

## **Theoretical Differences between Islamic Banking and Conventional Banking**

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### **Abstract**

*Islamic banking is growing almost 2-2.5 times as compare to the conventional banking in the countries which have more than 50% percent Muslim population and growth in the countries which have lesser than 50% Muslim population are also remarkable due to the innovative products and services, real asset creation that is more accelerating in the economic development. One of the main reasons of the growth is the conventional banking market have been saturated as compared to the Islamic banking market. The Islamic banking institutions are more risk taker because they directly involve in the management of the projects by creation partnership with the borrower and earns more than the conventional one's. The estimated size of Islamic banking is \$ 1.66 trillion to \$ 2.1 trillion worldwide. In this paper an effort has been made to provide the fundamental difference between the conventional banking and Islamic banking system*

**Keywords:** : Islamic Banking, Conventional Banking, Islamic Finance, Islamic Modes of Financing.

### **1. Introduction**

Conventional banking system rise up in the eighteen century and the major principles on which the building of conventional banking system is build up is the use of interest. Interest roots are before the advent of Islam. The roots of Islamic banking are found from the first trading agreement of Holy Prophet (PBUH) with Hazrat Khadija and after that she was married to Him. This transaction was on the basis of Mudarabah one has provided the investment and other one has provided His expertise (Labor and Entrepreneurship) and the profit has been shared between them as per pre agreed ratio. If there is any loss occurred it will be borne by the capital provider and the other one will bear the loss of his time and labor. The conventional banking system was flourishing from eighteen century was growing till now, but, it was found with a major drawback of interest and the Muslims are prohibited from the use of interest, so it was ever needed that Muslims should have their own financial institutions which are as per Islamic fundamentals.

When the Muslim world came into contact with the west then they were left with two choices: first one was to adopt the interest based banking system by arguing that the interest has not the element of riba which is prohibited in Quran and the other one was to accept the that the interest charged is the riba and the alternative system should be developed. In the nineteenth century various religious scholars argued that the interest is riba in the consumption loans where it is difficult to repay not in the commercial loans where the borrower easily can pay from the profit earned by using this loan. However, the Holy Quran has not made any distinction between the consumption loans and the productive loans, on these bases these views were rejected and the urge among Muslims to develop the banking system on the principles of Islam was still persistent. Siddiqi, (2004) has concluded that the views of the Muslims were unanimous that any excess amount charged in the contract of loan is riba. The concept of Islamic of Banking system was developed by the Muslim scholars in the twentieth century and has grown since then. Islamic banking comprises a system in accordance the Sharia principles and its practical application is in the form of developed Islamic economy.

Islamic banking and the conventional banking have some similar functions but the major difference is that Islamic banking is in accordance the rules of Shariah know as fiqh-al-muamalat (Islamic rules in the transactions). Supreme Court of Pakistan also declared the interest that the interest amount charged over the principal amount is not allowed in Islam:

“Any additional amount over the principal in a contract of loan or debt is the riba prohibited by the Holy Qur'an in several verses” (Usmani, 1999 Para 242).

Now, the Islamic banking and Islamic economy is in the refined form and it fulfills all the requirements of the economics system.

Islamic banking is the system of banking activities that is consistent with the principles of the Shariah means governing and basic rules are Islamic. Shariah prohibits the acceptance and payment of interest on the acceptance and lending of money and the trade and the other activities that provide the goods and services were allowed to earn the livelihood. So, in the 20<sup>th</sup> century a number of Islamic banks were emerged to provide the replacement to the conventional banking system as per Islamic laws and this banking system is not restricted to the Muslims only but also to the Non-Muslims also.

## **2. Conventional Modes of Financing**

### **2.1 Running Finance**

In case of running finance the customer is allowed to withdraw amount in access of credit balance maintained by him with the bank in his current account. The customer is allowed to operate by way of multiple transactions in the account, but, all the transaction should be made in accordance with the approved terms and conditions. Mark up has been charged on KIBOR plus bank spread. Mark up has been calculated on the availed balance on day end and calculated on daily basis, if one person has utilized the amount from morning and deposited into the account before day end then no interest will be charge to the customer. However, borrower is allowed to use this right for a specific period that is one year, two months before the expiry of sanctioned limit the customer account is reviewed and if customer behavior is found satisfactory, and then the tenor may be extended to the next year. The running finance facility is allowed to fulfill the working capital requirement of the firm; it is ensured by the field staff that the customer is using this credit facility for the sanctioned purpose only and not used for any other purpose of long term needs cannot be fulfilled by this credit facility. Two types of securities have been received by the bank against this facility. First one is the prime security hypothecation charge over the stocks of the firm with margin of 50% or lesser as the case may be i.e. if five million has been sanctioned to a firm with the margin requirement of 50%, it means that the firm should possess the stocks of ten million at the time of the visit to the hypothecated site. Field staff ensures the inspection of stocks on monthly and quarterly basis. Second one is the collateral in that may be in case of liquid security e.g. cash or near case, or residential, commercial, industrial or agricultural property against which the registered mortgage has been credit in the respective revenue office or society office. Property is evaluated by the independent valuator that is on the approved panel list of the bank or DFI.

### **2.2 Cash Finance**

Cash Finance has been disbursed to the borrower account against the pledge stocks of locally produced products. Customer stocks has been given to the bank allocated Muccadam and customer account is credited after deduction of some margin from the stocks. Mark up has been received from the customer on KIBOR plus bank spread that is normally from 1% to 5% or at the discretion of the management according to the business and financial market conditions. Delivery of pledged stocks can be made to the borrower on the repayment of loan along with mark up. Cash Finance is allowed to fulfill the seasonal requirements of the industry which are dealing, manufacturing, processing the locally produced products. Finance is allowed from 90 to 180 days and recycled again on the time of maturity.

