

BASIC DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC BANKING

Modes of Finance:

Conventional Banking



Conventional banks only have **one mode** of financing for its customers and that is 'Loan'.

Be it an individual customer, a business partnership or a corporate client. They all can avail an array of products with an underlying mode of debt only from a conventional bank. However, conventional banks have designed several products such as credit cards, running finance, car/house loans and long-term loan facility for different customer segments but all of them simplify to a loan advanced by a bank to its customer.

For instance, a credit card is also a debt instrument, also a car lease finance translates into an accrued loan for any customer.

Likewise, a registered partnership/ corporate customer avails both short-term and long-term financing facilities. All of them are essentially outstanding loans to a company and they pay interest/mark-up to the bank on quarterly/annual basis.

For example, if a customer avails a house/car finance from a bank and due to some reason car/house gets destroyed (total loss). The bank would then ask the customer to keep paying monthly installments despite the asset loss till insurance settlement comes in or else the customer would be reported defaulter in case of non-payment of the same and their e-CIB shall also be adversely affected

Islamic Banking



Islamic banks primarily work upon **three modes** of finance, namely, rental arrangement (Ijarah), trade/ sale basis (Murabaha, Musawammah, Salam, Istisna & Tijarah) and partnerships (Mudarabah & Musharakah).

Rental Basis (Ijarah): -

Ijarah or rental arrangement is where the usufruct of a durable asset is leased out to a customer against a certain rental payment for a mutually agreed tenor.

Trade/ Sale Basis:

Murabaha: -

It is that sale where bank (seller) discloses the cost and profit to the customer (buyer).

Musawammah: -

It is an ordinary sale where bank (seller) does not disclose cost and profit to its customer (buyer).

Salam: -

It is a sale where 100% payment is made in advance and goods delivery is set on a future date. Also, it has a limitation to be done upon homogenous goods.

Istisna: -

Sale transaction with spot or part payment for manufactured goods. An order is placed with the manufacturer to make a specific commodity to the purchaser.

Tijarah: -

It is a sale and agency based financing facility where finished stock is sold by customer (seller) to bank (buyer) to generate working capital for further business operations.

BASIC DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC BANKING

Conventional Banking



Modes of Finance:

Banks may offer this facility to manufacturer/producer/trader who sell finished goods on credit basis.

Partnership Modes:

Musharakah: -

Musharakah is a partnership where all the partners invest capital in a joint business and become owners of the business with their ratio of investment

They share profits as per agreed profit sharing ration and share loss as per investment ratios.

Mudarabah: -

Mudarabah is a partnership where one party invests capital (Rab Ul Maal) and the other party renders services (Mudarib) in a joint business.

Mudarabah

Islamic banks operate all types of savings/ remunerative accounts and term deposits on Mudarabah basis.

Islamic banks invest customer's deposits in Shariah-compliant avenues and share the profits with customers as per profit sharing ratios agreed on monthly basis.

Other Banking Modes:

Kafalah: -

It refers to the guarantee an Islamic bank provides to a third party (probably another bank or company) on behalf of its customer, in case they fail to pay the third party in due time.

Wakalah: -

It is usually a paid agency contract, where a customer hires a particular service from an Islamic bank for a certain price.



Product Name/ Type/ Desc	Conventional (Underlying Mode)	Islamic (Underlying Mode)	Difference
LIABILITY SIDE:			
Current A/C – All types & variants for Businesses/ Individuals	Loan Based 	Qard (Loan) Based 	Islamic Current Account are Qard based and funds are invested in shariah compliant avenues. However in Conventional banking, customer’s deposited funds are used in money lending and interest earning businesses.
Savings A/C & Term Deposits - Businesses/ Individuals	Interest Based	Mudarabah based	<p>Savings Account in Conventional banks are based on loan/qard basis and Conventional banks pay interest earned on loans to its depositors as returns whereas in Islamic banks saving account are based on the concept of Mudarabah and Islamic banks pay out actually earned profits on shariah compliant transactions.</p> <p>Mudarabah is a partnership of services and capital between two parties. In Islamic banks, banks render their services/ expertise against a capital (deposit) of a customer. It is a partnership where the returns are shared between the bank and client as per the agreed profit sharing ratio whereas, the loss is borne by the investor.</p>
Interest rate/ profit rate			<p>Conventional banks pay a fixed rate of return on depositor’s principle amount kept with the bank.</p> <p>However, Islamic bank pays a proportion of actual profit earned and realized to its depositors as per weightages and profit sharing ratios.</p>

ASSETS SIDE:

Running Finance/Working Capital Limits



Loan/revolving credit facility



Alfalah Running Musharkah/
 Alfalah Salam/
 Alfalah Istisna/
 Falah Tijarah Finance/
 Alfalah Murabaha Finance
 (Underlying mode is chosen as deemed suitable for a certain customer)

The risk of conventional and Islamic bank varies significantly.

Conventional banks only risk is if customer defaults and does not pay back the loan along the interest accrued.

