

Parallelism between Interest Rate and Profit Rate: Comparison of Islamic Banking and Conventional Banking

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Abstract

The most general argument about Islamic finance is that there is no difference at all between Islamic finance and conventional finance in practice since there exists parallelism between interest rate and profit rate. Some people claim that Islamic finance merely involves change in name. These people state the doubtful situation which is parallelism between interest rate that offering by conventional banks and profit rate that distributed by Islamic financial institutions to prove their arguments against Islamic finance. Aim of this article is to investigate arguments about the mentioned issue above and try to clarify doubts about Islamic finance.

Keywords: Conventional finance, Interest rate, Islamic Banking, Islamic finance, Profit rate
JEL: G20, G29, P10, P40

Introduction

Since the late 1990s Islamic financial industry has been growing at a rate of between 10% and 15% per year, and is expected to keep on growing at this rate for some years. The number of financial institutions is increasing in all over the world. Like every other aspect of Muslim life, Islamic financial institutions should be governed by Sharia and Fiqh which is interpretation of Sharia if we want to call those institutions as Islamic. Sharia that is Islamic law covers all aspect of life. Sharia has some sources. We can make these sources as two groups and show as follows:

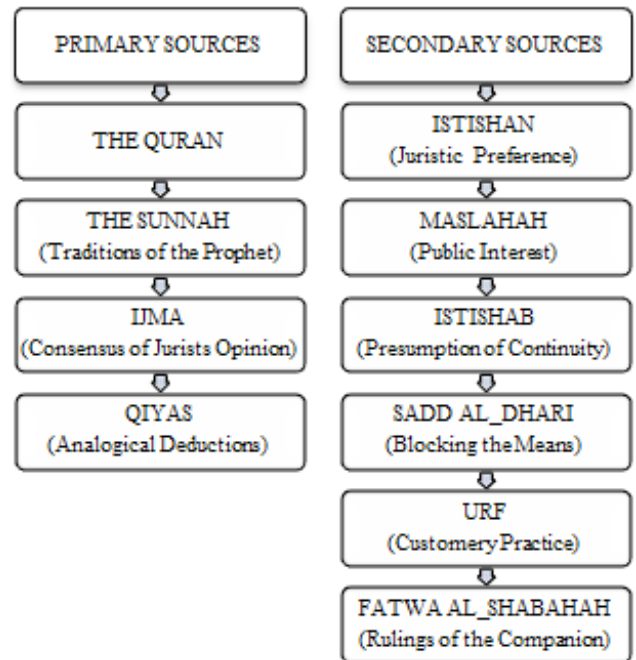


Table 1: Sources of Sharia
 Source: Agil Natt, *Basic Principles of Islamic Finance*, January 2007.

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The primary sources of Sharia are the Holy Quran and Sunnah of the holy Prophet. The Quran is the primary legal source of Islam since it is speech of Allah. According to Islamic belief it is necessary obeying injunctions in Holy Quran by all Muslims. Holy Quran has supplemented by Sunnah. The Sunnah which contains saying of holy Prophet Muhammad (s.a.s) and the actions done by the holy Prophet or the actions approved by holy Prophet. Sunnah can be considered as detailed explanations of Holy Quran and clarification of a matter that is not mentioned in Holy Quran directly. In Quran Allah says "Indeed you have in the Messenger of Allah an excellent example for the one who hopes in Allah and looks to the Last Day" (33: 21). Allah also says in another verse of Holy Quran "So if you obey him (i.e. Muhammad, s.a.s), only then you will be guided" (24: 54). Like obeying injunctions in Holy Quran, obeying the orders of the holy Prophet is necessary. Almost all Muslims believe accepting of the orders of Sunnah. The other primary sources of Sharia are Ijma (principles of Islamic jurisprudence) and Qiyas (analogical deduction) which are based on Ijtihad. Ijtihad is the mental effort of scholars having juristic expertise to find solutions for emerging problems and issues.

The latest financial crisis shows that conventional finance system is not perfect. After the crisis Islamic finance became very popular since it is declared as an alternative of conventional finance by both some Muslim and non Muslim economists. The Muslim population in both Muslim and non Muslim countries start to prefer Islamic financial institutions rather than conventional ones. In industry there is a simple rule if there is a demand then there is a supply. Islamic finance is being practiced in over 75 countries around the world with about 550 Islamic financial institutions in the field (Muhammad Ayub, Understanding Islamic Finance, 2007). Islamic assets under management stand at around \$700 billion and are growing faster than conventional finance assets. (Islamic Financial Services Board).