### **2.3 Demand Finance**

Demand finance is allowed to the borrower for the fixed time period usually for more than one year and repayment is made in the installments or lump sum at a future date. This finance facility is non-revolving in nature. The primary purpose of this facility is to finance the fixed assets, plant and machinery, land, building etc. of the firm. Future cash flow analysis is the sanctioning base of this facility that is reviewed time to time and onsite inspections are made to ensure that the projected cash flows are reflecting in real or not.

Demand finance usually allowed financing the fresh green field projects, replacing the old projects with fresh technology, enhancement to the existing infrastructure and restructuring or rescheduling to the existing loans. Registered Equitable charge has been made against the fixed assets of the firm as per companies' ordinance and hypothecation of plant and machinery or any other security acceptable to the bank.

#### **2.4 Payment against Documents (PAD)**

PAD is not a regular finance facility; it is created when bank receives documents against letter of credit issued by the bank and bank makes payment against these documents. The importer enters in a buy back agreement with the bank to purchase these documents by making payment to the bank, this agreement binds the importer to purchase these documents at the marked up price (Purchase Price). The retirement of the PAD occurs when the importer makes the payment to the bank and receives documents from it. In case of sight letter of credit the approved limit may be Finance Against Trust Receipt (FIM) or Finance Against Trust Receipt (FATR) and in case of usance LC it may be DDAA line. At some time the customer has approved DDAA line but fails to provide funds at the maturity of DA bills then bank makes payment against these documents and Forced PAD has been created. Customers which to whom forced PAD has been created, he is not allowed to open another LC until or unless he has not cleared the forced PAD payment. Further, PAD facility is only for the sight letter of credit, however, Formed PAD has been created when usance letter of credit reaches to its maturity. Personal Guarantee of the borrower and lien over import documents has been obtained.

#### **2.5 Inland Bills Purchased (IBP)**

This facility has been created when bank purchases bills from the drawer (seller) and sells the same to the drawee (purchaser) both the parties belongs to the same country. This facility has been given to the selected customers, and sanctioned on the receipt of acceptance against the bills from the drawee's bank. This facility is only sanctioned against the clean documents and not against the discrepant documents. IBP facility is given on the basis of mark up and marks down basis. Mark up applied when charges has been recovered from the drawee and the correspondent bank will honor the payment of bill of exchange and mark up will be charged as per bank circular. Mark down facility applied when the charges are recovered from the drawer. Customer is not given the full amount of the bill. Bank gives the amount of bill after deduction of commission charged on the handling of such bills. Commission is deducted on upfront basis and credit to the head as "Commission Received in Advance" and same will be credited to the income on completion of the transaction. If the amount of the bill is not recovered within the provided date then the mark down is charged at higher than the previous mark down and the difference between earlier mark down and after overdue of the facility mark down will be received from the customer. Primary security of this finance is the lien over export documents and secondary is the hypothecation over the current assets of the sole proprietorship, partnership and in case of company as per companies' ordinance; lien should be marked over near cash securities, registered or equitable mortgage of fixed assets and hypothecation of plant and machinery.

#### **2.6 Finance against Imported Merchandise (FIM)**

Finance against imported merchandise is only allowed to the borrower on mark up basis for the imported goods against the letter of credit established and the goods are pledged with the bank and buyer is required a specific consignment after a specific time period but total time period shall not exceed 120 days. Importer may have regular limit of FIM for the imported good/ custom duties/ government dues. However, the FIM for custom duties and government duties is discouraged. FIM is allowed when the importer is unable to dispose off the goods immediately and these goods will be disposed off after a specific time span. When the customer requests for FIM and handover the documents of the consignment then bank hands over the documents to his clearing agent and PAD has been created against these documents and funds are provided to the customer. On the receipt of the goods to the warehouse of the customer bank approved muccadam takes the charge of the sight and confirms the availability of the stocks and provides the stock report against the goods in his lock and key, then bank converts the PAD into FIM. Goods under the lock and key of the bank approved muccadam will be released after the receipt delivery order from the bank. Banks issues the delivery order to the customer after receiving the principle amount and mark up against the that principle amount for the release of specific trench. Securities in this credit facility is the personal guarantee of the borrower, specific margin requirements and collateral in shape of fixed assets e.g. land, building, plant and machinery etc. However, the securities requirements vary customer to customer according to their creditability.

## **2.7 Finance against Trust Receipts**

This finance facility is provided to the customer by releasing the title document of goods to the importer against sight letter of credit. FATR has been created against when the customer requests the bank for this facility and hands over the import documents. The bank officials get the signature of the borrower on the prescribed trust receipt and related documents. Purpose of obtaining the trust receipt is that the customer is not owner of the goods, he is only the trustee of those goods and will care those goods and before the sale of these goods he will pay the outstanding amount of this trust. This trust receipt binds the importer to pay the outstanding amount against the goods against whom the lien has been marked. It may be paid in lump sum or in installments. When customer pays against the each trench the mark up amount will be received against the adjusted principle outstanding amount.

This finance is only allowed against the sight letter of credit and this facility is not allowed against the usance letter of credit. SBP does not required any extra collateral more than the trust receipt, however, some banks takes some extra collateral so that the customer should deposit the sale proceed directly to the bank. In this facility the customer receipt's the imported goods and directly places these goods to his go down without the clearing or forwarding of the bank. Trust receipt is only allowed to the top tier customers who have very good credit history with the bank and does not face any credit problem. Theoretically, the bank's interest is secured until the goods are unsold. Practically, the field staff must know about the life cycle of the product finance against the trust receipt and ask to the importer for payment after the a specific time period and before the expiry of life cycle of the product. The time period of the trust receipt may be extended to the customers who are trust worthy, who have provided satisfactory collateral or whose production process is disturbed due to the non-availability of the goods for the processing. Securities in this case are the personal guarantee of the borrower, trust receipt signed by the borrower and secondary collateral in the shape of land, building, plant and machinery etc.

