Comparison of Islamic and Conventional Banking Practices Regarding House Finance in Pakistan: A Case of Hazara Division

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ABSTRACT

Is there any difference between the Islamic and conventional banks products for home financing? The researcher tries to find the answer to this question. Descriptive statistical tools Mean, Median and Standard Deviation are used for data analysis. Some differences were found. Firstly, the customers are more benefited from the Islamic banks products than conventional banks because of partnership base products. Secondly, in conventional banks the level of stress and conflict is comparatively more than the Islamic banks because the risk of default rate is higher in conventional banks. Thirdly, Islamic banks also contribute to the society as corporate social responsibility. These banks as a society member give charity to the needy people which it collected form the customers delayed payment. On the other hand the conventional banks shows this amount collected form customers as interest considered as bank income.

Keywords: Islamic banks, conventional banks, home financing, diminishing Musharka

INTRODUCTION

For smooth functioning of any economy there is a need for transformation of funds from surplus unit to the deficit unit of economy because those who have the money do not necessarily invest in profitable business. Madura (2012) stated that savers can invest their money either directly in the security markets or with the help of financial intermediaries. In current market scenario two third of the savings are invested with the help of financial intermediaries (Beck et al., 2014).

Iqbal et al. (1998) and Beck et al. (2014) argued that the process of financial intermediations eliminates the size of required funds and terms of both the parties. The banks collect small savings from individual households and facilitate the deficit sector to use these funds for mortgage as well as for short term financing. Financial intermediaries remove the mismatch of the size of funds required by the users of funds and supplier of the fund.

The banks facilitate the people who feel the need for shelter. Banks offer various products to buy a home to protect them from the environmental and social hazards. The conventional home financing is common form to purchase house around the world. Where as in Islamic banks offer share base home financing products to facilitate home buyers (Hamid & Masood, 2011). According to McMillen, (2012) comparative to the conventional home financing, in Islamic home financing the bank received monthly rent of the home purchased on the portion of funds supplied to buy the home and diminishes as the home buyer pays to bank to purchase the portion of bank. Under the Islamic home financing the risk is also distributed as the profit with the home buyer proportion to their investment.

Ramli et al. (2013) argue that the conventional banks charge interest on the mortgage loan which is forbidden in Islam, Islamic banks offer the partnership contracts and sales-based for home financing activities and based financing rate is used only as standard to determine the bank's return. (Meera, (2012) said that the most common home purchase financing products are al-Bay' Bithaman Ajil (BBA), Diminishing Musharkaand Al-Ijerah. The Diminishing Musharka is most common product for home financing around the world.

The main purpose of this research is to conduct a comparative analysis of conventional and Islamic banks products offered for home financing to customers. Random sampling technique is used to select the banks from Hazara division, three Islamic (Meezan bank, bank Islami and Askari bank) and three conventional banks (Allied bank limited, Habib bank limited and Muslim Commercial bank) are selected for data collection. In order to find out the difference between conventional banks' lending and Islamic banks products for home financing this comparative study is conducted. Mean, Median and standard deviation are used to analyze the collected data.

Our findings show that the customers are more benefited from Islamic home financing products. Secondly the level of stress and conflict in conventional banks is more than Islamic banks. Thirdly the Islamic banks contribute in society through giving charity to needy people.

The remaining part of paper is set as follows: section 2 consist of literature review, Section 3 methodology and Section 4 the results and findings. At the end conclusion and recommendation are given.

LITERATURE REVIEW

In capitalist system the prime source of revenue of conventional banks is interest charge on the money lending to the individuals and corporations. The main runner of operations of the conventional banks is interest. There may be other sources of the income charging fee on providing the services like transfer of funds, guarantees, safety of wealth, international trade facilities (Hanif, 2010).

Beck et al., (2013) argued that Islamic banking is growing concept in the Muslims as well as in the non-Muslims countries. In Islamic banking system riba (interest) is considered Haram and it enhance the participation of ownership equity in the economy. (Hanif, 2010) said that interest is prohibited in Islam because it is predetermining cost of capital and in return it stops the full employment. International credit crunch of (2007-08) occurred due to the interest based economic system.

