ISSN Online: 2709-7625
ISSN Print: 2709-7617
Vol.7 No.2, 2024

Differentiating Features of Islamic vs. Conventional Banks and Microfinance

Dr.Syed Abrar Hussain Shah *
Prof. Dr Altaf Hussain Langrial**
Dr. Hafiz Muhammad Hasan Mahmood***

ABSTRACT

This study provides a comparative analysis of the distinguishing features of Islamic and conventional banks and microfinance institutions, highlighting the unique principles guiding each system. Conventional banking and microfinance models primarily rely on interest-based lending and a focus on profit maximization, often involving mechanisms that can lead to financial exclusion or unsustainable debt for vulnerable borrowers. Islamic finance, by contrast, operates under Shariah (Islamic law), which prohibits riba (interest) and encourages ethical investments, risk-sharing, and asset-backed transactions. Key instruments in Islamic banking and microfinance such as mūdārabah, mushārakah, and ijārah emphasize fairness, risk distribution, and tangible asset backing, fostering a socially responsible approach that seeks to promote justice and mutual benefit.The analysis reveals that while conventional institutions often prioritize shareholder returns, Islamic banks and microfinance institutions aim to align financial objectives with social responsibility, serving as a model for ethical finance. Despite challenges such as regulatory complexities and scalability, the Islamic finance framework has shown significant promise in addressing financial inclusion in predominantly Muslim communities. The findings suggest that Islamic finance, if implemented effectively, can offer a sustainable and inclusive financial alternative that aligns economic growth with ethical and spiritual values. This paper finds that while Islamic microfinance faces challenges such as regulatory hurdles, scalability issues, and awareness limitations, it holds significant potential to offer a more equitable and sustainable approach to microfinance. By integrating financial goals with ethical considerations, Islamic microfinance presents an alternative framework that can contribute to both economic empowerment and social development in underserved communities.However, this model has faced criticism for high-interest rates and an overemphasis on debt, which can create unsustainable financial burdens on vulnerable populations.

Key Words: *Islamic vs. Conventional Banks, Differentiating Features, Microfinance, Musharakah, Mudārabah.*

Islamic microfinance institutes and banks have changed the borrowing relationship to various concepts that are acknowledged in Islam such as partnership (*Mushārakah Mudārabah*), or seller (bank) and buyer/renter (customer). The partnership principle in the finance products also offers customers profit sharing with the microfinance institutes and bank. However, if the customer faces a loss, the Islamic bank will bear part of it based on this contract. A banking system devoid of *Riba*

* Assistant Professor, COMSATS University Islamabad, Vehari Campus, Punjab, Pakistan. Abrarhussain@cuivehari.edu.pk
**Professor & Director, Institute of Islamic Studies, Bahauddin Zakariya University, Multan, Punjab, Pakistan. Altaf.langrial@bzu.edu.pk
***Lecturer, University of Education Lahore, Vehari Campus, Punjab, Pakistan. irhasan.mahmood@gmail.com,

fulfils the needs of both customers and the general public. Islamic banking, through the introduction of Islamic concepts, has successfully generated large profits in the business it participates.Nevertheless, the main concern of Islamic banking is to ensure that every bit of its business process is Pakistani compliant and this is more meaningful than reaping more profit. This main concern is a commitment, responsibility and preservation of the trust granted by Allah (s.w.t.) to human beings, which emphasizes the principle of cooperation amongst humans in fulfilling each respective need. Without hard work and wisdom, an Islamic bank or microfinance institutes will take the easy route and just copy the products and systems of conventional banking, without observing the implementation aspect of the Pakistani. Society should clearly understand that the Islamic banking system has revolutionized the relationship between the customer/saver and the microfinance institutes and bank. The relationship between the customer and a conventional bank and microfinance institutes are through the loan contract that entails interest on the principal. The borrower must pay the bank and microfinance institutes within the stipulated period.