## **2.8 Finance against Foreign Bills (FAFB)**

FAFB is a type of post shipment finance and sanctioned against the export bills drawn under LC or firm contracts and are sent for payment under documentary collection on DA basis. Documentary collection accompanied with the documents evidencing the shipment of goods. The customer arranges funds from own sources and makes the shipment to abroad, customer may require funds for more orders processing then he hands over the documents sent under LC or firm contracts to the bank and obtains finance against these documents. FAFB transaction is primarily secured by marking lien over the export bills. The term documentary credit is used for the bill of exchange along with other shipment documents.

These documents are not purchased by the bank and the title of goods in the foreign currency held with the exporter, because bank only accept these bills as a security of the finance not purchased, so the exchange rate risk held will the exporter. In case of adverse exchange rate the customer will bear the loss. If the bills have been dishonored on the presentations then the bank will recourse its right towards the borrower. Mark up has been received against this finance facility on KIBOR plus bank spread. Mark up will be received at the end of each calendar quarter or on the receipt of documents whichever is earlier. Primary security for this finance facility is the lien over import documents and secondary collateral is the lien over the cash or near cash securities, equitable / registered mortgage over the land, building or any other fixed assets of the firm, hypothecation of currents assets of the firm or hypothecation of plant and machinery.

## **2.9 Foreign Bills Purchased (FBP)**

Exporter makes shipment against LC sight or usance, he approaches the bank for funds, and bank purchases these bills at some discounted price and pays the amount of the bills to the exporter in Pak rupees. Export documents arranged firm orders or contracts cannot be negotiated under this finance facility. The difference between exchange rates buying and selling of the currencies is the bank's profit and the commission received from the customer is also the income of the bank. In FBP the foreign bills drawn under irrevocable LC are purchased from the exporter by the bank. In worst case scenario the risk of the decrease in the value of foreign currency is borne by the bank because he has taken the title of the documents in its personal capacity. After the receipt of the documents exporter's bank send these documents to the LC opening bank for the payment and receives the reimbursement amount in the nostro account maintained in the respective foreign currency. Documents which contain discrepancies are also negotiated, but for the discounting of discrepant documents a separate credit line FBP discrepant within the main FBP clean line approved.

Primary security against this facility is the lien over export documents to minimize the risk of discrepant documents secondary collateral should be obtained hypothecation of current assets in case of sole proprietorship or partnership and charge over current assets in case of private or public limited company, pledge/ lien over cash or near cash securities, registered or equitable mortgage of fixed assets of the firm, charge on fixed assets of the company as per procedure laid down in companies ordinance, hypothecation of plant and machinery.

### **2.10 Finance against Packing Credit (FAPC)**

Finance against packing credit is the pre shipment and post shipment facility provided to the exporters against valid letter of credit or firm orders. It is also applicable to the items which are not eligible under concessionary export refinance scheme of the government. This finance is provided to the exporter to meet the expenses such like freight charges, clearing / forwarding charges, handling charges, export duty, packing requirements, purchase of goods etc. FAPC is extended to the exporter by marking lien over the irrevocable letter of credit/ firm order and stocks requirement of the export thereof. It also requires the signing up the buy-back agreement with between the exporter and the bank. Secondary collateral is also obtained from the borrower to safe guard the bank interest.

This finance facility is granted to the exporter who has irrevocable letter of credit or firm orders and a credit line has been granted to the customer for the processing of this finance. This finance is allowed to the borrower as per post ship finance according to the LC and this pre shipment finance converted to the post shipment finance maximum period of 180 days from the date of shipment is the tenor of the LC is less than the 180 days or sight LC then the proceeds of the bill will be used to adjust the outstanding finance. Primary security for this finance facility is the lien over the export contracts LC, hypothecation over current assets in case of sole proprietorship or partnership and charge over the current assets in case of the private or public limited company pledge of stocks, lien over cash or near cash securities. Secondary collateral is the registered / equitable mortgage of the fixed assets, charge over the fixed assets of the public or private limited company as per requirements of the companies' ordinance, hypothecation of plant and machinery.

### **2.11 Foreign Currency Import Financing**

The banks provide the finance in the foreign currency normally in USD against the import purchases. This product is offered to the high profile customers who are already availing the credit facilities, have sufficient earning stream and good pay back behavior. Bank should ensure that various requirements of the SBP have been complied. Other existing facilities should be blocked like RF, CF, FATR etc. to allow this foreign currency finance facility. Lending shall be in US Dollar if the LC is in any other currency then the finance will be allowed in US Dollar with the arrangements of the treasury of the respective bank. Primary securities in the credit facility is the hypothecation over current asset of the firm in case of sole proprietorship or partnership and charge over the current assets of the company in case of public or private limited company, pledge of stocks, TR favoring respective bank, pledge or lien over the cash or near cash securities. Secondary security it the registered or equitable charge over the fixed assets, charge on fixed assets in case of public or private company as per companies ordinance, hypothecation of plant and machinery. Tenor of this credit facility is changed case to case basis but shall not exceed more than 180 days. Mark up on this credit facility is charged as LIBOR plus bank spread.

### **2.12 Foreign Currency Bill Discounting (FCBD)**

FCBD is the credit facility allowed in the foreign currency and sanctioned to the export oriented customers who have already availing other credit facilities with good market track record. SBP special terms and conditions will apply upon the sanctioning of this credit facility and other credit facilities will be blocked before the disbursement of this credit facility. Limit shall be monitored on regular basis and it should be ensured that the aggregate outstanding exposure will not exceed from the approved one. Customer is eligible if the exports are 250 million or three time of FCBD limit. Primary security is the lien over export documents and secondary security is the same as explained above in the various credit facilities.

