only two feasible alternatives which are western and Islamic banking. To these types of banking will be applied the following attributes:

- Ethical investment
- Non-predatory lending
- Socio-economic justice
- Business ethics
- Moral imperatives
- Interest-based activity
- Filtered industries
- Diversity of customers
- Cross cultural influence
- Profit-based activity

**A table with direct comparison of both banking types:**

<b>WESTERN BANKING</b>	<b>ISLAMIC BANKING</b>
Interest is at the core of the revenue stream as it is what the institution adds as a compensation of lending the money.	Interest is strictly forbidden and is considered to be haram, against the Shariah law.
Risks are minimized to zero as it is entirely the responsibility of the other party to pay off the settlements no matter the outcome of the undertaken activity (could be a mortgage or loan for investment). The bank is only a financial help provider; it does not get involved outside this specific financial scope.	Risks are shared. It is both the bank's and the customer's responsibility to make sure that the undertaken activity is viable and secure as both parties are partners. They share positive and negative outcomes. Therefore, the bank is not only a financial help provider but is also a partner that cares about the activities, the procedures and the methods.
Western banking is involved in all kinds of markets and activities. Of course, it has to be legal in the eyes of the law. It could launch a loan for an investor in pork manufacturing for example.	Islamic banking has some restrictions regarding the sector of activities. All that is forbidden by the Shariah law cannot be included in their financial products. For example, the bank cannot deal with an organization that sells alcohol as it is considered haram by Shariah law.
Western banking targets all customers no matter their religion and their beliefs. As long as the profile and financial backgrounds are valid, a transaction can be started.	Even though there is "Islamic" in the name of this type of banking, it is not only made for Muslims. In fact, non-Muslims customers are also free to use the Islamic banking for its practices, advantages and approaches if it suits their expectations.
In case of losses, it is entirely the responsibility of the borrower to give back the money lent.	In case of losses, the bank and the customer share the losses based on the percentage of their acquisition.

**Findings**

In conventional banking, a loan is a legal agreement which consists of borrowing an amount of money, charged in the form of interests, which have to be paid back to the lender in addition to the initial borrowed amount. However, the Islamic banking is increasingly developing its market share, especially in the Muslim countries and in Muslim communities where citizens are

looking for a “halal” way to seek financial help. In fact, in Islamic banking, interests, called “Riba”, are strictly forbidden, as according to the Quran, money cannot be generated from money and it has no intrinsic value: it is simply a medium for exchange. Then how does it work? –Basically, the bank and the customer both purchase a chosen property referred to as a joint ownership. With the monthly payments, composed of the rent of use and a part of the bank’s ownership, the customer gradually increases its share of the property until it is completely bought out. Regarding the investments loan services, the Islamic bank invest the money with the entrepreneur after conducting a study on the industry and made sure that it is not a sinful industry. The profit generated from the business is shared as well as the risks.

Moreover, in western banking, the lender/borrower relationship is at the core of the financing methods we have encountered so far since its creation. However, for the Islamic banking, we don’t talk about lender/borrower relationship anymore but instead, we talk about partnership. Both the customer and the bank are responsible for the property/investment, also known as risk sharing, as opposed to the western banking where the borrower is entirely in charge of the asset.

### Multi-Attribute Decision Making

The score will be given out of ten points: The risk increases as the score goes up. This means that when the percentage result is over 50% most of the risk is transferred to the customer. As opposed to when it is below 50% as in this case it means that the risk is share by both parties but the financial institution holds most of it. Therefore, a good score would be when the customer is free from any risk that could jeopardies his finance and the stability of his life. A bad one would be that the customer is in a situation where in case of any problem or difficulty, all of the responsibilities and consequences are on his charge.

As we can see in the table below, based on the attributes as well as the feasible alternatives, the riskiest approach to financial institutions regarding customers is the wester banking. In fact, with a total of 70/110 (63%) for the western banking against 40/110 (37%) for the Islamic banking we can safely say that in terms of customers’ self-interest, the safety of their financial assets, and the clear and unambiguous terms and conditions of the procedures, the Islamic banking is considered the safest option.

<u>Attributes</u> <u>Alternatives</u>	WESTERN BANKING	ISLAMIC BANKING
<b>ETHICAL INVESTMENT</b>	<b>6</b>	<b>4</b>
<b>NON-PREDATORY LENDING</b>	<b>5</b>	<b>5</b>

<b>SOCIO ECONOMIC JUSTICE</b>	<b>6</b>	<b>4</b>
<b>BUSINESS ETHICS</b>	<b>5</b>	<b>5</b>
<b>MORAL IMPERATIVES</b>	<b>7</b>	<b>3</b>
<b>INTEREST-BASED ACTIVITY</b>	<b>10</b>	<b>0</b>
<b>FILTERED INDUSTRIES</b>	<b>6</b>	<b>4</b>
<b>DIVERSITY OF CUSTOMERS</b>	<b>5</b>	<b>5</b>
<b>CROSS-CULTURAL INFLUENCE</b>	<b>5</b>	<b>5</b>
<b>PROFIT-BASED ACTIVITY</b>	<b>8</b>	<b>2</b>
<b>CUSTOMER-SUPPLIER RELATIONSHIP</b>	<b>7</b>	<b>3</b>

The type of relationship both parties have influences their attitude towards any potential risk. In the case of acquiring a home, the risk would be not to be able to pay the monthly settlements as specified in the contracts. Regarding investment loan, the risk would be that the business is not profitable enough to pay off the money. For the conventional banking, the financial organization charges with higher interests as the unpaid invoices accumulate, until the point where it actually takes possession of your asset. However, for the Islamic banking, it is not an interest penalty scheme, but first, a problem-solving approach.