The basic principles of Islamic finance can be summarized as follows:

Prohibition of Interest: Under Islamic law, any level of interest is prohibited. Islam encourages the making profit but forbids the charging of interest. Quran says that "But Allah has permitted and forbidden usury..." (2:275)

Ozsoy (2010) defines the interest as follow:

Interest is of two kinds. First, interest of loan (riba al-dain in Arabic), one that appears in loans as a percentage or any fixed payment added to the principle, is the most widespread, and the most debated, kind of interest known by all. Lending money, say €100, at a certain interest rate, say 5%, is the example. Second is interest of exchange (riba al-bai' in Arabic), one that appears in exchanges.

The second one -interest of exchange- is also divided into two kinds; one is called interest of surplus (riba al-fadl in Arabic) that appears as a quantitative surplus in one of the exchanged goods of the same kind -as in the case when two measures of corn is exchanged for three measures of corn, even if it is due to the difference of quality. And the other is called interest of delay or deferral (riba al-nasia in Arabic)

that appears in exchanges as a quantitative or potential surplus (value differentiation) when the delivery of one of the goods exchanged is delayed, as in the case when a ton of iron is sold for the same amount of iron on a deferral basis; let alone for a larger amount of delayed iron.

Prohibition of Uncertainty: The terms and the conditions which of the risk are not clearly understood by all parties to a financial transaction are not allowed.

Profit-Loss Sharing: Sharing profit or returns from assets are permitted if parties involved in a financial transaction share both the risks. So the business risks must be shared by the lender (seller) and borrower (buyer).

Ethical Investments: Investments such as alcohol, pornography, gambling, and pork based products are not allowed.

Money: Money is very important issue in any of financial system. The status, role, and function of money are not same in conventional finance and in Islamic finance. The philosophy of Islam about money is completely different from the conventional system. The usage of money is limited with its basic purpose in Islamic finance. Money has to be used as a medium of exchange and a measure of value. Money itself cannot be used for the purpose of trade. Money has to be exchanged for money, it can be borrowed but the payment on both sides must be equal. In conventional system, money is a commodity that can be sold or bought. Money can be rented for profit in the conventional system.

<ol style="list-style-type: none"> 1. An advance step toward achievement of Islamic economics. 2. Try to ensure social justice/welfare or the objectives of Sharia. 3. Flow of financial resources is in favour of the poor and disadvantaged sections of society. 4. Prepare and implement investment plans to reduce the income inequality and wealth disparity between the rich and poor. 5. Make arrangements for investment funds for assetless, poor but physically fit people. 6. Observe the legitimate and illegitimate criteria fixed by the Sharia in the case of production and investment. 7. Implement investment plans on mudaraba and musharakah to stimulate the income of the people below the property line. 8. Interest and usury are avoided at all levels of financial transactions. 	<ol style="list-style-type: none"> 1. Part of the capitalistic interest-based financial system. 2. Not concerned. 3. Not concerned. 4. Increase the gap. 5. All plans are taken out for the rich. 6. No such rules and regulations. 7. No such program. 8. The basis of all financial transactions is interest and high-level usury. 9. Depositors do not bear any risk, moreover the bank is inclined to pay back principal with a guaranteed interest amount. 10. Creditor-debtor relationship. 11. Projects below the fixed interest level are not considered. 12. Helps to increase capital of the capitalists. 13. Do not bear any loss of clients. 14. Cannot absorb any shock because of the ex ante commitment. 15. No such commitment; extend oppressions and exploitation. 16. On interest basis and create unusual bubble in the market, i.e. exorbitant in the call money rate.
<ol style="list-style-type: none"> 9. Depositors bear the risk, no need for depositors insurance. 10. The relationship between the depositors and entrepreneurs is friendly and cooperative. 11. Socially needed investment projects are considered. 12. Elimination of the exploitation interest and its hegemony. 13. Islamic banks become partner in the business of the client after sanctioning the credit and bear loss. 14. Islamic bank can absorb any endogenous or exogenous shock. 15. Islamic banking is committed to implementing welfare-oriented principles of financing. 16. Inter-bank transactions are on a profit and loss sharing basis. 17. Islamic banks work under the surveillance of the Sharia Supervisory Boards. 18. Lower rate of moral hazard problem because of the brotherhood relationship between the bank and customers. 19. Avoids speculation-related financial activities. 	<ol style="list-style-type: none"> 17. No such surveillance. 18. High moral hazard problem because relation is based only on monetary transactions. 19. Main functions are speculation related.

