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Article

The Importance of Studying Different Features on Deposit Operations of Islamic and Commercial Banks

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Abstract: A Bank is the establishment for the custody of money received from, or on behalf of, its customers. Interest being the cogwheel of the modern banking, is strictly prohibited in Islam and hence there can be no banking system in Islam based on Interest. Islamic Banking has the same purpose as conventional banking except that it operates in accordance with the governing rules of Shari'ah. The establishment and operation of Islamic banking and finance is governed by Shari'ah principles. These specific underlying principles give a new dimension to its governance structure, which is known as Shari'ah Governance. The aim of this research is to examine the theoretical and practical differences of deposit services between Conventional banks and Islamic banks. It also provides information on the first steps in the development of the Islamic banking market in Uzbekistan.

Key words: *Islamic bank, Deposit services, Uzbekistan, Wadiah, Investment Account, Conventional bank, Riba, Mudaraba, Legislation.*

Introduction

The banking system is the lifeline of any modern economy which helps in the financial intermediation by mobilizing deposits and disbursement of credit. Banking in a modern sense is the process of accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. The principal function of a Bank is to bring into a common fund or pool of idle money of the general public, for the purpose of making advances to others, to gain a return in the form of interest, fee and dividends in making advances and providing services to others. Interest being the cogwheel of the modern banking, is strictly prohibited in Islam and hence there can be no banking system in Islam as Interest. An Islamic bank is a financial institution which identifies itself with the spirit of Shariah, as laid down by the Holy Qur'an and Sunnah, as regards its objectives, principles, practices and operations. The veterans of Islam propose that a sound system of Banking is possible in Islam which should be based on the concepts of Mudharaba, Murabaha and Profit and Loss Sharing (PLS).

Islamic financial sector in Uzbekistan is still relatively undeveloped compared to its Central Asian neighbors, although the country has great potential for development. This has been acknowledged by experts from major international financial institutions (Islamic Development Bank Group, International Finance Corporation, Asian Development Bank, etc.). In this regard, the President of the Republic of Uzbekistan Sh.Mirziyoyev in his Address to the Oliy Majlis on December 29, 2020 said, "It is time to

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create a legal framework for the introduction of Islamic financial services in our country. Experts from the Islamic Development Bank and other international financial institutions will be involved in this, “he said. As a result of the international downturn in the banking and financial system and the need to radically improve the infrastructure of the financial market, the attention of the investment finance community to the Islamic form of financing has increased significantly. In modern conditions, the segment of Islamic finance on a global scale is one of the fastest growing: turnover is estimated at more than $ 1,300 billion. The sufficiently intensive development of Islamic banking is due to the growing demand and the significant accumulation of financial resources by Muslim countries.

Problem statement

The financial sector of Uzbekistan has seen significant growth in recent years, with a push towards diversification and modernization. However, despite these developments, the implementation of Islamic banking, particularly deposit services, faces substantial challenges. Islamic banking, which adheres to Sharia principles, prohibits interest (riba) and emphasizes profit-sharing, ethical investments, and risk-sharing. These principles differ fundamentally from conventional banking practices, creating a unique set of challenges for banks in Uzbekistan looking to offer Islamic deposit services. The first major challenge is the lack of a comprehensive regulatory framework that supports Islamic banking. Uzbekistan's current financial regulations are primarily designed for conventional banking, and there is limited legal infrastructure to accommodate the unique aspects of Islamic finance. This regulatory gap makes it difficult for banks to offer Islamic deposit services that are fully compliant with Sharia law, leading to uncertainties in product development, risk management, and legal enforcement. Another significant challenge is the lack of awareness and understanding of Islamic banking principles among both consumers and banking professionals. Islamic finance is relatively new in Uzbekistan, and there is limited expertise in the field. This lack of knowledge can result in misconceptions about the nature and benefits of Islamic banking, leading to low consumer demand and difficulties in training staff to effectively manage and market Islamic deposit products. Additionally, there is the challenge of insufficient Sharia-compliant investment opportunities within the Uzbek economy. Islamic banking relies on profit-sharing mechanisms and investments in permissible (halal) sectors. The limited availability of Sharia-compliant assets and investment opportunities in Uzbekistan poses a significant barrier to the successful implementation of Islamic deposit services, as it restricts the banks' ability to generate returns on deposits in a manner consistent with Islamic principles. Lastly, the absence of a robust Islamic financial infrastructure, including institutions such as Sharia boards, Islamic banking scholars, and dedicated Islamic finance departments within banks, hampers the growth of Islamic banking in Uzbekistan. Without this infrastructure, ensuring Sharia compliance and building consumer trust in Islamic deposit products becomes challenging. In summary, while there is potential for the growth of Islamic banking in Uzbekistan, the implementation of Islamic bank deposit services faces significant hurdles, including regulatory challenges, lack of awareness, limited investment opportunities, and underdeveloped financial infrastructure. Addressing these challenges is crucial for the successful integration of Islamic banking into Uzbekistan's financial system.