Islamic bank's risk changes with the mode of financing, each mode has a different risk profile, and customer's business nature also adds in Islamic bank's risk of financing.

For example, in trade modes like Murabaha/Musawammah, Islamic bank actually owns the very asset(s) in the transaction and assumes all associated risks of the asset(s) before selling them to the customer. If asset(s) go into total loss during the process of sale to customer, Islamic bank would solely bare the loss.

LCs/Contratcts/ Guarantees

Credit warranty against a Fee(as per SOC) & mark-up on credit advanced

Trade based modes:
 Murabaha/Musawamah
 (As explained above)
 Service based modes:
 Wakala/ Kafalah
 (As explained above)

Both Islamic and conventional banks charge a fee against these non-funded facilities, which is allowed in Shariah. However if conventional banks make payments on behalf of its customer, it charges interest to them on delayed payments to the bank. Islamic banks cannot charge interest but they charge profit on credit sale of imported goods to the customer, as the import is made on risk of the bank in such case.(under bank's ownership)

ASSETS SIDE:

Long-Term Finance

A loan facility spread over years of tenor.



Alfalah Diminishing Musharakah/

Alfalah Ijarah



Conventional banks provide loans to their customers and charge mark-up (interest quarterly) to their customers on the outstanding principle amount. Compounding of interest also takes place on annual basis. Whereas in case of DM, Islamic banks form joint ownership in a new asset and rent out their share of asset to the customer and also sell its' ownership share in that very asset to the customer on periodic basis. Thus called diminishing musharakah, a declining partnership, where bank's ownership share decreases and customer's increases over the tenor.

In Ijarah, an asset is bought on behalf of customer and its usufruct is leased out to the customer for a certain tenor, the bank remains owner of the asset throughout the tenor and receives monthly installments from customer. However, transfer of asset is done either by gifting (Hiba) the asset to the customer at the end of tenor, or by recognizing last installment/ security deposit of the customer as consideration for the sale of asset to the customer.

KEY DIFFERENCES

Lending & Borrowing Mechanism.



Conventional banks borrow funds from depositors on qarz and further advance money to customers on loan. Keeping a spread between rate of deposit and rate of lending, which is their profit margin.



Islamic banks collect deposits on qarz in current account.
Savings Accounts are Mudarabah based.

Islamic banks offer financing under three shariah modes mainly; Rental, Partnership and Trade..

Conventional banks collect funds on debt basis and advance money on debt basis, charging interest to customers, as their profit. Also, the return they give to depositors is Riba (Interest) as it's a benefit on Qard (debt).

Islamic banks collect funds either on qard basis or on Mudarabah basis.

Offering returns/profits only on Mudarabah based accounts as return on Qard is Riba(Interest), which is strictly forbidden in Islam.

Treating Money/Currency as Commodity

Conventional banks identify currency/money as commodity, thus they can trade or rent it and make profit of it.

Islamic banks do not recognize money as commodity; therefore, they cannot sell money and rent money to make profits. Charging money over money in a debt contract is Interest (Riba).

Conventional banks treat money as commodity so they rent money for interest and sell money on interest.

Islamic banks deem currency/money as a 'mode of exchange', thus Islamic banks do not sell/ rent money for profit. However, they may rent a fixed asset or sell a Shariah-Compliant asset to customer for a profit.

KEY DIFFERENCES

Risk Sharing

Conventional banks only offer debt to customers; contract of debt does not have any other risk than default for the lender.

Thus, they do not share any risk with their customers at all. All the financial risk is borne by the borrower i.e. the customer

Islamic banks have participatory modes such as Musharakah and Mudarabah. Both are partnerships and by default that means sharing of profit as per agreed ratio and sharing of loss as per investment ratio. Thereby, Islamic banks do share risk with customers in such modes.

Conventional banks offer services on debt for both depositors and borrowers, so they do not share risk with any of the customers. Whereas, Islamic banks share risks with their customers, both depositors and financed, as per the underlying participatory mode and their risk profile, respectively.

Late Payment Charges

Conventional banks make significant chunk of their net profits from late payment charges levied on their customers. Late payments are considerable income for all the banks and add to their profitability. Moreover, conventional banks do not waive off these charges in business as usual, as this compounds their interest amount and reaps more monetary benefit for the bank.

Islamic banks only charge charity to discipline the clients from delaying payments from due dates. More importantly, Shariah bars Islamic banks from repricing the outstanding amount, which becomes a debt.

In addition, charity income does not add to Islamic bank's profitability but collected and used for welfare support in health and education sectors only.

Late payment charges are conventional bank's income and constitute a sizable chunk in their overall profitability of the bank.

In contrast, Islamic banks understand that if they do not make due payments timely to the bank, the bank would not be able to dispense profits to its depositors on time. In order to maintain financial discipline among the clients undertake that binds a client to pay charity in the name of Allah in case of deliberate late payment or intentional delays to the bank. Islamic banks collect charity from such customers and the amount collected does not boost their profits and can only be used for welfare in health and education sectors as per SBP charity policy.