### **2.13 Foreign Currency Export Financing (FCEF)**

Conventional banks provide this finance facility in foreign currency normally in USD if the bills are in any other foreign currency then cross rate will apply to convert these bills into the USD. This export oriented credit facility is given to the customer who have already available to the customer who already availing credit facilities with good track record.

For the financing of credit facility specific term and conditions of SBP will apply and the already availing credit facilities will be blocked. This finance is available in both cases pre-shipment and post-shipment. Security in case of pre-shipment is the same as explained in the above section under FAPC. Securities in case of post shipment are the same as explained in the described in the FAFB security.

## **2.14 SBP Export Refinance Schemes**

Export refinance scheme is the concessionary mark up rates to the commercial banks for boosting the exports of our country. Following are the available schemes:

### **I. Export Refinance Scheme-I (ERF-I)**

ERF-I is provided on the basis of firm order/ export LC/ Contracts or presenting the documents which confirm the shipment has been made under export LC or firm sales contract or case to case basis. This finance is the 100% of the value of firm export order or contract sales both at pre-shipment or post shipment stages. The indirect exporters who provide raw material to the direct exporters for the final processing and export are also eligible for this credit facility in the pre shipment stage. Banks sanction the finance to the exporters and get refinanced from the SBP at the discounted rate from the general financing. The total amount of finance to the exporter shall not exceed from the total amount of firm order/ sales contracts/ letter of credit. Rate on the refinance scheme is scheduled by SBP on time to time basis. The securities of pre shipment are already discussed in the FAPC and securities against the post shipment are already discussed in the FAFB.

### **II. Export Refinance Scheme II (ERF-II)**

In the ERF-II the no firm order / export LC or sales contracts are needed. This credit facility is sanctioned on the basis of the last year export performance of the exporter. EE statement has been submitted to the commercial bank and after the reconciliation of the record the commercial banks submits the same to the SBP for the authentication and when the exports are authenticated by the SBP record then the commercial banks allows the exporter the half finance of the last year export business which are authenticated from the SBP. EE ERF-II entitlement letter is received from the SBP and finance is sanctioned by the commercial banks with some points of the SBP keeping in mind i.e. the exporter is required to make double exports than the ERF-II finance amount. Markup rate is very concessional upon this credit facility. If the customer fails to comply the double exports of the finance facility then the SBP imposes the penalty to the exporter for non fulfillment the required targeted exports. Primary security in this case the lien over the approved EE statement (from SBP), hypothecation of current assets of the firm in case of sole proprietorship or partnership and the charge over the current assets in case of public or private limited companies, pledge of stocks, lien over the cash or near cash securities. The secondary collateral in the registered or equitable mortgage of fixed assets charge over the fixed assets in case of public or private company should be registered with SECP as per companies' ordinance, hypothecation of plant and machinery.

### **III. Long Term Finance Facility (LTFF)**

LTFF is available to the eligible borrowers on the concessionary markup rates for the import of plant, machinery, generator, accessories, equipment etc. The LTFF is available to the commercial banks from SBP on the concessionary mark up rate. The low markup rate is the government policy is an incentive to the borrowers to boost the exports of the country which is most import to maintain the equilibrium of the balance of payment. The monitoring of the project is the prime responsibility of the financing bank and securities of this credit facility are obtained up to the satisfaction of the borrowing bank.

SBP provides different concessions on the credit facilities from time to time basis.

## **2.15 Letter of Credit (LC)**

Letter of credit is a document issued by the bank on the request of the importer confirming the payment of imported material in accordance with the terms and conditions of the letter of credit to the exporter. The letter of credit is issued to the exporter as per instructions of the importer; it may be issued for the sight payment or for the some future date this amount is paid on the receipt of documents. The documents include the commercial invoice, certificate of origin, transport documents as per the mode of transport and other documents as per terms and conditions of the letter of credit. LC is the documentary credit and for the security of this transaction counter guarantee has been obtained from the importer that he will compensate to the bank in case of any harmful situation.

Parties to the letter of credit are the importer, who requests the letter of credit, LC issuing bank or the bank of the importer, Advising Bank, Exporter or for whom the letter of credit has been issued, confirming bank, negotiating bank and reimbursing bank. There are different types of LC but irrevocable LC is mostly in practice. The mode of payment may be by negotiation of LC, or by acceptance, or at sight or deferred payment. Specific rate of the commission has been received from the importer at the opening of the letter of credit. The approving authorities may require some cash margin in advance to be received to secure the bank interest. At some times the importer does not pay off the liability, and then the issuing bank is liable to pay the amount of LC to the exporter. In such cases forced PAD has been created and amount has been remitted to the negotiating bank. Subsequently the recovery efforts have been initiated against the importer and on the receipt of the recovery the forced PAD has been cancelled. Primary security is the lien over the import documents and secondary security registered or equitable charge over the fixed assets, cash or near cash securities and hypothecation of plant and machinery etc.

### **2.16 DA Bills and Documents Delivered Against Acceptance (DDAA)**

This credit facility is extended to the customer to whom bank has already handed over the documents against the acceptance of the usance bills; it means the customer has already taken the custody of the imported merchandise. Such type of facility is provided to the reputable customers or backed by the heavy collateral. The bank has only the accepted bills against which payment is still awaited. The imported merchandise should be under the bank pledge until or unless the approval for the DDAA has been received from the competent authorities who are usually backed by the trust receipt. The bank will charge the commission and handling charges as per bank schedule of charges.