Study objective: Comparison of the deposits between Conventional banks and Islamic banks.

Study question: What are the main differences and similarities of deposit services of these two different systems of banks?

Significance of the study

Contribution to Financial Inclusion: Islamic banking offers an alternative to conventional banking that aligns with the ethical and religious beliefs of a significant portion of the population. By exploring the challenges and opportunities of implementing Islamic deposit services, this study contributes to enhancing financial inclusion in Uzbekistan, enabling more people to participate in the formal financial system.

Market Development and Innovation: For banks and financial institutions, understanding the challenges and opportunities of Islamic deposit services can lead to the development of innovative financial products tailored to the needs of different market segments. This can enhance competition in the banking sector, leading to better services and products for consumers.

Literature review

Several studies highlight the significant role of regulatory frameworks in the successful implementation of Islamic banking services. A study by Ahmed and El-Gamal (2022) discusses the importance of aligning national financial regulations with Islamic finance principles to ensure compliance and foster growth in the sector. They argue that the absence of a dedicated Islamic banking regulatory framework in Uzbekistan poses a major challenge, as existing laws are primarily designed for conventional banking. This gap creates uncertainties for financial institutions attempting to introduce Sharia-compliant products, including deposit services.

Numerous challenges and opportunities have been identified in the literature regarding the implementation of Islamic deposit services in Uzbekistan. A study by Bekchanov (2021) identifies the primary challenges as regulatory hurdles, limited Sharia-compliant investment opportunities, and the nascent stage of consumer awareness. However, the study also notes the significant potential for growth, given the increasing interest in ethical and religiously compliant financial products among the population.

A comprehensive review by Ismailov and Abdullaev (2023) further explores the specific operational challenges faced by banks attempting to introduce Islamic deposit products. These include the difficulty in finding Sharia-compliant investment opportunities within Uzbekistan's economy, which is still dominated by conventional finance. The authors suggest that expanding the range of halal investment opportunities, such as through the development of Islamic bonds (sukuk) and Sharia-compliant mutual funds, could help address this issue.

The establishment of a robust institutional infrastructure is crucial for the development of Islamic banking. Research by Khan and Murad (2022) emphasizes the need for Sharia boards, Islamic finance experts, and specialized departments within banks to ensure the effective implementation of Islamic banking services. In the context of Uzbekistan, Khan and Murad highlight the scarcity of trained professionals and institutions capable of providing Sharia-compliant financial services. They suggest that partnerships with international Islamic finance organizations and the development of local expertise are necessary to build a sustainable Islamic banking infrastructure.

Research methodology

The applied methodology in the study is a combination of systematic library research and content analysis of the current legal infrastructure in Uzbekistan. Firstly, previous studies in the matter were systematically reviewed and their conclusions summarized. Thereafter, an analysis of content in various legal documents pertaining to the activities of Islamic finance institutions was undertaken.

The relevant financing documents from Uzbekistan's finance industry were utilised to collect data for this study. This information was sorted and organised concurring with the studied issues in Islamic finance. Next, the issues were compared to the theories of Islamic finance and the opinions of scholars. Whenever available, data was obtained directly from the official legal portal of the government of the Republic of Uzbekistan, which is Lex.uz.

Furthermore, official statements of the representatives of the government of Uzbekistan were pulled from the respective official websites, such as one regarding The Central Bank of the Republic of Uzbekistan at Cbu.uz, or the official government news agency, Uzbekistan National News Agency at Uza.uz. Nevertheless, if such statements or information regarding Islamic finance in the country could not be found in those sources, popular local news media, such as Kun.uz, Daryo.uz, or UzDaily.uz, or international news agencies, such as Islamic Finance News (IFN) were utilised. Relevant statistics of secondary data were brought in either from the State Statistics Committee of Uzbekistan or the Islamic Development Bank (IsDB) or its subsidiaries, such as the International Islamic Trade Finance Corporation (ITFC). Other reliable sources of data and information are also referenced wherever necessary.