Having said that, many users remain reluctant to avail Islamic banking products and are unaware about the actual differences between Islamic and conventional banks, some even claim that Islamic banks merely change the terminology in order to label the products as *Shariah* compliant. No doubt this assumption is largely based on ignorance and lack of knowledge which this article will try to clarify.Many are still saying that Islamic products and services are just conventional products that have been window dressed. Some even claim that Islamic banking only changes the terms such as 'interest' into profit rate, '*Ujr* or wage cost, and other Arabic terms are viewed by critics as tricks. These general statements should not be made without knowing exactly how an Islamic bank operates; as such statements will inhibit the revival and development of the Islamic banking industry. We do acknowledge that there are problems in the implementation process and other problems in Islamic banking. However, in my opinion, it is normal to experience difficulty before achieving success.All stakeholders, whether Pakistani scholars, lawyers, judges, customers or the Islamic bank administration, are still in the learning process. It is undeniable that mistakes will occur here and there throughout this process. Islamic banking is still in the process of maturity and achieving perfection. Thus, deficiencies will occur throughout this journey. Yet, these deficiencies do not make Islamic banking and microfinance system haram and invalid. Just like a new Muslim who has yet to perform the five daily *Salah* (prayers) as he is in the process of learning and understanding it, this falls under the forgivable category. What really matters are that the process is heading forward (i.e. improving) and not falling backwards.

Conventional Banking and Microfinance (Product Detail)

Assets Side Details	Liability Side Products
1. Bank is the lender	1. Bank is the Borrower
2. Bank is the Borrower	2. Bank is the lender

Islamic Banking and Microfinance (Products Detail)

Assets Side Details

- *Murabahah*, *Musawamah*, *Salam*, *Istisna* (**Sale / Trade Base**)
- *Musharakah*, *Mudarabah* (**Participatory Base**)
- *Ijarah*, *Wakalah* (**Service Base**)

Liability Side Products

- *Musharakah*
- *Mudarabah*

Products and Tools of Islamic Banking

The most important Islamic investment techniques practiced by the Islamic Banks are as follows:

1. *Sukuk*/Securitization

The Islamic Banks provide structuring, arranging, and placement services, as well as advisory services, for companies seeking financing through *Sukuk* issuance, and sees great opportunities and potential for Islamic finance and Islamic financial markets in this area, whereby new issues are distributed to investors in the primary market, and existing securities are traded in the secondary market.

The capital market is the market where companies can raise long-term financing. Nowadays, *Sukuk* are being looked at as an Islamic equivalent of bonds, hence *Sukuk* are securities that comply with the Islamic law and its investment principles and provide access for both Islamic investors and companies seeking *Shariah*-compliant financing to the capital market.

Sukuk basically relies on the concept of asset monetization, and can be issued on existing as well as specific assets that may become available at a future date; the concept of *Sukuk* can in some cases also be viewed as Islamic securitization which is very similar to conventional asset-backed securitization whereby a corporate entity moves its assets to an ostensibly bankruptcy-remote vehicle that acquires the assets with the proceeds of issuance of securities.

2. *Musawamah* Sale

This transaction is executed when a customer approaches the Bank for assistance in purchasing a particular commodity. In such circumstances, the Bank buys the goods from a third party (supplier) at a price agreed between the Bank and the supplier without interference from the customer.

The Bank will then offer the goods to the customer at a price including profit. The customer then has the option to accept the goods or reject it within a fixed period of time. If the customer accepts the goods, the Bank will sell the goods to the customer and he/she will then pay the sale price in instalments to the Bank over an agreed period of time. A *Musawamah* sale transaction is usually confined to goods purchased from the local market.

3. *Murabahah* Sale

Mudarabah represents another of the most desirable forms of Islamic financing arrangements. In a novel approach, the business to be undertaken under *Mudarabah* was regulated through the promulgation of a separate statute, called the *Mudarabah* Companies (Floatation and Control) Ordinance 1980.

The customer approaches the Bank for assistance in importing certain goods and provides the Bank with the specifications of the goods in terms of description, quantity, price etc.

The Bank then imports the goods on its own account in order to sell to the client at a price which covers the cost and an agreed profit margin. The customer pays the price to the bank in instalments over an agreed period of time.