Source: Ahmad and Hassan

Table 2: Comparison of Islamic banking and conventional banking respectively

Islamic finance is a relatively young industry but with a great potential. The market size is estimated to be worth about £250 billion globally (GMB publishing, Islamic Finance, 2008). Islamic finance has a short history on the other hand from a small base it reaches a very huge size in the market when its short history is concerned.

Islamic finance is the most developed branch of economics. It has been developing exponentially. There are many new concepts and tools introduced as an Islamic finance products in recent years. However Muslim community is not sure that what are admissible and what are forbidden. In the Medieval time the church declared decisions about the discussed topics, like Vatikan in these days. When we look at the all Muslims all around the world, we see that there is no final authority which involve the discussions and gives final decisions especially in Sunni Muslims. There are some independent advisory institutions but they represent some parts of the community. In this case how a muslim will decide that an Islamic product is really Islamic or not. We have primary and secondary sources, there are Fatwas about every aspects of daily life. Islam is designed to supply everthing what is needed and to bring solutions of human beings. So if we search we can find our answer. The issue is the problem or the situation is not clearly stated. To decide an Islamic tool or product complies with Shariah or not it must defined very well and the process of the activities must be clear in every steps. Transparency will help to eliminate the differences between theory of Islamic finance and practice of Islamic finance. Islamic financial products refer to financial market transactions, any operations and services that comply with Sharia that is Islamic laws, rules and principles.

Data and Methodology: Parallelism between Interest Rate and Profit Rate

Data was collected through the official web pages of some Turkish banks that run as conventional banks and some Islamic financial banks where running in Turkey. The offered interest rate by banks represented and evaluated their average. Same process was done for profit rates that distributed by some Islamic banks in Turkey. These data were announced the public through the official web pages of the chosen financial institutions in the study. In the second phase there would be a simple comparison of those interest rates and profit rates. By using tables the existence of parallelism would be tried to state to investigate the possible reasons. The comparison of inflation rate and profit rate that distributed by Islamic banks that run in Turkey was stated in the study too. Parallelism among the interest rates that offered by conventional banks, profit rates that distributed by Islamic banks and inflation rate tried to be shown empirically in the study. Therefore instead of some assumptions, the real case which exists in the current mar-

ket will be analyzed and discussed by the author. After establishing the real situation, the reasons behind the facts will be investigated and stated.

Islamic finance depends on main principle of profit and loss sharing (PLS) system between two parties' investors and financiers. At the end of decided periods, an Islamic bank has to share its profit with its clients who accepted risks of investments. Maybe in 1980s, pious Muslim people did not have many options to invest their money according to Islamic laws. However at the present time about 180 Islamic banks with 120 Islamic financial institutions (non banks) operate throughout the world. It is the fact that customers who place their deposits at saving and investment in Islamic banks or financial institutions are guided by the profit motive. This is parallel to the utility maximization theory, so this theory is valid among the Muslim customers. This explains why also some non Muslims invest their money to Islamic banks. Islamic banks aware of this fact too. Muslim people seem to agree sharing profit and loss but their aim is to get maximum profit from their savings or investments. Therefore Islamic banks try to motivate their clients by showing and proving them how their choice is profitable if they work with Islamic banks that is free interest system. Sekreter (2011) examined rate of returns some free interest banks that can be said Islamic banks in Turkey. He collected the following information as follow:

Table 3: Distributed profit rates by selected Islamic banks in Turkey

Bank 1

Accounts	1 Month		3 Months		6 Months		1 Year	
	Net	Gross	Net	Gross	Net	Gross	Net	Gross
Turkuaz Account	513.7	604.3	1,607.8	1,891.5	3,301.9	3,884.5	7,358.4	8,656.94
Pearl Account	548.0	644.7	1,715.0	2,017.6	3,522.0	4,143.5	7,849.0	9,234.12
Emerald Account	582.3	685.0	1,822.2	2,143.7	3,742.1	4,402.4	8,339.6	9,811.29
Ruby Account	616.5	725.2	1,929.4	2,269.8	3,962.2	4,661.4	8,830.1	10,388.3
Diamond Account	650.70	765.53	2,036.60	2,396.00	4,182.40	4,920.47	9,320.70	10,965.53

Source: finansbank.com.tr

Bank 2

	1 Month	3 Months	6 Months	1 Year
For 1,000 TL	6,54	20,75	43,54	92,99
For \$ 1,000	2,81	9,60	19,61	45,14
For EURO 1000	2,71	8,77	17,04	37,91

