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A Comparative Analysis of Islamic Banks and Conventional Banks

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Abstract: This article explores the important aspects of buying a house with Islamic banks and conventional banks. Islamic banks operate according to Sharia principles, prohibiting interest (riba) and promoting ethical financial transactions. Conventional banks, on the other hand, offer interest-based financing. Key aspects examined include financing methods, contractual structures, transparency, ethical considerations, credit assessment, down payments, regulatory compliance, and risk-sharing. Understanding these aspects is crucial for individuals seeking to purchase a house and navigate the financial options available to them.

Key words: Islamic banks, conventional banks, house buying, financing methods, Sharia compliance, interest-based financing, Murabaha, Ijara, Musharaka, credit assessment, down payment, risk-sharing, transparency, ethical considerations, regulatory compliance.

Introduction:

The demand for housing has perennial relevance, being a fundamental human need. With the expanding population, this demand continues to escalate. Consequently, there exists a considerable disparity between the income levels of the populace and the cost of housing. This diminishes purchasing power and necessitates long-term payment schemes. In response, banks in Uzbekistan, as elsewhere globally, offer mortgage loans to facilitate housing purchases.

However, like other sectors, challenges and deficiencies are evident in this domain. Issues such as escalating housing costs, high interest rates and penalties, misalignment with religious beliefs, and complex payment structures are prevalent. Notably, the populace's increasing religious awareness is driving a decline in demand for conventional mortgage loans while fueling a surge in interest for Islamic banking services. Hence, it becomes imperative to examine the merits and demerits of Islamic banks versus traditional banks.

This study aims to explore and compare the advantages and disadvantages of Islamic banks and traditional banks in the context of housing finance. By delving into these aspects, we can gain insights into the suitability and efficacy of both banking systems in meeting the housing needs of the populace. Moreover, this analysis can inform policymakers and financial institutions in crafting strategies to address the evolving demands and preferences of consumers in the housing finance sector.

Literature Analysis:

Several scholarly works have contributed significantly to the understanding of housing finance through Islamic banks. Michael JT McMillen's article "Islamic Housing Finance: A Conceptual Overview" provides a foundational understanding of the principles and transaction structures involved in Sharia-compliant housing finance. The article succinctly summarizes the six most commonly used financing structures, including rent (lease), diminishing partnership (musharakah mutanakisah), cost and sale (murabahah and tawarruk), deferred payment sale (bay' bithaman ajil), and the two-tier construction contract financing (istisna'a - parallel istisna'a). This conceptual overview serves as a valuable resource for those seeking to grasp the fundamentals of Islamic housing finance.

Mufti Mohammad Taqi Usmani's book "Introduction to Islamic Finance" offers comprehensive insights into various aspects of Islamic finance, including housing finance. Usmani's expertise in Islamic jurisprudence and finance lends credibility to the information provided, making it a crucial reference for researchers and practitioners in the field.

Norazlina Abd Wahab's article "Islamic Social Finance Initiatives: An Insight into Bank Islam Malaysia Berhad's Innovative BangKIT Microfinance Product" delves into innovative Islamic social finance initiatives, shedding light on Bank Islam Malaysia Berhad's BangKIT microfinance product. This article underscores the importance of inclusive finance solutions, including microfinance, in addressing housing needs within Islamic finance frameworks.

Similarly, Oybek Akhmadjonov's work "Islamic Finance and Banking" contributes to the literature by providing a comprehensive overview of Islamic finance principles and practices, including housing finance. Akhmadjonov's examination of Islamic banking operations and financial instruments enriches the understanding of how Islamic financial institutions facilitate housing purchases in accordance with Sharia principles.

Overall, these works collectively deepen our understanding of Islamic housing finance, offering insights into transaction structures, principles, and innovative initiatives in the field. They serve as valuable resources for researchers, policymakers, and practitioners seeking to navigate the complexities of housing finance within Islamic finance frameworks.

Research methodology. In this study, a combination of research methods was employed to analyze and compare the advantages and disadvantages of Islamic banks and traditional banks in the context of housing finance. The following research methodologies were utilized: Logical analysis, cause and effect, formal statistical data summarization methods were used in research.

Analysis and results. Islamic banking is a financial system based on Islamic law or Shariah. It operates under the guidance of Islamic scholars and aims to promote ethical and socially responsible investment. Islamic finance prohibits charging interest on loans and paying interest on saving accounts and instead uses other mechanisms such as profit and loss sharing to financial transactions. Islamic banking is based on the teachings of the Prophet Muhammad (peace be upon him), who emphasized the importance of honesty, justice and ethical behavior in all financial transactions . Islamic finance works according to the principles of "murabahah" (profit sharing) and "wakala" (agency), which allows financing transactions without charging interest. Instead of charging interest on loans, Islamic finance uses a profit-sharing system where the lender receives a portion of the profits generated by the borrower's business. In addition, Islamic finance uses the concept of "mudarabah" (joint venture), where one partner gives money to invest in the other party's business. The parties will share in the profit according to the agreement, and if there is a loss, the investing party will bear the full loss, and the other party responsible for carrying out the work will lose for the labor and time spent. In general, Islamic banking is a financial system that operates on the basis of Shariah principles and aims to promote ethical and socially responsible investments. It focuses heavily on profit and loss sharing mechanisms and has gained popularity in recent years due to its focus on ethical and socially responsible investing.

Currently, the procedure for issuing a mortgage loan in the traditional banking system includes several stages:

1. Application: The borrower submits a mortgage application to the bank providing personal and financial information such as income, assets, debts, employment information and property details.