4. *Istisna'a*

This is a form of contractual relationship whereby the client agrees with the Bank to execute a certain project bearing all the costs of raw materials and salaries. The Bank then delivers the accomplished project price and commissions one or more construction companies to execute the project.

5. *Mudarabah* Investment

Mudarabah is a mode of financing whereby the Bank would provide the funds for a certain business project or transaction and the customer would provide the professional expertise and know-how to run the business or execute the transaction. Thus, a joint venture is formed between the Bank and the client and any profits are shared in a predetermined ratio.

Through this mode the Bank has executed and continues to execute various projects on a regular basis.

6. *Musharakah* Investment

Musharakah Investment is considered to be the main factor that differentiates an Islamic bank from a conventional commercial bank. According to this technique the Bank provides a share of the finance required by a customer for a business project or for the purchase of specific merchandise and becomes a partner in the business or the transaction. The resultant profits or losses are shared by the Bank and the customer at a *Shariah*-compliant ratio agreed upon in advance.

Under this method the Bank purchases an asset like a building, machinery or equipment and leases it to others. Before an *Ijarah* is undertaken, a feasibility study is conducted to ascertain its profitability and compliance with Shariah.

Evidently, the *Musharakah* also envisaged a complex arrangement of profit and loss sharing just as it was present in the case of PTCs. But in its design the seriousness to evolve a truly Islamic instrument is quite evident. It was indeed a departure from the traditional financing arrangement and thus entailed significant risk which banks assumed in undertaking business based on this arrangement.

Some of the features of the instrument that attracted criticism were: One, the profit-sharing arrangement did not strictly conform to the requirements of *Shariah* particularly in the treatment of losses and payment of provisional profits and their adjustment through the participation reserve. Two, despite being a sharing arrangement, the actual agreement was cast within the framework of a creditor and debtor relationship, and was also protected as such in the law. Three, *Musharakah* also demanded securities that were akin to relationship between a creditor and debtor. Finally, in the absence of a legal framework regulating the operation of *Musharakah*, there was no standardization of the agreement and the terms and conditions of various agreements varied considerably.

7. *Ijarah* (الإجارة)

Factually, Ijarah means leasing. Within this deal the bank buys equipment and leases it temporarily to a client for certain payment. At that, the client is entitled to purchase the equipment from the financial institution within the period of contract validity or after its expiry subject to preliminary arrangement with the bank.

8. *Salam* (السلم)

Investment tool that provides for purchase of certain goods by forward payment. In Muslim countries this toll is used, as a rule, for finance of the projects in agricultural sector. Mandatory condition for *Salam* is back up of the deal with real goods (for instance, crops).

9. *Takaful* (التكافل)

Takaful is a type of insurance common in Muslim countries. It is based on a special mechanism of profit and loss allocation in accordance with the moral and ethics of Sharia. In the framework of *Takaful,* the insured persons can pretend for a part of profit of the Insurer from the funds paid into the insurance fund, less expenses. In other words, the insured person becomes in fact a shareholder of the insurance company entitled for the part of profit corresponding to its contribution amount.

10. Governing principles of Islamic Banking and Microfinance: -

- The absence of interest- based (***Riba'***) transactions
- Avoidance of speculations (***Gharar***)

- Avoidance of betting and gambling (***Qimar* and *Maysir***)
- Avoidance of oppression (Z***ulm***)
- Introduction of Z***akat***
- Discouragement of the production of goods and services which contradict the Islamic value (***Haram***)

Allah (s.w.a) says;

الَّذِينَ يُنفِقُونَ أَمْوَالَهُم بِاللَّيْلِ وَالنَّهَارِ سِرًّا وَعَلاَنِيَةً فَلَهُمْ أَجْرُهُمْ عِندَ رَبِّهِمْ وَلاَ خَوْفٌ عَلَيْهِمْ وَلاَ هُمْ يَحْزَنُونَ[1].

"Those who charge usury (*Riba'*/interest) are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, God permits commerce and prohibits usury. Thus, whoever heeds this commandment from his Lord and refrains from usury, he may keep his past earnings and his judgment and refrains from usury, he may keep his past earnings and his judgment rests with God. As for those who persist in usury, they will incur Hell, wherein they abide forever."