According to Bader et al., (2008) and Islam et al., (2014) found that Islamic banking has grown worldwide at a remarkable rate during the last three decades. These researchers were of the opinion that that Islamic financial institutions increases from 70 in 1975 to 300 in 2005 and 430 in 2010 in more than 75 countries. (Khan, 2010) point out that the annual growth rate of the Islamic Banking is about 15% in 2008 and they perform functions in about 70 countries. It is based on Shariah complying rules; it tries to convert the entire interest based system accordance to the Islamic cannons.

Beck et al. (2013) and Chong and Liu, (2009) said that the progress of Islamic banking is high during the past four spans in terms of players and scope. Islamic banking exists in more than 70 countries throughout the world and working side by side with conventional banks. Islamic banking is not prevalent to only Islamic countries, but also exists in Non-Muslims countries as well. According to (Aggarwal and Yousef, 2000) the instruments that islamic banking recommend are in acoordaance with the religious thinking and cultural distinctiveness of muslims societies.

Chong and Liu, (2009) argued that Islamic banking is different in theoretical prospective from conventional banking due to interest that is prohibited in Islam. Profit and loss sharing is the exclusive structures of Islamic banking which is based on Islamic mode of financing, Musharka and Mudarabah. According to Johns et al. (2013) risk in the Islamic banks compare to traditional banking is low because it is share with the depositors. In recent financial crises the Islamic banks were more insulated contrast to conventional banks which were led difficulties in that time. Amin et al., (2013) said that to retain the customers with the banks, market discipline is necessary to follow by the Islamic banks. Market discipline refers to the monitoring of investment and borrowers more closely to make sure honest reporting of profit and losses.

House Financing

Alam et al., (2012) argue that Human being needs shelter as other basic needs; food and cloths. They fulfill their need by means of constructing own house, renting or purchasing from others. Only few people can purchase or build their own house from their own resources, but most of them haven't the financial affordability to purchase house. To meet the basic need they move towards the banks to get house mortgage for the long term repayment from the individual personal income. According to Badav et al., (2014) in developed countries the mortgage loans are critical part of individual welfare because it is major liability of individuals as home is shown as corresponding asses in their balance sheet. For developing countries mortgage financing is also a critical segment of policy making to maturity transformation.

According to Madura, (2012) the bankers recognized that in the economic expansion period 2004-2006 the value of the real property gradually increases, so the risk of default was comparatively low. The bank can recover all the money if the resident unable to pay debt amount. Gerardi et al., (2007) said at the time of economic growth, most of the banks offered subprime loans to the house buyers who have the lower credit worthiness; higher current debts and lower income. These loans are beneficial for the commercial banks because they charge up-front fees and higher interest rate to pay off the risk of bank default. However in 2008, many subprime mortgage defaults occurred because of the global economic depression. The banks and the financial institutions take the ownership of the house which leads to decrease in the prices of the houses, which subsequently cuts the value of the collateral. The subprime loan is for the borrowers who have the low credit worthiness or they are not financially sound.

The conventional home financing is common form to purchase house around the world. The buyer signs a contract with the bank to pay schedule payment over the specified period of time. The commercial banks provide mortgage loans to the two groups of customers. One is for the residential purpose and the other is for commercial purpose. The bank loans for residential purpose is used by the general public for the construction or purchasing of house, while the commercial real estate mortgage loan is used for the business purposes; purchasing or building shopping malls, corporate offices, hotels and restaurants (Madura, 2012).

Islamic Home Financing

Hamid and Masood, (2011) discussed that home financing in Islamic banks are based on the Shariah rules. The interest and uncertainty is forbidden in Islam. The loans offer to purchase home are baked by the real property and these loans are payback in installment with monthly rent. Comparative to the conventional home financing, in Islamic home financing the bank received monthly rent of the home purchased on the portion of funds supplied to buy the home and diminishes as the home buyer pays to bank to purchase the portion of bank.

Ahmad and Shahed (2010) argued that in Islamic mortgage the relationship between the customer and bank is affable rather than aggressive which approves that the interests of both is similar and is not contrasting. Thomas, (2001) point of view is that the conventional mortgage financing create conflicts, insecurity and stress while the income and wealth is not equally distributed. On the other hand the shared equity financing minimize the stress, insecurity and conflict and make progressive and equitable society.