### **2.17 Guarantee, Performance / Bid Bond**

A contract of guarantee is a contract to perform the promise or discharge the liability of third party in case of his default. The person or organization who gives the guarantee is called the guarantor, for whom is given called principal debtor, to whom is given is called creditor. In other words the bank guarantee is the irrevocable undertaking provided by the bank to the beneficiary that the payment will be made against the presentation of written statement if the contractually obligations have not fulfilled. Bank guarantee is the unilateral agreement between the bank and the beneficiary which is concluded on the behalf of third party. Specific commission has been received for the issuance of bank guarantee. The bank guarantee should be issued for a specific period one issued can be continued within the validity of the guarantee, if guarantee once expired then it cannot be continued, it will be issued as new bank guarantee. Primary security is the counter guarantee obtained from the principal debtor along with the specific cash margin shall be obtained that should not be less than 20% of the bank guarantee and secondary collateral is the registered or equitable mortgage of fixed assets, hypothecation of plant and machinery, charge over fixed assets should be register in case of public or private limited company as per the procedure laid down in companies ordinance.

## **Islamic Modes of Financing**

### **3.1 Musharakah**

The literal meaning of Musharakah is sharing or partnership. Under the Islamic Jurisprudence the Musharakah means a joint enterprise made to run a business in which profit is shared as per their agreed ratio and loss as per their contribution. It is a substitute to the interest based financing to enhance the production and distribution of wealth. Musharakah can be further bifurcated as follow:

- I. Shirkat-UI-Milk: is the way of partnering for the business by two or more persons for the purpose of earning profit. Shirkat-UI-Milk can be formed by the following ways:
  - a. When two or more persons purchase some machinery, equipment or any other property and this relationship come to existing by their own will is called Shirkat-UI-Milk optional.
- II. Another form of Shirkat-UI-Milk is created without any effort of the partners own will. Means when a person dies and he left property for his legal heirs and they come into partnership. This is called Shirkat-UI-Milk Compulsory.
- III. Shirkat-UI- Aqad: is the joint commercial enterprise and it comes into existence by the mutual contract between the partners. Shirkat-UI-Aqad can be bifurcated as follow:

- a. Shirkat-Ul-Amwal: where all the partners are agreed to bring capital to establish an enterprise.
- b. Shirkat-Ul-Aamal: where some people make a partnership to render the services to earn jointly. The livelihood earned by all of them can be distributed among them as per their agreed ratio.
- c. Shirkat-Ul-Wajooah: where no capital is invested by the partners and they purchase some product or asset and sell it with profit. By paying to the seller the remaining profit will be shared among the partners as per their agreed ratio.

Musharakah is mostly established by the parties with their mutual contract, so, it is necessary for the Musharakah that features of a free contract will exist there means consent of the parties should be free, both should be sane, both should be major and may be able to enter in a contract and fraud and misrepresentation should not be there. Management of Musharakah may be done by all the partners or they may enter into another agreement that management should be done by a specific person who may be expert in his field. Profit is distributed on the agreed terms and the loss is distributed on the percentage share of the investment. If the Investor may bear loss then the service provider will also not receive any amount against his services rendered to the Musharakah. Musharakah can be terminated by mere notice by one partner, or on the completion of specific project, if one partner may want to leave then remaining partner may purchase the share of leaving partner.

### 3.2 Mudarabah

Mudarabah is type of partnership in which one partner brings investment and the other one joins the business for his expertise. The person who comes with investment is called Rab-ul-Maal and the person who comes with his expertise is called Mudarib. Profit has been shared between them as per their agreed ratio. If loss occurred then it will be borne by the Rab-ul-Maal solely, if loss is occurred due to the negligence of the Mudarib then it will be recovered from the Mudarib only.

There are two types of Mudarabah that are discussed as follow:-

1. Al Mudarabah Al Muqayyadah: A type of Mudarabah in which Rab-ul-Maal may specify a particular business or place where the Mudarib can invest the amount received from the Rab-ul-Maal is called Al Mudarabah Al Muqayyadah or restricted Mudarabah.
2. Al Mudarabah Al Mutlaqah: When the Rab-ul-Maal gives freedom to the Mudarib that he can do any business which he deems fit for the purpose of earning profit he can use the funds sanctioned for Mudarabah. It is called Al Mudarabah Al Mutlaqah or unrestricted Mudarabah. Mudarib is allowed to all the activities which are in the normal course of business, but, he is not allowed to work for the activities which are beyond the routine matters, in this case the consent of the Rab-ul-Maal is necessary.

The Rab-ul-Maal provides his agreed investment to the Mudarib and leaves the rest on the Mudarib. However, the Rab-ul-Maal can oversee the activities of the Mudarib and also take part in the activities of the Mudarabah with the consent of the Mudarib. Profit will be shared by the Mudarib to the agreed ratio and the meal, clothing, conveyance and medical expenses will not be borne by the Mudarabah. As stated above if any loss occurred by the Mudarabah it will be only bear by the Rab-ul-Maal and if loss is occurred by Mudarabah due to the negligence of Mudarib it will solely borne by the Mudarib.

Mudarabah can be terminated on the completion of specific time period or any one of the partners may serve notice to the other one for the termination of the Mudarabah. Musharakah and Mudarabah are used for the both asset and liability side financing. Details of the both have been provided as follow:

#### *Asset Side Financing Under Islamic Modes:*

Project Financing, Short Term, Medium Term and Long Term Financing, Small, Medium and Large Enterprise Financing, Import Financing, Import and Inland Letter of Credit, Bridge Financing, Letter of Credit Opening with (Musharakah) and without Margin (Mudarabah), Working Capital Financing and Short Term Advances

#### *Liabilities Side Financing Under Islamic Modes*

Profit is paid on pre agreed ration on the basis of Musharakah, Mudarabah on the current account, saving accounts and investment accounts, Interbank lending and borrowing, Certificates of Investment, T-Bills and Federal Government Financing, Musharakah Based Securitization of Large Projects, Certificates of Investment Based on Murabah, To run the long term projects certificates of Islamic Musharakah Bonds has been issued and profit has been paid on the investments