11. *Riba'* literally means "increase" or "excess"

- An increase in a loan transaction or exchange of commodity accrues to the owner (lender) without giving an equivalent counter-value or recompense in return.

"**Same exchange value" illustrations: -**

- Exchanging 1kg of grapes with 1.5kg of grapes that are of the same type, quality and value. Page 5 type, quality and value
- RM100 exchangeable for RM110
- Hence, if items are the same then any differences (incremental or otherwise) in their exchange value is *Riba.*

12. Other considerations:

- A contractual difference in value of 2 (or more items) of different type, quality and value when exchanged is not *Riba'*.
- If agreed differences is changed post-transaction, the changed amount is *Riba*.

13. Rationale for the Prohibition of *Riba'*

To promote economically just, socially fair and ethically and correct economic behaviour, Inequality is exemplified in the situation where the lender is guaranteed a positive return without assuming any share of the borrower's risk whilst the borrower takes upon himself all sorts of risks in addition to his efforts, skills and labour.

Riba' violates the principle of property rights. Money lent on interest is used either productively that it creates additional wealth or otherwise. When money used (together with labour and entrepreneurial skills) to produce additional wealth, such money lent cannot have any property rights claim to the incremental wealth because there was no prior bargain over it. Instead 'interest', demanded a guaranteed return regardless of the enterprise.

- Promotion of profit-and-risk-sharing. The sharing of risks and uncertainties of the enterprise is fundamental to *Shariah* contracts. *Shariah* condemns the act of guaranteeing (even by the entrepreneur) to restore the invested funds intact.
- Act of lending is an act of charity. Lending should be a benevolent act. If money is needed other than for commercial purposes (thus, risk- sharing), such need should not be exploited where

[1] Surah Al-Baqarah :2: 274

the borrower is put under undue burden. Verse 57:11 "Who is he that will lend unto Allah a goodly loan, that He may double it for him or his may be a rich reward…

- *Gharar* generally means unqualified and unqualified uncertainty, hazard, deceit, chance or risk.
- Majority Islamic scholars view *Gharar* as 'both ignorance of the material attributes of the subject matter of a sale and also uncertainty regarding its availability and existence'.

***Gharar* is prevented when transactions are transparent with:**

All details agreed in advance; and

- Ownership undisputed.
- For *Gharar* to invalidate a contract, it must not be trivial, must be relating to the object of contract and must prove specifically in conflict with (trade) custom. However, non-trivial *Gharar* may be tolerated if there is an overriding *Maslahah* or public benefit.
- Preventable uncertainty is present in any contract subject to risks in the ordinary course of business – *Istisna'* or Salam contracts.
- Prohibition of *Gharar* is indirectly a risk management in Islam hence encouraging the exercise of due diligence and avoidance of contracts with high degree of information asymmetry with extreme pay-offs
- Nonetheless, treating *Gharar* as risk has its consequences i.e. trading of
- Nonetheless, treating *Gharar* as risk has its consequences i.e. trading of risks therefore is prohibited where the traded risks may have been transferable in derivative format.
- In its literal meaning, Qīmār refers to betting and wagering. Technically, it involves taking ownership of some form of wealth (māl) by way of a wager. *Qimar* or gambling includes every game in which the winner receives something (money, goods, etc.) from the loser. This zero sum game constitutes wagering on very risky outcomes which Shariah outspokenly forbids.
- On the other hand, Maysir is broader in scope than *Qimar*. *Maysir* includes all kinds of gambling, that is, it is more than a particular game of chance. The term "*Maysir*" was originally used as a reference to a pre-Islamic game of arrows in which seven persons gambled for shares (portions) of an allotted prize. *Maysir* is prohibited by *Shariah* on the grounds that the agreement between participants is based on immoral inducement provided by entirely wishful hopes in the participants' minds that they will gain by mere chance, with no consideration for the possibility of loss.
- *Zulm* refers to all form of inequity, injustice, exploitation, oppression and wrong doing.
- A person either deprives others of their rights or does not fulfil his obligations towards them.