Research Findings

The primary barrier to conducting Islamic finance operations by commercial banks is the presence of a ban for banks engaging in production and trade activities. Article 7 of the Law of Uzbekistan on Banks and Banking Activities prohibits commercial banks from engaging in production, trade, and insurance activities[9]. As Islamic banks base their activities on their direct involvement with trade and business, this ban is considered the main obstacle to conducting the activities of Islamic banks. Commercial banks that want to offer Islamic finance products through Islamic windows also complain about these issues. Abrorov and Imamnazarov specify that commercial banks that participated in their survey on issues of Islamic banking identified the nonconformity of banking and tax legislation as a main impediment to the introduction of Islamic finance in Uzbekistan [10]. Unless this barrier is removed or Islamic banks are given special treatment and permitted to conduct trade activities, the introduction of Islamic banking is impossible in the country. For example, Kazakhstan's banking law set a special rule concerning the activities of Islamic banks, allowing them to finance production and trade activities by contributions done directly in the charter capital of legal entities or under partnership terms[11].

Commercial banks, both conventional and Islamic, are dependent on depositor's money as a source of funds. According to the Keynesian theory of demand for money, there are three main motives why people hold money: transactions, precautionary and investment. In order to cater for these motives, commercial banks offer three categories of deposit facilities that are demand, savings and time deposits. Demand deposit facility is most commonly referred to as current account and is designed for those who need money for transaction purposes.

This motive can be looked at from the point of view of consumers who want income to meet their household expenditure and from the viewpoint of businessmen who require money and want to hold it in order to carry on their business. Hence, the purpose of deposit facility is for convenience or for making daily commitments. The second category of deposit is the savings account, which caters the need of those who wishes to save money but at the same time want to earn an income.

A full comprehension of the operation of a bank can only be achieved through the understanding of various items contained in its balance sheet. The banks' asset side comprises of a set of items that may vary between banks, depending on internal as well as external factors. On the other hand, the banks' liabilities side represents the nature of typical bank business, which is low margin and high leverage. The funding structure of banks directly impacts on its cost of operation and thus, determines their potential profit and level of risk.

Overall, the nature of Islamic banks' balance sheet is very similar to the conventional ones. However, there is a difference that distinguishes between the two of them, that is, Islamic banking applies Islamic law or popularly termed today as Shari'ah into their activities. This Shari'ah compliant instruments can be utilised to perform functions of Islamic banks that are the same as conventional banks, such as asset intermediation and mobilisation.

Like conventional banks, Islamic banks accumulate their liability side from retail deposits, namely current account, savings account, and fixed deposit account. However, Islamic banks receive these accounts under special contracts, complying to Islamic law or Shari'ah; that distinguishes it from conventional banks.

Islamic Society in its real sense is an association for the purpose of harmonious co-existence. The actions of individuals in the Islamic society should carry on the code of moral values and conduct. Islamic society is thus, based upon righteousness and mutual help. Islamic Jurisprudence, in particular, prohibits all such transactions in which some or all of the following components are present:

• Any return on money that is predetermined in amount (or percentage) and therefore, includes modern day Interest. (riba)

• Uncertainty (gharar) in contracts, which means prohibition on the sale of items whose existence or characteristics are not certain, and which are ambiguous upon contractual terms.

• Gambling (maisir) – applies to the dealings in futures and options to them speculative level.

• The activities relating to the trade of commodities prohibited (Haram) by Islam like; activities relating to provision of pork, alcohol, and gambling services.

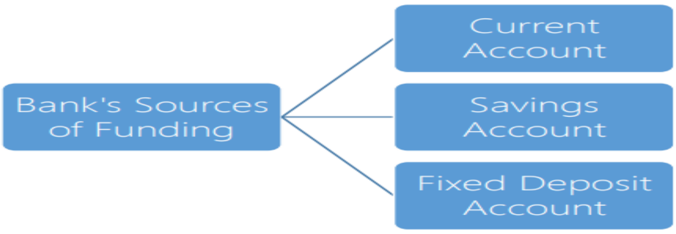

Figure1: Source of funding for a conventional bank

Current Account (Checking Account)

Conventional Banks

Individuals or businesses who desire the convenience of issuing cheques for making payments most commonly hold current accounts. These deposits have no maturity, no minimum balance and may be withdrawn at any time. Most of the time, current accounts do not pay interest. However, with the advancement in electronic payment systems, the popularity of such deposits may be limited to businesses who demand flexibility in withdrawing funds between cash or writing cheques.