Under the Islamic home financing the risk is also distributed as the profit with the home buyer proportion to their investment. When the buyer is unable to pay the schedule principal amount to the bank the contract is not terminated (McMillen, 2012). Abdulkhalik, (2014) said that if customer fails to pay rent on mentioned date, he/she will contribute certain amount of penalty which is considered as charity by bank. The bank does not get benefit from this amount. Ahmad & Shahed, (2010) comment that if even he unable to pay the monthly rent, he/she would depart from the home and bank give it to the other on rent or sale in the market. The customer will get the rent up to the portion of investment or/and receive the share of proceed based on the percentage of home they owns if the home is sold in the market.

Islamic Home Financing Products

As the conventional banks charge interest on the mortgage loan which is forbidden in Islam, Islamic banks offer interest free products. The most common home purchase financing products are al-Bay' Bithaman Ajil (BBA), Diminishing Musharka also known as Musharka Mutanakisa Partnership (MMP) and Al-Ijerah. The BBA home purchase model is most common in Malaysia, Brunei and Indonesia, while the MMP is practiced in around the world, in Muslims and as well as Non-Muslims countries like United States, Australia, Canada and United Kingdom.

Al-Bay' Bithaman Ajil

The *al-Bay' Bithaman Ajil (BBA)* is a sale agreement which facilitate the buyer the advantage to pay in the future. It is a modification in the Murabaha (cost plus) agreement, where the products are transfer instantly, however the sale price along with profit is paid over a long period of time in installments. The BBA is argument among most of the Shariah scholars and criticized its acceptability mostly by the Middle East scholars, while some Shariah council (Council of Islamic Ideology Pakistan) is agreed upon its acceptability.

The Islamic banks provide the BBA facility to enables the home buyer to pay the cost of financing, e.g. a home purchased by the financer for 15 years at a fixed rate. The house is purchased by the Islamic bank from the customer and sells at higher price to the other customer. According to Shariah the bank is liable for all the defects and liabilities till the holding of ownership of the property (Meera and Razak, 2013).

Diminishing Musharka

Iqbal and Mirakhor, (2011), define the *Diminishing Musharka or MMP* as it is based on equity partnership. In mutual partnership, the banks (financer) and customer create contract to jointly purchase a home. The bank gives the option to the buyer to purchase the bank's portion in the home over the period of contract. McMillen, (2012) said that customer pays the schedule payment and monthly rent to purchase the portion of home which bought by bank. The rent is paid on the outstanding portion which is owned by the bank. At initial the customer pay for example 15% as initial margin and the remaining of 85% is paid by the bank. The customer will repay the 85% share to the bank at equal installment until the ownership of home is fully transferred to the customer.

According to Jain, (2013) The customer can terminate the contract at any time either by paying all the remaining payment at any point of time to purchase the whole portion of the bank, but it compensate all the loss of future return at predetermine cost or the customer also

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have the right to terminate contract by discontinuing the banks offered facility and can claim for the portion of the investment made by the investor. It can be done by selling the property in the market and get the portion of investment, the bank charge some fee for early termination of the contract. Iqbal and Mirakhor, (2011) argued that home buyer has the option in both cases to get advantage by using the cost and benefit analysis. In the boom period when the prices of the property are going upward he/she can retain the property till the contract and get the complete benefit. While in burst when the prices of property goes to diminishing, can discontinue the contract, and sale the property in the market and get his portion of investment.

In contract with the DM, conventional financing is differing by the nature of transaction (Jain, 2013). Ahmad and Hassan, (2007) said that in lender borrower relation, the bank (lender) advances funds to the home buyer (borrower) to repay in future with some extra; interest, which is strictly prohibited in Shariah. While in the DM the relationship between the bank and buyer as co-owner of the home.

Al-Ijara

Ijara is alternate product for leasing used by the Islamic banks. The consumer selects a home and request to the bank for financing. The bank after analyzing the home and customer, buy the home and leases to the customer for schedule rent but the title of the home remains with the bank (Thomas, 2001). Rizwanullah et al., (2012) argued that homebuyer contributes to the account to purchase the home and will also pay the periodic rental payment to the bank for using the bank property. The lesser (bank) is responsible for the expenses related to the ownership while the home buyer is responsible for the expenses related to the use of home.

According to Ahmad and Shahed, (2010) the amount of rent is reset after a year and each payment increases the home buyer equity, ultimately retiring the banks equity. The homebuyer has the option to discontinue the facility in part when the schedule payments are reset.