***Zulm* also refers to trading in matters which are prohibited (haram) under *Shariah* such as**: -

- Alcoholic drinks/beverages; and
- Non halal poultry/meat, pork

History, Products and Tools of Conventional Banking

Modern economic and financial history is usually traced back to the coffee houses of London. The London Royal Exchange was established in 1565. ([2]) At that time moneychangers were already

[2] The Royal Exchange in the City of London was founded in 1565 by Sir Thomas Gresham to act as a centre of commerce for the city. The site was provided by the City of London Corporation and the Worshipful Company of Mercers, and is roughly triangular, formed by the converging streets of Cornhill and Thread Needle Street.

called bankers, though the term "bank" usually referred to their offices, and did not carry the meaning it does today. There was also a hierarchical order among professionals; at the top were the bankers who did business with heads of state, next were the city exchanges, and at the bottom were the pawn shops or "Lombard's. ([3]) Some European cities today have a Lombard street where the pawn shop was located.

After the siege of Antwerp, trade moved to Amsterdam. In 1609 the *Amsterdamsche Wisselbank ([4])* was founded which made Amsterdam the financial centre of the world until the Industrial Revolution.

Banking offices were usually located near centres of trade, and in the late 17th century, the largest centres for commerce were the ports of Amsterdam ([5]), London, and Hamburg. Individuals could participate in the lucrative East India trade by purchasing bills of credit from these banks, but the price they received for commodities was dependent on the ships returning (which often didn't happen on time) and on the cargo they carried (which often wasn't according to plan). The commodities market was very volatile for this reason, and also because of the many wars that led to cargo seizures and loss of ships.

1. Interest

Interest is a fee paid on borrowed assets. According to oxford Dictionary Interest means the money paid for the use of money lent.([6])It is the price paid for the use of borrowed money, or, money earned by deposited funds.([7])Assets that are sometimes lent with interest include money, shares, consumer goods through hire purchase, major assets such as aircraft, and even entire factories in finance lease arrangements. The interest is calculated upon the value of the assets in the same manner as upon money. Interest can be thought of as "rent of money". For example, if you want to borrow money from the bank, there is a certain rate you have to pay according to how much you want loaned to you. ([8])

Interest is compensation to the lender for forgoing other useful investments that could have been made with the loaned asset. These forgone investments are known as the opportunity cost. Instead of the lender using the assets directly, they are advanced to the borrower. The borrower then enjoys the benefit of using the assets ahead of the effort required to obtain them, while the lender enjoys the benefit of the fee paid by the borrower for the privilege. The amount lent, or the value of the assets lent, is called the principle. This principle value is held by the borrower on credit. Interest is therefore the price of credit, not the price of money as it is commonly believed to be. The percentage of the principle that is paid as a fee (the interest), over a certain period of time, is called the interest rate. ([9])

[3] Lombard banking refers to the historical use of the term 'Lombard' for a pawn shop in the Middle Ages, a type of banking that originated with the prosperous northern Italian region of Lombardy

[4] The Bank of Amsterdam (Amsterdamsche Wisselbank in Dutch) was an early commercial bank, vouched for by the city of Amsterdam, established in 1609

[5] Amsterdam is the capital and largest city of the Netherlands, located in the province of North Holland in the west of the country.

[6] The pocket Oxford Dictionary (2005) Oxford University press London UK

[7] Astronomy.com "Accrued interest Absolute" Exploring the world of knowledgehttp://www.absoluteastronomy.com/topics/accrued_interest

[8]Banking history. (2009) Wikipedia the free encyclopaedia. [Online] January 2009.

[9] Ibid

ISSN Online: 2709-7625
ISSN Print: 2709-7617
Vol.7 No.2, 2024

Usury means according to the Oxford Dictionary "lending of money at interest, esp. at an exorbitant or illegal rate.[10] This definition makes it clear that the usury means the interest there is not so much difference between interest and usury.

2. Capital and Interest

Historically, the concept of capital has been so closely bound to the concept of interest that it seems wise to take these two topics together, even though in the modern view it is capital and income rather than capital and interest that are the related concepts.