Islamic Banks

In the Islamic banking system, depositors grant full authority to the bank to utilise funds deposited for investment purposes, at the bank's own risk. Both profit (accrued) and losses (borne) will flow to the bank. The depositor is not paid any share of the profits made by the bank with the deposits invested but is allowed to withdraw the deposits at any time. This is consistent with the Islamic principle of qard hasan (interest-free loan) where customers' deposits are treated as a benevolent (interest-free) loans, and the bank is free to utilise these funds at its own risk without specific permission of the depositor, guaranteeing only the principal amount deposited (without any return). However, the bank may elect to reward depositors with hibah (gift), as long as it is not stipulated in the contract or agreed upon the commencement of the deposit. The other view of amanah (trust) also applies to current accounts. Banks are to hold deposited funds in trust with no conditions for deposit and withdrawal, while being able to utilise these funds at its own risk with regards to profit and loss-making – with prior permission of the depositors.

Furthermore, the mudarabah concept is also applicable to the current accounts of Islamic banks. The principle mudarabah (profit and loss sharing or entrepreneurship) will position the bank as a mudarib (agent-manager), with the funds supplied by the rabb al-mal (investor or depositor). With mudarabah current account deposits, Islamic banks operate on a predetermined ratio for sharing profits at the point of account opening – as compared to the usual practice of rewarding based on predetermined fixed interest rate in conventional banking system or payment of dividends at discretion under wadi'ah accounts. The Shari'ah Advisory Council (SAC) also issued a ruling that the withdrawal of the mudarabah current account deposit funds (the mudarabah capital) is permissible as long as a minimum balance limit has been set in the account, where full withdrawal of deposits is considered as termination of the mudarabah contract. Mudarabah operates under the principle of profit-and-loss sharing or joint-venture. However, in the application of mudarabah, the bank acts as the rabb al-mal, supplying funds to its customers. With that being said, the mudarib (agent-manager or entrepreneur) will be funded by the bank. The proportion of profits to be paid to the bank is agreed in advance, based on an agreed ratio. In this scenario, any losses will be the liability of the bank and the customer only sacrifices his share in the profits and efforts in managing the funds provided.

Savings Account (Demand Deposits)

Conventional Banks

Savings accounts are similar to current accounts in all aspects with the exception of the cheque writing facility. The withdrawal of funds from savings accounts is limited to only electronic methods such as ATMs, EFTPOS and direct debit; depositors are not able to issue cheques to make payments. These accounts cater to those who wish to save money and earn some interest income, such as individuals who hold money for precautionary motives.

Islamic Banks

Savings deposit in the Islamic banking system is similar to conventional banking system's saving account, with the exception that it does not permit riba. Return on capital can only be justified in the Shari'ah context only when the capital employed is exposed to business risk. Therefore, the guaranteed return of the principal and interest in the conventional banking system's savings account is not justifiable. However, if the bank wishes to refund some portion of the profits earned from the utilisation of depositors' funds, it may do so at its discretion and treated as a gift. The first type of savings account as exhibited below follows the principles of qard hasan. The qard principle allows the bank to benefit from the holding of customers' funds (by investing it elsewhere) and to return an equivalent replacement at maturity. The funds placed with the Islamic bank is not meant for profit-generation, rather it is benevolent (tabarru') by nature. Customers deposit funds with an authorisation for the bank to invest the funds deposited. The share of profits that the bank may elect to give out to the depositors depends on the minimum balance maintained during the month. Depositors with a satisfactory minimum balance are entitled to a share of profits. This practice is applied for example, in Bahrain Islamic Bank under the arrangements (or metrics) of savings account with authorisation to invest. Savings account also operate under the principles of wadi'ah (safe custody) and dhaman (suretyship) contract, and defined as 'wadi'ah yad damanah' or safekeeping with guarantee – where the bank will act as a custodian for the funds, while being able to utilise the depositors' funds and be solely liable for damaged inflicted on the funds deposited. The depositors are also entitled to discretionary hibah offered by the bank. This practice is applied in Bank Islam Malaysia under the concept of wadi'ah yad damanah. Some savings account follows the principles of qard hasan where it operates in tandem with the current accounts offered by the bank. The banks may also offer non-fixed cash bonuses or other form of incentives to attract customers. This practice is applied in Iranian Islamic banks.