In fact, the bank will first try to restructure the customer's finances in order to enable the monthly payments; if it's still not enough, then the bank charges the customer with a late payment fine. The worst case scenario being that the bank still owes money to the other party, then it will have no choice but to put the asset back to the market. When sold, the bank gives to its partner the share of the property he owns.

## **ETHICS**

When comparing both financing contracts' attitude towards difficulty, we can say that the conventional bank agreement with the borrower is solely based on finance. In fact, if the borrower faces a difficult path, the lender's priority is at best to make a profit and at worst to avoid any kind of losses. Therefore, the borrower will have to leave the property with, most of the time, nothing. However, for the Islamic banking, putting the property back in the market is

a way to minimize the short term losses but it is also partially beneficial for the customer. As a matter of fact, when the property is sold in the market, the customer has a percentage share that he has been paying for a number of months in prior. Plus, both parties can benefit from an added value on their property that they share based on their legal contract. Therefore, the customer has to leave the property, just like the conventional banking, but this time with an amount of money that can be a valuable help.

Engaging in a financial contract with an institution is always temporary and has an end date which refers to the final settlement. Most borrowers will last until the end of the predefined contract; however others could end it sooner by paying the full amount at once. In conventional banking, an early settlement means less interest to charge the borrower. Therefore, no matter when you decide to pay off your contract, you will inevitably pay extra amount of money. However, the Islamic bank considers that the service it provided has been achieved, which was to acquire a home or run a business. Therefore, it does not charge for an early end of a contract. The customer will have full equity on the property which marks the end of the partnership.

Furthermore, the conventional banking as well as the Islamic banking are open for anyone who is willing to follow the respective concepts and conditions of each banking type. In fact, unlike what the title insists on, Islamic banking is not only targeting Muslims but all individuals who want to experience a new banking approach with new methods and processes. Muslims choose it for their faith and non-Muslims would choose it for the advantages it proposes. Same goes for the conventional banking as it is, and has always been, made for everyone.

## **Legal representation**

Conventional and Islamic banking have their respective features and differences. However, the most critical difference that can be a prejudice for the Islamic banking contract relies on the fact that it is misrepresented in countries where the court is not founded on the Islamic Sharia. In fact, except for Iran and Saudi Arabia, no other court is equipped with the right legal framework to successfully and fairly treat an Islamic banking dispute. In other words, in the other countries, the civil law has more power as the judges are not trained to deal with such disputes.

Moreover, Islamic banking also deals with non-Muslim customers which means that when brought to court, the Sharia law has no jurisdiction over them. This means that when dealing with an Islamic banking dispute, the civil law is also applicable as the Sharia law has a limited enforcement power. As the disputes concerning Islamic contracts have been increasing during the past decade, it has been suggested that, when dealing with such contract, the judge could have a sharia law advisor that will be able to give recommendations, explanations and advices.

This does not change the fact that the civil law judge has the final say and this say can be not applicable to the Sharia law. However, the fact that an advisor is now permissible could

represent a first step towards a court section where Sharia law could apply its full framework and juridical system. It would only be logical as if an Islamic bank has the right to open its doors in a country, it should also be able to deal with the consequences of its system. As a result, for now, the system is as it is and any contracts made to represent an Islamic bank transaction is weakly enforced and represented in court which can be a real inconvenient for customers.

Based on the above analysis and comparison of both feasible alternatives, we cannot really choose a preferred one as, first of all, the Islamic banking is indeed increasingly developing but only represents for now 1% of global financial activities. Secondly, it is in fact an attractive solution for Muslim communities but will need time to gain in credibility and prove that it is a reliable alternative everyone can choose. Moreover, the funds western banks hold is not nearly close to the Islamic banking one which enables western banking to provide financial solutions to the large share of customers.

However, in terms of terms, procedures and methodologies, we can safely say that Islamic banking is the less risky approach to financial services. It is in fact a solution that provides customers with security, visibility and assurance for a brighter tomorrow.