RESEARCH METHODOLOGY

To carry out the research study quantitative research methodology is used. The target of our research study is the Islamic and conventional banks operating in Hazara Division, Pakistan. We select three conventional banks such as Allied bank limited, Habib Bank Limited and Muslim commercial bank and three Islamic banks such as Meezan Bank, Bank Islami and Askari Bank with the through random sampling technique. Conventional banks ABL, HBL and MCB have been selected through random sampling from the conventional banking sector because these are performing their activities in almost every central location of Hazara division which representing the whole population of conventional banks. While Meezan Bank Bank Islami and Askari Bank, which are considered the banks mostly based on Shariah Principles, are also selected through random sampling technique from the Islamic Banking Sector representing the whole population of Islamic Banks in Hazara Division. The random sampling technique is used to select the sample from the entire population. 120 respondents were selected from both Islamic and conventional banks from Mansehra and Abbottabad districts. Data was collected from respondents with the help of questioners on five liker scale. The questionnaire consist of 15 questions for conventional and 15 for Islamic banks where Questions 1-7 related with banks operations for home financing, questions 8-10 related with customer view about home financing and remaining are general questions related with the home financing products, repayment of loan and default rate on maturity. Total of 120 questionnaires was distributed personally among the selected respondents. 46 completed questionnaires were received back from conventional banks and 42 from Islamic banks.

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Descriptive statistical tools such as Mean, Median, Standard deviation were used to analyze the data.

The main objectives of this study are

1. To analyze the Islamic banks practices for home financing
2. To analyze the Conventional banks practices for home financing
3. To assess the differences between the practices of Islamic and conventional banks for home financing.

RESULTS AND DISCUSSION

The below table indicates mean, median, mode and standard deviation of tools for Comparison of Islamic and Conventional Banking practices regarding home financing in Pakistan.

Table 1. Result of Conventional Banks Respondents

Questions	*N*	*Mean*	*Median*	*Std. Deviation*
1.	46	4	4	0.69921
2.	46	4.0652	4.000	0.49
3.	46	2.2174	2.000	0.84098
4.	46	4.3478	4.000	0.70608
5.	46	3.6957	4.000	0.91578
6.	46	3.9783	4.000	0.61424
7.	46	4.087	4.000	0.66084
8.	46	3.8261	4.000	0.7395
9.	46	1.4783	1.000	0.72232
10.	46	1.7174	1.000	0.98122
11.	46	1.000	1.000	0.0000
12.	46	1.000	1.000	0.0000
13.	46	3.087	3.000	1.07137
14.	46	2.0435	2.000	0.81531
15.	46	1	1.000	0

From the table 1 and table 2, it is cleared that the value of mean and median for question No 1 is 4, and 4 for conventional banks and 1.83 and 2 respectively for Islamic banks. The response for question no 1, frequencies shows that 65.2% respondents are agree and 19.6% were strongly agree while only 4.3% were disagree in conventional banks. On the other hand the frequencies for Islamic banks were 54.3% were disagree and 26.1% were strongly

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disagree with question no 1 “The customer is liable for all the losses related to natural disaster and market risk related to the home”. The Standard Deviation for conventional banks was 0.699 which indicate most of the respondents were agree with the statement while in Islamic banks the standard deviation was 0.621 which shows some variation in responses for question no1, mostly are agree and strongly agree.

Table 2. Results of Islamic banks Respondents

Questions	*N*	*Mean*	*Median*	*Std. Deviation*
1.	42	1.8333	2.000	.62143
2.	42	3.6667	4.000	.78606
3.	42	3.7381	4.000	.70051
4.	42	3.8571	4.000	.68330
5.	42	3.9524	4.000	.53885
6.	42	4.0238	4.000	.51741
7.	42	3.7619	4.000	.84995
8.	42	3.8333	4.000	.72974
9.	42	2.0476	2.000	.66083
10.	42	2.1667	2.000	.76243
11.	42	1.0000	1.000	.00000
12.	42	2.0000	2.000	.00000
13.	42	1.4762	1.000	.77264
14.	42	2.7143	2.000	.89131
15.	42	2.1429	2.000	.35417

The values of mean, median and mode for question no 2 are 4.065 and 4 for conventional banks and 3.666 and 4 for Islamic banks respectively. The frequencies for responses for question 2 are 76.1% agree, 15.2% strongly agree and 8.7% were nor agree nor disagree in conventional banks and 58.7% agree, 6.5% strongly agree and 10.9% were not agree nor disagree in Islamic banks with question no 2 “All the expenses incurred during the process to purchase of home such as registration, stamp duty fee and insurance are paid by the consumer”. The standard deviation for this question is 0.49 in responses of conventional banks employees and 0.78 for Islamic banks. The Islamic banks data shows more variation than conventional banks responses are. This mean, median and standard deviation for question shows that in both conventional and Islamic banks customer bear most the expenses that are incurred in purchasing of home.