Source: albarakaturk.com.tr 07/12/2010

Bank 3

Account Type	1 Month- Total Amount of Net Profit	1 Month- Total Amount of Gross Profit	3-Month Net Income Total Amount	3-Month Total Amount of Gross Profit	6 Months- Net Income Total Amount	6 months- Amount of Gross Profit	1-Year Net Profit Share Amount	1 Year Total Amount of Gross Profit
Joined Account	566.77	666.78	1684.16	1981.36	3565.6	4194.82		
Sharing Accounts Paid in December	573.85	675.12	1747.31	2055.66	3783.01	4450.6		

Source: bankasya.com.tr

Bank 4

Account type	participation
Amount	10000 TL
Maturity	365 days
Gross rate/annual	8.74%
Net rate/annual	7.43%
Distributed gross profit	873.75
Distributed net profit	742.69

Source: kuvaytturk.com.tr

It can be seen that rates of return are very close in these Islamic banks. The interval of rates of gross return is between 9.35% and 9.55%. The net return rate is about %8. The inflation rate in Turkey is 9.25% (source: TUIK, September 2010). Now let examine interest rates of conventional banks in Turkey.

Islamic Banks	Time intervals for the distributed profit rates	Net-Gross profit rates
Bank 1	1-3-6 months, 1 year	Both given
Bank 2	1-3-6 months, 1 year	Only gross given
Bank 3	1-3-6 months	Both given
Bank 4	1 year	Both given

Table 4: Profit rates summary of Islamic banks in Turkey

However if time is chosen as one year, net profit instead of gross, and average of different types of accounts that are offered by the given Islamic banks above after that average profit rate is calculated as %8.13.

In the research of Sekreter (2011) randomly three conventional banks are chosen, and the interest rates

that offered by banks differ according to amount that is invested to the bank and the chosen maturity. The following table shows these different options for interest rates and the interest rates per annum are summarized in the next table as follow:

Table 5: Interest rates of some banks that run in Turkey

Bank 1

1000 until	10 to 20 thousand	20 to 50 thousand	50 to 100 thousand	100 thousand and over
SIGHT	0	0	0	0
7-27 DAYS	0	0	0	0
28-31 DAYS	0	7,25	7,25	7,4
32-91 DAYS	0	7,25	7,25	7,4
92-180 DAYS	0	7,25	7,25	7,4
181-364 DAYS	0	7,5	7,5	7,75
365-400 DAYS	0	7,5	7,5	7,75

Last Updated: 07/12/2010 12:24:00

Source: akbank.com.tr * Deposit interest rates are for information purposes when you want to trade Retail Internet Branch and will be available on the rates shown in our branches.

Bank 2

	TL	USD	EUR	GBP
0-1 days	0.00%	0.00%	0.00%	0.00%
2-3 days	0.00%	0.00%	0.00%	0.00%
4-6 days	0.00%	0.00%	0.00%	0.00%
7-14 days	0.00%	0.00%	0.00%	0.00%
15-29 days	4.75%	0.15%	0.15%	0.20%
30-59 days	7.50%	1.50%	1.50%	1.25%
60-89 days	7.50%	1.50%	1.50%	1.25%
90-119 days	7.50%	1.50%	1.50%	1.25%
120-179 days	7.50%	1.50%	1.50%	1.25%
180-239 days	7.75%	1.50%	1.50%	1.25%
240-269 days	7.75%	1.50%	1.50%	1.25%
270-329 days	8.00%	1.50%	1.50%	1.25%
330-385 days	8.00%	1.50%	1.50%	1.25%

Source: HSBC bank, E-deposit accounts for the interest rates specified in the table, the current annual simple interest rates in Turkey have shown that HSBC Bank A.Ş. reserves the right to change interest

Bank 3

Maturity	500.00 to 25,000.00	25,000.00 to 100,000.00	100,000.00 to 500,000.00	500.000,00+
1 to 6 days	-	6,50	6,50	6,50
7 to 13 days	-	7,25	7,25	7,25
14 to 20 days	-	7,50	7,50	7,50
21 to 27 days	-	8,00	8,00	8,00
28 to 31 days	8,25	8,25	8,25	8,25
1 month	8,50	8,50	8,50	8,50
32 to 45 days	8,50	8,50	8,50	8,50
46 to 60 days	8,50	8,50	8,50	8,50
61 to 75 days	8,75	8,75	8,75	8,75
76 to 89 days	8,75	8,75	8,75	8,75
90 to 91 days	8,75	8,75	8,75	8,75
3 months	8,75	8,75	8,75	8,75
92 to 95 days	8,75	8,75	8,75	8,75
96 to 105 days	8,75	8,75	8,75	8,75
106 to 145 days	8,75	8,75	8,75	8,75
146 to 178 days	8,75	8,75	8,75	8,75
179 to 180 days	8,75	8,75	8,75	8,75
6 months	8,75	8,75	8,75	8,75
181 to 185 days	8,75	8,75	8,75	8,75
186 to 217 days	8,75	8,75	8,75	8,75
218 to 249 days	8,75	8,75	8,75	8,75
250 to 280 days	8,75	8,75	8,75	8,75
281 to 315 days	8,75	8,75	8,75	8,75
316 to 364 days	8,75	8,75	8,75	8,75
12 months	8,75	8,75	8,75	8,75