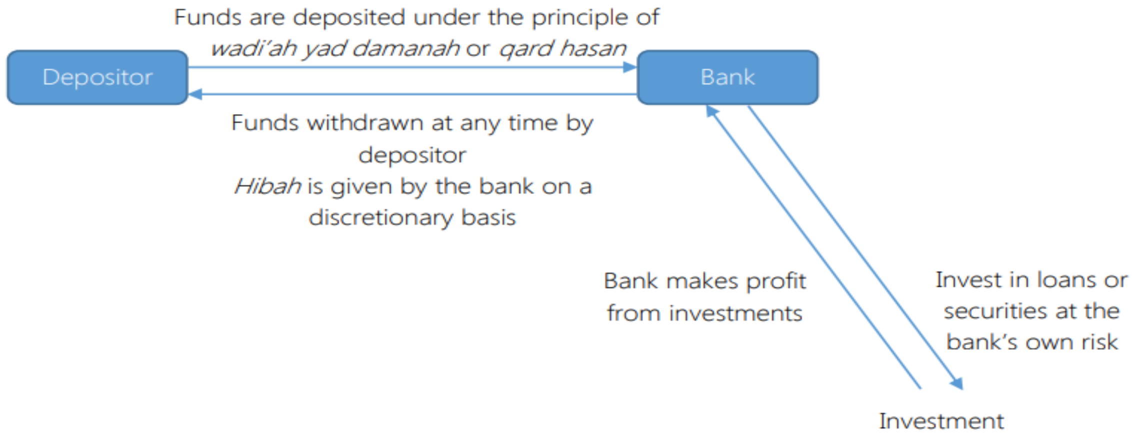

Figure 2: Flow of savings account in Islamic bank

Fixed Deposit (Term Deposit Facility)

Conventional Banks

This facility caters to depositors who wish to earn higher interest income than savings account, at the expense of the flexibility in withdrawing funds. Usually, there is a minimum deposit amount and the interest rates offered may increase with the size of the deposit amount. With regards to withdrawal of funds, fixed deposits have a specified maturity date, and a penalty will be incurred should the funds be withdrawn prior to the maturity date.

Islamic Banks

The term deposit facilities provided by Islamic banks typically operate under the principle of mudarabah (profit and loss sharing) and is usually regarded as investment deposits, similar to mudarabah current accounts offering predetermined ratios for profit-sharing. With the Islamic term deposits, the amount of profit to be received by each depositor will depend on the return on the bank's investment using the funds provided. However, losses will be borne by the funds supplier, while the manager would sacrifice only its share in the profits and efforts in managing funds. With regards to early withdrawal of funds, it is not permissible in investment deposit contracts and additional deposits into the same account is also not allowed, although customers may open additional accounts should they have more funds to deposit. Under the mudarabah al-muqayyadah (restricted mudarabah), the depositor will specify the particular business to be invested by the bank, as opposed to the mudarabah al-mutlaqah (unrestricted mudarabah). Under the wakalah (unrestricted investment) account, deposits are made for a specified maturity, with profits calculated and distributed at the end of the financial year.

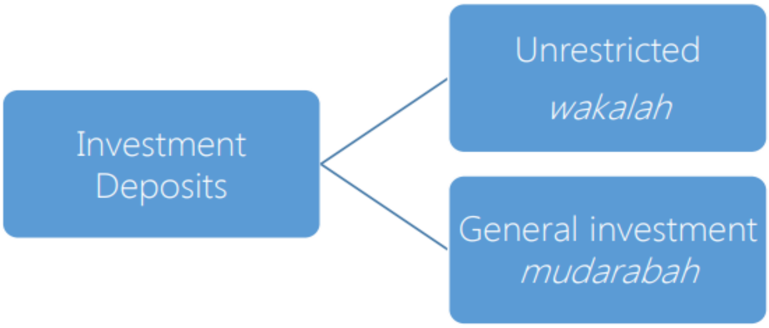

Figure 3: Investment deposits

Mudarabah is a general investment contract that arranges for profit and loss between two parties, namely Islamic banks and customer/investor. In this contract, banks, as the enterprenеur, will share a percentage of profit for their management effort of the fund. However, in case of losses, the investor (rabb al-mal) will bear all the losses.