For question no3 “The relationship between the home buyer and Bank is affable when any dispute arises” the mean, median and standard deviation are 2.21, 2 and 0.84 for conventional banks and 3.73, 4 and 0.70 for Islamic banks respectively. The frequencies for question no 3 are 65% disagree, 13% strongly disagree and 13% were agree in conventional banks and 67% agree, 10.9% nor agree nor disagree and 8.7% were disagree in Islamic banks. The value of standard deviation for both type of banks indicates that all data points are closed to mean and showing no variation in respondents' response.

The mean, median and standard deviation values are 4.34, 4 and 0.70 and 3.85for conventional banks and 4 and 0.68 for question no 4 for Islamic banks respectively for question no 4. The frequencies of respondents are 45.7% agree and 45.7% are strongly agree in conventional banks while 67.4% agree, 8.7% strongly agree, 6.5% disagree and 8.7% were nor agree nor disagree in Islamic banks for question no 4 "The element of conflicts and stress is more when the home buyer is unable to pay his schedule payments on time". These results show that conventional banks face more conflicts and stress when the customers are unable to pay their monthly payments.

The values of mean and median for question no 5 are 3.69 and 4 for conventional banks and 3.95 and 4 for Islamic banks respectively. And standard deviations are 0.91 and 0.53 for conventional and Islamic banks respectively. This shows that there is more variation in responses of conventional banks employees compare to Islamic bank's employees. The frequencies for responses for conventional banks are 67.4% agree, 10.9% strongly agree and 19.6% disagree and for Islamic banks 71.7% agree, 8.7% strongly agree and 8.7 are not agree nor disagree for question no 5 "customers pay the monthly schedule payment with interest at time". These values show that conventional banks face problems in receiving monthly payment from customers while Islamic banks can cover more than conventional banks.

For question no 6 the conventional banks mean, median and standard deviation values are 3.97, 4 and 0.61 respectively while for Islamic banks these values are 4.02,4 and 0.51. The frequencies of conventional banks respondents are disagree and Islamic banks respondents frequencies are 69.6% agree, 15.2% strongly agree and 13% are not agree n 47.8% agree, 15.2% strongly agree, 8.7% disagree and 19.6% are not agree nor disagree with question no 6 "Risk of default is comparatively low in economic expansion period and more in contraction period". These values indicate that almost both banks are agreed that in economic expansion period the risk of default is low.

The values of mean, median and mode for question no 7 are 4.087, and 4 for conventional banks and 3.76 and 4 for Islamic banks respectively. The frequencies for responses for question 7 are 63% agree, 23.9% strongly agree and 10.9% were nor agree nor disagree in conventional banks and 47.8% agree, 15.2% strongly agree and 19.6% were not agree nor disagree in Islamic banks with question no 7 "The interest of delayed payment, imposed on the customer is easily recovered from them". The standard deviation for this question is 0.66 in responses of conventional banks employees and 0.84 for Islamic banks. The Islamic banks data shows more variation than conventional banks. These values indicate that conventional and Islamic banks can easily recover the interest/penalty from customer which is imposed in case of delayed payment.

Conventional banks mean median and standard deviation values are 3.82, 4 and 0.73 while for Islamic banks these values are 3.83, 4 and 0.72 respectively for question no 8. The standard deviation values of banks shows there is no variation in responses of employees. The frequencies of responses of conventional banks are 67.4% agree, 8.7% strongly agree, 8.7% disagree and 6.5% not agree nor disagree, and frequencies of responses of Islamic banks are 69.6% agree, 10.9% strongly agree, 8.7% disagree and 10.9% not agree nor disagree with question no 8 "customers are satisfied or dissatisfied with the rate of interest charged from them".