### **3.3 Diminishing Musharakah:**

This is the development has been made a new shape of Musharakah. Diminishing Musharakah was become the need of current era to coup the needs of Islamic banking customer as compared to the conventional one. In Diminishing Musharakah the partners arrange investments for the joint ownership of property or equipment or for the establishment of joint enterprise. In it the total value of the asset has been divided into the small units and some units have been paid by the one partner and the remaining one are paid by the other partner. Diminishing Musharakah is the best alternative to fetch the customer from the conventional banking as they use the interest based financing facilities and pay more and more to those financial institutions. Some examples of the diminishing Musharakah has been provided as follow:

1. If someone wants to purchase a house and does not have enough funds in hand then he reaches a financier to provide funds to him. The total value of home will be made in some parts such as total 10 units made against the total value of the house. The borrower may enter into an agreement with the financier that he will made payment against the 2 units of the house and remaining one 8 units should be purchased by the financier. The borrower will use the remaining 8 units as the share of the financier and will pay rent against the 8 units of the financier and also enters into another agreement that he will purchase one unit after the expiry of each three months and after the expiry of twenty four months the total units will be purchased by the borrower and the financier share will be zero after the lapse to twenty four months during these period the borrower will pay rent against the outstanding share of the financier. The rent will be determined at the time of agreement and that will be near to the market prevailing rates and not more than this. In this way the borrower will be able to purchase a house and the financier will be able to earn profit or rent against his investment.

Diminishing Musharakah can be used for the financing of fixed assets, house financing, plant and factory financing, car/ transport financing, project financing of fixed assets etc.

### **3.4 Murabaha**

Murabaha is a specific type of sale in which the seller expressly tells the cost of the purchased commodities and sells the person by adding his profit thereon. Murabaha is not an interest based loan, it is just commodity sale for the deferred price. Bai Murabahah is the purchase of the commodity by the bank on the behalf of the customer and later on sold to the customer by adding some profit in the purchase price, this is the replacement of the conventional interest based financing which is prohibited in Islam. Murabahah is the old mode of financing as the Musharakah; approximately, the 70% of the Islamic banking transactions are based on the Murabahah based investment. Normal sale is the bargaining between two or more parties without disclosing the purchase price, however, when purchase price has been disclosed and added profit between it for the sale it becomes Murabahah and if the payment is made on the some future date it will be called Murabahah Muajjal. Securities in Murabahah are the equitable or registered mortgage of the fixed assets, hypothecation or pledge of stocks, charge or lien over some other assets acceptable to the bank for security purpose.

The seller (bank) may ask to the buyer for the third party guarantee, if the buyer defaults then the seller can ask the payment to the guarantor, while receiving the guarantee from third party it should be ensured that the guarantor should not charge any interest or commission on the guaranteed amount from the person for whom guarantee is given to the bank. However, the guarantor may ask for the documentation expenses etc. If the customer does not pay as per the defined schedule of payment then the rate of the Murabahah profit will neither be changed nor shall any penalty be charged to the customer. If the buyer deliberately defaults, they should be demanded the compensation to the Islamic bank for the loss which is suffered to the Islamic bank on the default of the buyer.

A grace period of one month should be given to the defaulter, but after the lapse of one month, compensation should be demanded. If the defaulter does not pay the due amount within the stipulated time period then the customer should be charged with penalty and this amount will not be added in the income of the Islamic Financial Institution, will be given as charity (Usmani, 2002) Murabahah can be used for the financing of asset financing, raw material financing, house financing, inventor financing, equipment financing, import financing, export financing (pre shipment), consumer goods financing, land financing, vehicle financing, shop financing, tour package financing, education package financing, all other services which can be sold in the shape of package etc.

### 3.5 Salam

Salam is an Islamic mode of financing which can be used in the agriculture sector, in this finance facility the seller undertakes the delivery of goods at some future date and receives the advance payment fully paid at spot for the goods to be supplied. The price is in net cash and the delivery of the goods is at some future date. When the riba was declared haram and the farmers who use to obtain the interest based loan and feed their families till the harvesting, at the harvesting of the crop they pay their loans along with interest. The Holy Prophet PBUH allowed the farmers to sell their crops in advance to the buyer and delivery shall be made on the harvesting of the crops. Salam can be used to fulfill the needs of the import and export business. Salam is the beneficial for both the parties. For the seller it is beneficial because the money is received in advance and for the buyer is that the purchase price under Salam is comparatively lower than the normal price. It is necessary that the full amount is to be paid for the future commodity, if the full amount is not paid then the need of the seller may not be fulfilled then the purpose of the advance sale may not be fulfilled. Only those goods can be sold under the Salam contract in which the quality and the quantity can be exactly specified. All the details related to the quality must be expressly specified at the time of creation of Salam. Exact date and place of delivery must be specified in the contract and this date should be when this commodity will be normally in the market. Salam can't be created for which the delivery is at spot. Price of Salam and the price of spot sale are different and this difference is the profit of the bank. A security in the form of guarantee, mortgage or hypothecation is required so that the delivery of goods from the seller must be ensured. At the time of delivery seller must deliver goods not the price of the goods. Bank can create parallel Salam for the already created Salam, it should be ensured the Salam should not be conditional with respect to the first one; difference between the prices of two Salam is the profit of the bank.

### 3.6 Istisna

Istisna is a sale transaction where a commodity is not come into existence; it is an order to the manufacturer for the manufacturing of a product for the purchaser and the manufacturer uses his own material for the manufacturing of the required product. Price of the Istisna should be settled with the involvement of the all the parties to it and all other specifications of the product must be settled down so that there is no ambiguity has left. The contract of Istisna can be cancelled by any one of the party to it before the manufacturing process has been started, if once the manufacturing process has been started the contract cannot be cancelled. As stated above the time of delivery should be specified, the purchaser should give maximum time in which the product easily can be manufactured, so that if the deliverables are not delivered within time limit the purchaser is not bound to purchase or he may purchase it at some lower cost the lowered price can be the amount of penalty which is calculated on daily basis.