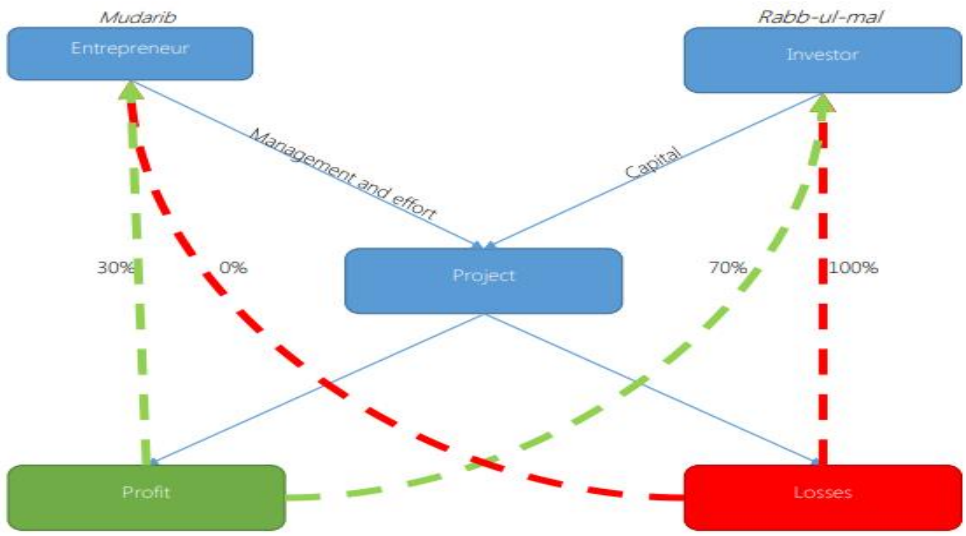

Figure 4: Flow of mudarabah contract in Islamic banks

Islamic Banks Risk in Mudarabah Deposits

A profit equalisation reserve has been permitted for the Islamic banks on the argument to provide a more stabilised rate of return to maintain competitiveness with the conventional banking system. As profit rates may fluctuate with changes in income and deposits, PER also aims to increase investor confidence in the Islamic bank. A PER provision account is shared by both the deposit/investor and the Islamic bank. When the Islamic banks earn a higher return comparative to the market, an amount from the gross income in placed into the PER account – to be paid out when the banks are earning lower return comparative to the market. The PER aims to assist banks in providing a more stable rate of return to depositors by paying out from its reserves in times of low profit. The waiving of a portion of right to receive profits for the purpose of market stability is consistent with the concept of mubara'ah (waiving of right). Furthermore, Islamic banks may mitigate displaced commercial risk in maintaining competitiveness with the conventional banking system in times of rising market interest rates by paying higher profits to its customers, possibly forgoing its own portion in the profits. The SAC rules that the Islamic banks' decision to forgo its earnings is permissible as it is implemented without affecting the customers' right to receive profit, in addition to customers receiving more profit than the pre-agreed profit-sharing ratio. The mudarib's negligence in dealing with third party related to the mudarabah capital will result in the bank being held responsible for losses incurred, as the mudarib is responsible to use his expertise in managing the mudarabah funds and is liable to refund the capital to the rabb al-mal.

Summary

Summarizing the above analysis, it can be pointed out that the establishment of Islamic finance is an important factor in the development of the Uzbek economy. There must be a legal basis for the Islamic banks to start operating and carry out their activities at their fullest in Uzbekistan. Hence, as mentioned above, the activities of Islamic finance have their own characteristics and differ from traditional banks. The current legislation does not provide for Islamic finance. At the same time, it should be noted that after the address of the President Shavkat Mirziyoyev to the Oliy Majlis (Parliament) and laments that it is the high time to create a legal framework, Deputy Chairman of the Central Bank Bekzod Khamroyev informed at a press conference on January 11, 2021 that the new law "On non-bank credit institutions" will include the concept of Islamic finance. We can say that with the adoption of this long-awaited law in Uzbekistan, Islamic banks will have the opportunity to fully implement their activities. At present, officials should also keep in mind that the introduction of Islamic financial services in Uzbekistan will be carried out by parallelly solving a number of problems related to the lack of human resources, and the need on increasing literacy among prominent consumers.

Moreover, the Islamic financial services sector will be an important factor, foundation and development prospects for the bright future of Uzbekistan, which will increase the interest of foreign investors in the country, which reflects the deep roots of Islam in its culture. and will be able to make full use of it in the sustainable development of the country. Based on the above information, we believe that the comprehensive introduction of the Islamic financial services industry in Uzbekistan will open the following opportunities for the country:

➢increase and diversify foreign investment;

➢creating an environment of fair and transparent competition in the banking sector and the ability to diversify the assets of the banking system;

➢ensuring maximum participation of free funds available to the population and businesses in economic development;

➢development and diversification of the capital market in the country;

➢contribute to the implementation of the state program to combat poverty.

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