The mean and median values of question no 9 and 10 are 1.47 & 1, and 1.71 & 1 in conventional banks and 2.04 & 2, and 2.16 & 2 in Islamic banks respectively. Frequencies of responses of conventional banks are 63% strongly dissatisfied and 28.3% were dissatisfied and Islamic banks frequencies are 58.7% dissatisfied and 15.2% not satisfied nor dissatisfied with question no 9 “customers are satisfied or dissatisfied with the documentation procedure of a loan”. The frequencies of responses of conventional banks are 54% strongly dissatisfied, 30.4% dissatisfied and 10.9% not satisfied nor dissatisfied, and in Islamic bank 63% dissatisfied, 10.9% highly dissatisfied, 8.7% satisfied and 8.7% not satisfied nor dissatisfied with question no 10 “customers are satisfied or dissatisfied with the sanctioning process of a loan”. These values signify that the customers are not satisfied with the documentation and sanctioning procedure involve in taking loan to buy home.

For question no 11 and 12 mean and median is 1 and 1 in conventional banks. The frequencies of responses are 100% yes for question no 11 “Bank charge penalty from customer when payment delayed.” The same results are for Islamic banks as well for question no 11. In question no 12 the banks responses in Islamic and conventional banks are different. The mean and median in Islamic banks for question no 12 are 2 and 2. The frequencies are 100% as charity in Islamic banks and 100% as bank income in conventional banks of question no 12 “If the answer of Question 11 is yes; what should be done with the amount charge from customer as penalty?”

In conventional banks the mean and median values for question no 13 are 3.08 and 3 respectively. The frequencies of responses are 39.1% are 10-15, 26.1% are 15-20, 8.7% are above 20%, 17.4% are 5-10 and 8.7% are less than 5% for question no13. The standard deviation value is 1.07 which shows variation in the responses of conventional banks employees. While in Islamic banks the mean, median and standard deviation are 1.47, 1.0 and 0.77 respectively. The frequencies are 60.9% are less than 5% and 19.6% are 5-10 and 8.7% are 10-15 for question no 13 “How many customers default on the maturity?” the standard deviation value shows less variation in responses compare to conventional banks employees in Islamic banks.

In response to the question no 14 the values of mean, median and standard deviation are 2.04, 2 and 0.81 in conventional banks and 2.71, 2 and 0.89 in Islamic banks respectively. The frequencies of respondents are 60.9% difficult, 21.7% very difficult, 8.7% don’t know and 8.7% easy in conventional banks and 52.2% difficult, 13% don’t know and 26.1% easy in Islamic banks for question no 14 “How difficult is it for the customer to find a bank willing to finance you for buying home?” The standard deviation value of both banks shows some variation in responses of banks employees. The responses of banks employees values of mean, median and standard deviation for question no 15 are 1.0, 1.0 and 0 in conventional banks and 2.14, 2.0 and 0.35 in Islamic banks respectively. The frequencies of responses are 100% secured loan in conventional banks and 84.7% Diminishing Musharka and 14.7% Al-Ijara.

CONCLUSION

In this paper we found some differences in the conventional and Islamic banks practices regarding home financing. Firstly we come to the point that customers are more benefited from the Islamic banks products up to some extent. The Islamic banks offer home financing products to its customers on partnership basis, in case of any damages both customer and bank share on agreed ratio while in conventional banks offered mortgage loan which will be recover whatever the situation of customers is. Secondly, in conventional banks the level of stress and conflict is comparatively more than the Islamic banks because the risk of default rate is high. On the other hand the shared equity financing minimize the stress, insecurity and conflict and make happy and equitable society which approves that the interests of both is similar not contrasting. Thirdly Islamic banks also contribute to the society as corporate social responsibility. These banks as a society member give charity to the needy people which it collected form the customers delayed payment. On the other hand the conventional banks shows this amount collected form customers as interest considered as income of the bank.

At the end the researchers come to the point that the customers and society is more benefited from the Islamic banks products for home financing. The conventional banks now trying to shift their operations in accordance with Shariah rules. We recommend to banks to offers Shariah complaints products. These are more beneficial for both banks as well as for society. For future researcher can explore the more sophisticated products for home financing as well as to satisfy other financial need of society which are accordance with Shariah rules and benefited to customers.

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