Conventional banks	Interest rates
Bank 1	%7.75
Bank 2	%8.00
Bank 3	%8.75

Table 6: Average interest rates per annum offered by conventional banks in Turkey

When the average interest rate is calculated, the result is %8.17.

The result we observe that Islamic banks' return rates and conventional banks' interest rates are parallel. How it can be possible that there would be many Islamic banks, they will use many types of Islamic financial products, they will invest many different areas, they will work according to profit-loss sharing system and then they will distribute almost same amount profit-they never declare any loss to their clients/depositors- that very close to interest rates. In the current conditions of contemporary Islamic finance, the explanations about the parallelism between profit rates and interest rates are not convincing people about Islamic finance.

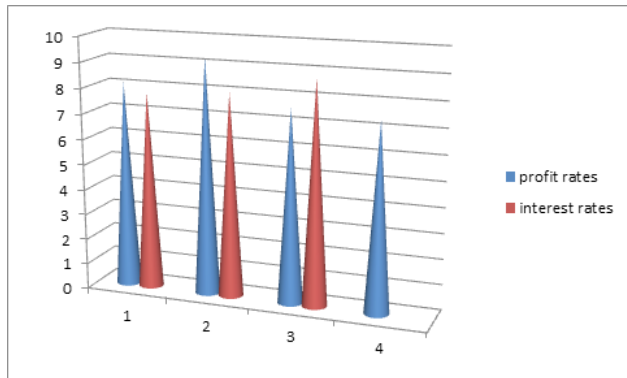


Table 7: Comparison of interest rates and profit rates

The people who have doubts about Islamic finance could not be persuaded because of similarity between return rates and interest rates. Their opinion about Islamic finance is just another name for interest-based system. Some Islamic scholars and jurists say that since Islamic banks are living in an interest-based financial system it is normal that the similarity between interest rates and return rates, otherwise Islamic finance do not have chance to survive in these economical system. They also say that this similarity does not mean that Islamic banks are distributing interest to their clients or savers. The issue is neither blaming Islamic banks nor defending them.

Conclusion

The concept of Islamic finance is based on profit-loss sharing system. There are many discussions about return rates which distributed from Islamic banks as profit. The researches which are done in this work show that there are deep doubts in Islamic finance and very important questions which must be answered. The parallelism between distributed profit rates by Islamic banks and interest rates declared by conventional banks, and the parallelism between profit rates and inflation are feeding these deep doubts. "Unfortunately what is happening is that Islamic finance in some ways is moving more and more closely to the conventional finance," says Prof.Dr. Habib Ahmed, a world authority on Islamic finance. "For all its successors, Islamic finance still accounts for less than 1.0 per cent of global financial instrument," says Raja Dr Nazrin Shah, crown prince of the northern Malaysian state of Perak (Kuala Lumpur, March 17 (NNN-Bername)). Since Islamic finance is covering very small part of conventional finance world and it is trying to survive in this world, the parallelism between profit rates and interest rates is an expected result. According to researches, the trends of clients/depositors who save their money in Islamic financial institutions are similar to conventional banks' customers. Both clients/customers want to maximize their incomes. Islamic banks are aware of this fact. The Islamic banks' managers think that if the bank declares a serious amount of loss or even in the case of very low profit rates, the clients or savers can withdraw the money that they save in the bank. So Islamic banks use profit equalization reserve to protect clients/depositors' income against the reduction. So when Islamic banks believe the rate of returns will be very below the interest rates they can use their reserve to increase the return rates. Profit equalization reserve is used to stabilize the rate of return to depositors by Islamic financial institutions. Profit equalization reserve can be defined as the reserve which is done by Islamic banks. Islamic banking and the services offered Islamic financial institutions may be similar to conventional financial system. The existence of parallelism between profit rates and interest rates does not mean that Islamic finance is just mimicking conventional system, it is just a natural result of the recent situation.

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