### 3.7 Istijrar

Istijrar is the purchasing of good from time to time in different quantities. According to the Islamic jurisprudence Istijrar is an agreement where buyer purchases things from time to time and on every time there is no offer, acceptance or bargaining. There is only one agreement in which all the terms and conditions have been finalized. Price is determined after the completion of all the transactions, if the price is determined in advance then it should be implemented for the whole transactions, but there are certain conditions as the seller should disclose the price of each transaction and the sale becomes the valid if the buyer posses the goods and the amount has been paid on the completion of all the transactions, in case the seller does not disclose the price of each transaction but the contractor knows that the market price of the product is the same as seller demanded then the product will be purchased by the contractor, at the time of the possession if the sale price is unknown or the contractor does not bother about it and there is significant difference between the sale price and the cost price then the sale will not be valid and it will be valid at the time of settlement. Istijrar is used now a day four kind of the financing: Mudarabah, Murabaha, Ijarah & Musharakah. Istijrar can be involved in first three kinds. First three kinds the direct Istijrar have been applied however; Istijrar in Musharakah can be created to work with the suppliers of the borrowers. The bank may create Murabahah on the basis of Istijrar and enters into another contract with the borrower whenever the existing customer or the new one want to purchase the goods from the supplier the bank purchases on Murabaha and Istijrar, sells the same to the borrower on the basis of Murabaha and Istijrar basis.

### 3.8 Ijarah

Ijarah is a term of Islamic Fiqah which means to give something on rent. In Islamic Jurisprudence the term Ijarah is used for two different meanings.

First one is to employ a person on wages as consideration for his services which are rendered to the employer. Second one is to transfer the usufructs of an asset or property against which rent is received from the person to whom the usufructs are transferred. Both type of financing are used, but the second one is more popular for the purpose of investment as well as financing also. Like Murabahah, Ijarah is not original mode of financing it is simply transaction to transfer the rights property from one person to another for a specific period and consideration. Financial institutions have adopted the Ijarah as mode of financing instead the long term financing on interest basis. In the Ijarah agreement lessee purchases the asset on the behalf of the lessor and all the expenses are borne by the lessor and he receives rent on the use of asset to the lessee. After a specific period the lessor will transfer the assets to the lessee till then the lessor has received the amount of asset plus profit in form of rent. The interest based financial has been replaced with Ijarah.

### 3. Difference between Islamic Banking and Conventional Banking

<b>Conventional Banking</b>	<b>Islamic Banking</b>
1- Conventional banking is governed by all the man made principles and no divine guidance has been followed by these banks.	1-Islamic banking is mostly governed under the divine guidance and only business are supported by this banking which are allowed in Islam and these businesses are beneficial for society at all and no one is distressed with these businesses.
2- Conventional banking is supported by the capitalist economy which allows all type of transactions for the purpose of earning of higher profit, it may be riba, hoarding, gambling, dealing in unlawful goods and services, short sales in short all the speculative transactions can be deal in this banking system.	2-In the Islamic banking system no speculative transaction is allowed, interest based transactions are prohibited, unbridle profit at the cost of another party is discouraged, economic decisions are not controlled by some hands, natural demand and supply process is not run and controlled by some hands.
3-The purpose of the conventional banking is to maximize profit only. They deal in money and monetary papers only not any type of goods. UCP 600 article 05 "bank deals in papers not in goods."	3- Money is not a subject matter of trade and it has no intrinsic utility, its only medium of exchange, profit on the trade of money is prohibited in Islam. Financing in Islam is based on the illiquid assets which creates real assets and inventories. In the Islamic inventories or goods are purchased by the bank for his customer.
4-As per capitalist theory, the capital and enterprise are two factors of production, capital gains fixed returns in the shape of interest and the enterprise receives its return in the shape of profit or loss as the case may be.	4- In the Islam the capital and the enterprise are not two factors of production. Every person who provides investment to a commercial enterprise also has the fear of loss due to which he is entitled to a proportionate share of profit. As the risk of the business is concerned the capital has an intrinsic element of the entrepreneurship and the capital earns the profit not a fixed return on it.
5- In the conventional banking system only the guidelines or rules are followed which are made for the purpose of earning profit.	5- Not only the man made rules and regulations are followed but also the religious guidelines are the law making main source of the Islamic banking.
6-Conventional banking system provide loans to every business and earns profit, it may be harmful to the society at large like tobacco, alcohol etc.	6-Loans are only provided to the business which are productive to the society and the lending to the institutions or business is not made which are harmful to the society.
7- Business model of the conventional banking system is to receive money from the people who have in access and lend the same to the people who need money for the establishment and enhancement of their businesses. Lesser amount is paid to the depositors and higher amount is charged to the borrowers of the money and the difference between the spread is the profit of the business, the borrowers have to pay the principle and markup amount even in case of loss in his business.	7-Musharakah has been created with the depositors and profit and loss has been shared with them. The amount received from the depositors invested in the real business or trade which creates real asset, if profit is generated from the business same have been shared with the depositors after retaining some profit of the bank. Risk of loss is borne by the bank at all the times, but if the loss is due to the negligence of the borrower, or its intention of default then the loss amount is paid by the borrower only.
8-Legal department only provides guidance for creation of products and services to serve the society at large.	8- Legal department is also supervised by the Sharia Board, only Sharia complied products and services are introduced to the general public to fulfill their personal and business needs. The Islamic banking rules and regulations are made in the light of Quran, Sunnah, Ijma and Qiyas.
9-Interest has been paid by the borrower even in case of loss, both the principle and additional amount is paid by him.	9-The borrower shares the amount of profit, if the business faces loss and the principle is lost, the borrower is not bound to pay back to the bank, neither principle nor markup.
10-If the borrower does not pay the borrowed money or the amount of markup within the sanctioned time limit, the additional amount is charged on the outstanding amount like Special Markup Rate has been charged in addition of Temporary Markup Rate.	10- In the Islamic banking normal profit has been charged to borrower. If the borrower does not pay within the sanctioned time period the customer is not charged extra amount for the bank income. A penalty amount has been charged to the customer so that he may not willfully pay amount considering that no amount is charged by Islamic banks on the overdue period of finance.