## **Conclusion**

**To summarize, this research paper has been undertaken to answer the following questions:**

### **1. How do Western and Islamic banking differ?**

Western and Islamic Banking are both financial solution provider that seek to help households as well as organizations. However, they do have different approaches. On one hand, Western banking holds a borrower and lender relationship with the other party based on an interest charging method. The borrower will pay monthly settlements composed of part of the initial lent money plus interests. The risk is entirely transferred to the customer as the bank is not willing to take any risk on the behalf of its client. On the hand, the Islamic banking holds a partnership with its customer as they enter into a joint ownership or co-investment and are both hold responsible for it. This means that the risk is shared as well as the profit. The Islamic bank generates profits by monthly charging the other party a rent on the property plus a share of the asset. As the payments accumulates, the customers buy the asset out.

### **2. What is the ethic behind each banking type?**

Western Banking has a financial relationship with the customer meaning that in case of any financial issue the bank will do anything to minimize its loss without considering the situation for the other party. For Islamic banking it is not the case as first of all it is a partnership and both parties have their share on the asset. Therefore, losses affect both parties and gains is enjoyed by both of them. Plus, the Islamic banking considers that it is made to help customers. This help schemes differ from the western bank as its DNA is to be profitable.

### 3. How are both types of contracts legally represented?

As the Islamic banking only represent 1% of the global financial activities, it is still not completely represented in court as not all the juridical professional is aware of the rules, procedures and fairness framework of this financial approach. As opposed to western banking as it has been around for centuries and is the only approach know and mastered by everyone.

Western and Islamic banking are two financial concepts that target different markets, not for the religion aspect of it, but more for the advantages and inconveniences each on has to offer. The Islamic banking has a strong foundation regarding the risk sharing feature which is a serious argument for individuals who are seeking financial help. However, the conventional banking, which has been around for almost two centuries, has a strong foundation regarding the legislations, representations, juridical enforcements and many other aspects that can attract customers' confidence and trust. However, after the 2008 financial crisis, conventional banking has lost part of its credibility which left room for Islamic banking to rise and respond to customer demands for acquiring homes in an alternative way that is valid and promising.

## BIBLIOGRAPHY

Al Rayan Bank | Islamic banking | Sharia compliant & ethical. (n.d.). Retrieved from <https://www.alrayanbank.co.uk>

Islamic banking vs. Conventional banking: What are the differences? (2016, June 9). Retrieved from <http://musliminc.com/islamic-banking-vs-conventional-banking-what-are-the-differences-7967>

Osborne, H. (2013, October 29). Islamic finance? the lowdown on sharia-compliant money. Retrieved from <https://www.theguardian.com/money/2013/oct/29/islamic-finance-sharia-compliant-money-interest>

Sharia-law-compliant home purchase plans. (n.d.). Retrieved from <https://www.moneyadvice.service.org.uk/en/articles/sharia-compliant-home-purchase-plans>

Islamic vs Conventional Banking – Allied Bank Limited. (2016, June 16). Retrieved from <https://www.abl.com/islamic-banking/islamic-vs-conventional-banking/>

Al Rayan Bank. (n.d.). Retrieved from <https://www.youtube.com/channel/UCkhobhkvLkXpsmCRTxatrNq>

Débat autour de la finance islamique sur Luxe Radio. (2014, February 4). Retrieved from <https://www.youtube.com/watch?v=il4BwCuDUhw>

The difference between conventional and Islamic banking. (n.d.). Retrieved from <https://www.lawteacher.net/free-law-essays/contract-law/the-difference-between-conventional-and-islamic-banking-contract-law-essay.php>

Bilal (2017). Difference Islamic Banking and Commercial Banking & Features.... (online) Slideshare.net. Available at: <http://www.slideshare.net/mutahirbilal47/difference-between-islamic-banking-and-commercial-banking-features-of-islamic-economic-system-in-pakistan> (Accessed 8 Nov.2017).

Evening Standard. (2017). Islamic banking: an alternative to the conventional financial system. (online) Available at: <http://www.standard.co.uk/news/islamic-banking-an-ethical-alternative-to-the-conventional-financial-system-a3583031.html> (Accessed 8 Nov. 2017).

Classroom.synonym.com. (2017). A modern Comparison of Western Banking to Islamic Banking: Synonym. (online) Available at: <http://classroom.synonym.com/a-modern-comparison-of-western-banking-to-islamic-banking-12086596.html> Accessed 9 Nov. 2017)

Magscholar.com. (2017). Cite a Website – Cite this for Me (online) Available at: <http://www.magscholar.com/joomla/images/docs/ajbr/ajbrv5n1/ajbr150005.pdf> (Accessed Nov. 2017).

## About the Author



**Sarah Bennani Kemmoun**

Paris, France



**Sarah Bennani Kemmoun** is a Master's degree student in Project management and Business development at Skema Business school, Paris, France. She spent four years in London, United Kingdom where she graduated with honours with a BSc Management. London city shaped her personality and mind-set which made her a strong, goal-focused and ambitious woman. Her social skills have enabled her to open to other cultures, environments and people in general which has helped her broaden her horizon and made her a more considerate and respectful person.

Moreover, her internships in the consultancy industry and the manufacturing sector have highlighted her organisation skills, multi-tasking capabilities, strong adaptability to any type of situation or context, her analysis skills as well as her evaluation abilities.