A Review of the Discussion on Islamic & Traditional Banking Products

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# Summary of Banking

<table>
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<th>IB</th>
<th>TB</th>
<th>Central Bank (CB)</th>
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<tbody>
<tr>
<td><strong>Profit/Interest Rate</strong></td>
<td>Not assured return, indicative rate (%).</td>
<td>Determined, stated from day 1.</td>
<td>No lender last resort role with IBs.</td>
</tr>
<tr>
<td><strong>Customers</strong></td>
<td>Closer to Equity than Deposit, profit/loss relationship.</td>
<td>Monetary transactions, untied to project.</td>
<td>Deposit insurance, TB customers. Some exceptions.</td>
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<tr>
<td><strong>Bank</strong></td>
<td>Equity, profit/loss share relationship, principal secured in DD.</td>
<td>No co-investor role.</td>
<td>Rate setting, regulation at systemic level for TB.</td>
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<tr>
<td><strong>Risk</strong></td>
<td>Institution shares risk of loss in co-investment. More project evaluation &amp; valuation (Service value added in achieving investment).</td>
<td>Money is lent without specific goals ID’d.</td>
<td>Reserve Ratios for TB.</td>
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**IB & TB Products: Demand Deposits (DD)**

**Role**
- Client: “lends” to IB when deposits.
- Bank: “repays” client when DD returned. No “reward” for keeping deposit “safekeeping.”

**Ownership**
- Client: Money is deposited and expect its return at any time
- Bank: cannot use money for commercial purposes

**Responsibility**
- Client: provides an interest-free loan with the promise that there is no reward as a lender
- Bank: borrower is obliged to repay the qard under all circumstances unless the lender relieves him of this obligation
IB & TB Products: Demand Deposits (DD)

**Cashflows**
- Client: Only expectation is principal returned.
- Bank: promises no return to the depositor while holding the bank accountable to repay the deposited funds at any time. For TB there is interest on overdraft (becomes loan).

**Type of Service**
- Client: Safekeeping of money. Nothing indirectly measured since sum all gains zero (no money Pool).
- Bank: (Qard Daman/Hassan) there are fees. TB can lend out money-FISIM.
Investment Deposits v. Fixed Deposits

**Role**
- **Client:** shares risk.
- **Bank:** has project risk but can adjust prices as a way of indexing. Finances project for investment return with no pre-determined percentage.

**Ownership**
- **Client:** Shareholder in project with no corporate voting rights.
- **Bank:** decide share percentage from first day but not distributed amount.

**Responsibility**
- **Client:** Give bank “agent” role limited for bank investment gains
  - Bank: takes responsibility to invest. Must reimburse for only misconduct.
- **Client:** No investment action.
- **Bank:** No corporate responsibility. Principal and interest, passive role.

**Investment Deposits v. Fixed Deposits**
- **Client:** No investment risk. Markets and liquidity. Has Regulatory deposit insurance.
- **Bank:** provides income money for short tenors at set rates and loans it out (Net Interest Income). No rate adjustment during the tenor.
- **Client:** Money can be lent out.
- **Bank:** fixed rate. Only source of funds from market/CB can be adjusted. Risk of Bank solvency.
- **Client:** No investment action.
- **Bank:** No corporate responsibility. Principal and interest, passive role.
Investment Deposits v. Fixed Deposits

**Cashflows**
- Client: investment partner proceeds.
- Bank: investment partner in amount over time. Takes explicit charges for management and administration fees. Stable cashflows & react to market.

- Client: Receive interest/pay interest.
- Bank: Only pay/receive interest without charging fees. Interest on deposits pre-determined.

**Type of Service**
- Client: avails of using investment services as an investor.
- Bank: Intermediation function is secondary—pure banking.

- Client: Money is lent for any reason.
- Bank: Intermediary function. No investment dealing only passively deposited money.

**Issues for National Accounts**
- Profit Equalization reserves are owned by whom? Impact?
- Accrual versus cash basis accounting impact/implication

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Musharaka (Mortgages)

Asset Based approach.

- Use of assets and receives a service.  
- Income on a fixed asset from which there is “rent.”  
- Musharakah agreement may be entered into for a short-term or long-term period. The capital contributed by the bank in a Musharaka may remain constant throughout the contracted period. (CM)  
- Otherwise the bank gradually transfers its share in the Musharaka to the Musharik so as to decrease its share in order to transfer the ownership. (DM)  
- Profits are shared in accordance with the Musharakah agreement. Losses are normally shared in proportion to the capital contributed by each Musharik.

Source: AlBaraka
Traditional Bank (Mortgages)

- Asset Based approach.
  - Ownership title remains with client and only reverts to Bank in case of default.
  - Money on money interest approach as Bank does not buy an asset to resell.
  - Installment has an interest component.
  - Return on money is interest (on money) as no asset resale will happen.
  - This is clearly not an asset-backed approach to financing.
  - A “mortgage” is two separate legal documents
    - “Promissory” note is a promise to pay (IOU)
    - Deed of Trust – pledges real property as collateral
  - Mortgage Note (Promissory Note):
    - The promissory note is a promise that the borrower will be personally liable for paying the amount of the money in the note and specifies the manner in which the debt is to be paid.
Cost-Plus approach:
- Terms are fixed from the outset of the agreement (in particular value of payment)
- In the event of early termination, no discount applied for early settlement
- Rebate on the deferred sale price permitted, but at the discretion of the financier.

Source: Norton Rose Fulbright
Asset Based approach.

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Conclusion: The Way Forward

Contrasts

• Money on money interest approach as Bank does not buy an asset to resell.
• Asset based financing represented by profits and not relying less on markets-
  Monetary authorities for rates charged and returns achieved.
• Possession and ownership interest with a link to risk sharing is of critical
  value (added) in the chain of Islamic Finance transactions.

Method

• Commercial interest: IBs assess the nature of the product/service that is
  offered to clients (if market-linked or a private business endeavor) and the
  due diligence needed.
• Cashflows: Where interest income is derived and earned versus profits on
  equity shares.
• Ownership: When and whom owns a underlying asset is critical and a
  foundation of IB commercial dealings.
• Risk management: asset based financing leaved the IB with alternatives to
  non-payment.

Impact

• We consider the above and further matters in a Systems of National Account
  discussion.