	The penalty amount is not credited to the bank income; this amount is paid as charity and common benefits of the society at large.
11-The conventional banks charged interest so that the value of money can be maintained in the inflationary economy, if let the money idle and not invested in any business that brings fruits it loses its purchasing power parity as compared to the invested money which earns interest.	11-The Islamic financial institutions facilitates the mobilization of money and real assets are created in the economy the invested money earns profit and inflationary gaps can be fulfilled by the fruits of investment and purchasing power parity has been maintained even in the inflationary economy.
12-Customer will be charged from the time when the finance amount is credited to his account, bank is not concerned either goods or inventories has been purchased by the customer no not. The customer will be charged till the date the amount is not repaid to the bank.	12- The Islamic bank charges the customer when the agreement of purchase of goods has been executed between the bank and the borrower and the profit will be charged on the outstanding amount till the amount is repaid to the bank by selling the purchased goods.
13-Application of the rate is KIBOR (Karachi Inter Bank Offer Rate) and LIBOR (London Interbank Offer Rate) as bench marking rate and whole conventional banking system is governed by using these rates.	13-Islamic banking system does not use these rates for the execution of their agreements as bench mark. These rates are considered to check the market parameters and the execution of the agreement is made on their own assessed rates. Working on the IBOR (Islamic Inter Bank Offer Rate) is started and soon it will be introduced in Pakistan.
14-Bill Discounting like Bills of Exchange and Promissory Note is freely made in the conventional banking system as explained above the Foreign Bills Discounting in the local currency or Foreign Currency Bill Discounting it is made in the USD, interest has been charged on the outstanding number of days at the pre-agreed rate.	14- Bill of Exchange and Promissory Note are not used for the discounting purpose because these are only certificates showing money not real assets. However the certificates showing ownership in the real assets are traded in Islamic banking system like shares, lease certificates, Musharakah certificates are traded because they represent tangible assets on their back.
15-Export Refinance II credit facility is allowed to the exporters at the lower rate even below the KIBOR to enhance the exports, so that balance of payment can be managed. A pool of funds has been maintained for this purpose from which the payment is made.	15-Export Refinance II scheme is also given by the Islamic banks and also gets refinanced from the SBP. However, the pool of funds from which refinance availed is separately maintained from the conventional one.
16-Running Finance is allowed to the customers through which he is allowed to withdraw more money than its credit balance up to the sanctioned line and markup is calculated on daily basis on such credit facility.	16- No credit facility in the shape of running finance is allowed to the customers' even credit card and such like products are not allowed, because in it only cash has been given to the customer and upon the outstanding balance the markup charged that is interest.
17- Conventional banking system emphasis to increase the deposits and less consider the origin of the money and once money received then KYC of the customer is reviewed and updated.	17- The Islamic banking system KYC is more stringent as compared to the conventional ones. The loan transactions require the proper documentation same at the time of depositing the money the customer KYC is made strictly. During the KYC process if it is assessed/ feared by the KYC officer that the money will be used for any illegal purpose, such type of transactions are not entertained in the Islamic banking system.

#### 4. Conclusion

Conventional banking system is the interest based in it money is given to the borrower and the fixed amount of interest has been received on the pre-agreed ration, lender has no concern it is invested by the borrower somewhere or held with him, the borrower has to pay the principal amount along with the mark up amount till the maturity of the loan. On the other side Islamic banking system if it receives the amount from the investor this amount is received on the basis of Musharakah or qard and this amount invested in to the profitable business, the returns are shared with the investor after keeping some profit with the bank, if this amount is given to a borrower then the partnership has been created with the borrower or the product has been purchased on the behalf of the borrower and then given to him, in this way real asset, product or services has been created in the economy and the loan is used for the sanctioned purpose only. Islamic banking system has to work in the Sharia compliant rules which have some restrictions as compared to the conventional banking system protocols. First, Islamic bank cannot lend the amount in the form of money upon which interest will be received, however the amount is given by purchasing the required product or asset by the bank for the borrower or he is given amount on the basis of Musharakah and profit or loss is borne by the bank. Second, finance is not provided to any person or firm who will use it for any purpose which is restricted by the Sharia e.g. pornography, alcohol or any other business which is against the common benefit of the society at large. Third, if the finance is provided to the borrower on the basis of profit and loss sharing then the profit is shared on the basis of pre-agreed ration and the loss has been shared as per the ratio of capital invested by the partners.

The Islamic banking does not provide loan to any firm or individual without the confirmation in the real sector. One of the unique features of the Islamic banking is the formation of Mudarabah, the finance is sanctioned to the skillful individuals so that they can stand and can earn for themselves and for the investor also. All the products and services are as per Sharia compliant and authenticated by the Sharia board and the Islamic Fiqah Academy. Islamic banking is showing signs that it will continue to grow even some one does not subscribe on the matter of interest, but on the basis of innovative ideas which can add more variety as compared to the existing conventional banking system. One of the main selling differences is that the Islamic banking is more concerned with the viability of the projects and the profitability of the operation which are left by the conventional banking due to the lack of the collateral, more of these projects are financed by the Islamic banking on the basis of profit and loss sharing basis. Islamic banking is more enterprising as compared to the conventional banking and it can play a catalytic role in development of economy. Islamic banks are growing in Pakistan 2- 2.5 times faster as compared to the conventional banking and have captured more than 50% consumer market even with a smaller size and network. Despite of limited market as compare to the conventional one Islamic banking is more growing worldwide. Governing institutional support as per Sharia protocols will accelerate the growth of Islamic banking.

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