2. Pre-Approval: The bank evaluates the borrower's financial condition, creditworthiness and property valuation to determine the borrower's eligibility for the loan. At this stage, a pre-approval may be issued indicating the maximum loan amount that the borrower can take.
3. Property Appraisal: An independent appraiser evaluates the property to ensure it meets the bank's criteria and loan-to-value (LTV) requirements.
4. Underwriting: The bank's underwriting team reviews the borrower's application, credit history, property appraisal and other relevant documents to assess risk and make a final decision on lending .
5. Approval and Closing: Upon approval, the bank will provide a commitment letter outlining the terms of the loan. Both parties (borrower and lender) then proceed to closing, where legal documents are signed and the loan is funded.

The payment procedure will be as follows:

1. Monthly Payments: The borrower is required to make regular monthly payments that usually include principal and interest, but may also include property taxes and insurance.
2. Amortization Schedule: The bank provides an amortization schedule that shows how each payment is split between interest and principal. Early payments during the loan term cover interest first, and later payments gradually reduce the principal amount.
3. Grace Period and Late Payments: There may be a grace period for late payments, after which penalties or late fees may apply. The bank may also report late payments to the credit bureaus, which will affect the borrower's credit score.
4. Prepayment Options: Some mortgages allow borrowers to make additional payments or pay off the loan early without penalty. Others may have prepayment penalties for paying off the loan before a certain period.
5. Repayment Period: The loan is repaid over an agreed period (eg 15, 20, or 30 years), at the end of which the loan is fully repaid and the borrower has full ownership of the property.

In Islamic banking, the lending rules are based on Sharia principles and prohibit the charging of interest on loans. Instead of charging interest, Islamic finance uses a profit-sharing system where the lender receives a portion of the profits generated by the borrower's business. In Islamic banking, lending rules are based on the concept of "mudarabah", in which a lender and a borrower form a partnership to finance a project.

The rules of the competition are as follows:

1. The partnership must be established by a written contract that must be in accordance with the principles of Sharia.
2. The lender must provide capital for the partnership, while the borrower contributes management and operational skills and experience.
3. The borrower must submit a detailed business plan, which is approved by the lender and the Shariah scholar.
4. The lender and the borrower must agree on the terms of the partnership, including the ratio of profit sharing, the duration of the partnership, and the method of calculating profits and losses.
5. Lender and borrower must agree on the use of funds to be used only for partnership purposes.
6. The lender and the borrower must agree on the distribution of profits and losses, which must be based on the agreed profit sharing ratio .
7. The partnership must be regularly reviewed by a Shari'ah scholar to ensure its compliance with Shari'ah principles .

In general, lending rules in Islamic banking are based on the concept of mudarabah, which is a joint venture between the lender and the borrower. Mudoraba rules are designed to ensure that the partnership is honest, fair and ethical , and that the borrower's business is compliant with Sharia principles.

The procedure for buying a house on the basis of Islamic banking is as follows.

In Islamic banking, mortgage loans are structured in accordance with the principles of Sharia law, which prohibits the payment or receipt of interest (riba). Instead , Islamic finance relies on alternative arrangements that conform to Shariah principles.

One of the common methods used by Islamic banks for home financing is murabahah . In a murabahah transaction, the bank buys the property and then sells it to the buyer at a higher price, allowing the buyer to pay in installments. The higher price includes the bank's profit margin, and the buyer knows the total costs in advance, because there is no "gharar" (uncertainty).

Another method is a property lease agreement. The bank buys the property and leases it to the buyer for an agreed period, during which the buyer pays the rent . A portion of the rent can be used to buy the property. At the end of the lease term, ownership is transferred to the buyer .

A diminishing partnership is another model in which the bank and the buyer purchase the property together. The buyer pays the rent for the use of the bank share and gradually buys the bank share. Ultimately, the buyer becomes the sole owner of the property.

These Islamic mortgage systems ensure that financing is based on Shariah-compliant, interest-free, asset-backed transactions.

Ensure borrowers fully understand the terms of their mortgage, including the payment schedule, interest rates, fees and potential penalties, ensure that payments are made on time, and that any payments are made during the repayment period. It is very important to avoid the consequences.

Conclusions and Recommendations:

Our research underscores the importance of providing inclusive and Sharia-compliant alternatives to traditional mortgage loans for purchasing homes. By offering housing purchase services based on Islamic banking principles, we can address the needs of a significant segment of the population who refrain from utilizing traditional banking services due to religious convictions. This not only ensures financial inclusivity but also yields economic benefits for both parties involved.

It is crucial to recognize that individuals have the right to access financial services that align with their religious beliefs. While traditional banks may not cater to the needs of certain religious communities, Islamic banking offers a viable solution that respects religious values and financial requirements. By embracing Islamic banking principles, we can broaden access to housing finance and promote financial inclusion on a larger scale.

The home buying procedures discussed in our article are widely used across different economies, but it's essential to acknowledge that nuances exist in the implementation of these principles, especially concerning Sharia compliance. Not all structures may be permissible under the Sharia principles practiced in specific jurisdictions or sects. Therefore, it's imperative for individuals and organizations considering these structures to consult qualified Shari'ah scholars to ensure compliance with relevant principles and regulations.

In conclusion, we encourage further exploration and adoption of housing finance alternatives, particularly those rooted in Islamic banking principles, to address the diverse needs of communities and promote financial inclusivity. By leveraging Sharia-compliant solutions, we can foster a more equitable and accessible housing finance system for all.

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