Interest as a form of income may be defined as income that is received as a result of the possession of contractual obligations for payment on the part of another. Interest, in other words, is income that is received as a result of the ownership of a bond, a promissory note, or some other instrument that represents a promise on the part of some other party to pay sums in the future. The obligations may take many forms. In the case of the perpetuity, the undertaking is to pay a certain sum each year or other interval of time for the indefinite future. A bond with a date of maturity usually involves a promise to pay a certain sum each year for a given number of years, and then a larger sum on the terminal date. A promissory note frequently consists of a promise to pay a single sum at a date that is some time in the future.[11]

3.Simple interest

When an interest is charged on the original amount, or principle amount lent is called simple interest, or *when* the fee charged for borrowing money is a fixed yearly percentage of the amount borrowed, it is called simple interest. The amount borrowed is called the principal, or the present value of the transaction. The amount owed at the end of the lending period is known as the future value of the principal.[12] The value of the principal is equal to the principal plus the simple interest. The amount of simple interest is a function of three variables, Amount borrowed (lent) or principal amount and interest rate per time period and the number of time periods for which the principal amount is borrowed. ([13])

It is calculated as:

$SI= P_0(i)(n)$

SI= Simple interest in Rupees.

P_0= Principal, amount borrowed at time period 0

I= interest rate per time period

N=Number of time periods.

4. Compound Interest

The compound interest is interest paid on any previous interest earned, as well as on the principal borrowed. ([14])Interest earned over a period of time is added to the principal amount and the calculation for the next period is based on the total of this principal amount and interest earned. This method, called compounding of interest, enables the interest itself to earn interest. The time interval between successive additions of interest is called a conversion period. If this time

[10] The pocket Oxford Dictionary (2005) Oxford University press London UK

[11] Capital and interest. (2009) Encyclopaedia Britannica. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica

[12] *Percentage and interest*. (2009). *Britannica Student Library*. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica

[13] Jams C Langhorne, John M Wachowicz, Jr (1998)" *Fundamental of Financial Management*" Tenth edition. Prentice-Hall, Incorporation ISBN Page- 37

[14] Ibid page-7

interval is one year, interest is said to be compounded, or converted, annually. Similarly, six-month intervals apply to interest compounded semi-annually; three-month intervals, interest compounded quarterly; one-month intervals, interest compounded monthly; one-week intervals, interest compounded weekly; one-day intervals, interest compounded daily. ([15])

The calculation of compounded value as follows.

$FV_n = P_0(1+i)^n$

FVn= Future compounded value of n period

P_0= Principal, amount borrowed at time period 0

n= Number of Period

Modern Banking

Many of the Lombardy merchants depending on them despite the fact that church was totally against the usury. They dealt with not only keeping the money in safe custody but also changed money for the travellers or merchants engaged in foreign trade ([16]).

The business of changing money was so lucrative that king Edward III ([17]) established the Office of Royal Exchanger for changing foreign money at a profit for the benefit of the Crown. ([18])

Banking as it is now practiced dates from the Banco di Rialto, founded in Venice in 1587. It accepted demand deposits and permitted depositors to transfer their credits by checks. It could not make loans, however, or pay interest on deposits. Its services were free since its expenses were paid by the city. The Banco Giro was formed in Venice in 1619. The two banks merged in 1637 and continued to operate under the name Banco Giro until Napoleon liquidated it in 1806. ([19])

Definition of Banking: A bank is a financial institution that deals with money and credit. It is organized on a joint stock company system primarily for the earning of profit. Commercial bank accepts deposits from individuals, firms and companies at a lower rate of interest and gives at higher rate of interest to those who need them. The difference between the terms at which can be borrowed, and that at which it lends, forms the source of its profit. A bank thus, is a profit earning institute, according to Crowther, "A bank is a firm which collects money from those who have it spare. It lends money to those who require it" in the words of Mr. Parking. "A bank is a firm that takes deposits from households and firms and makes loans to other households and firms" ([20])

[15] *Percentage and interest*. (2009). Britannica Student Library. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica

[16] *Bank and banking*. (2009). Britannica Student Library. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica

(Born 1312, ruled 1327–77) became king at the age of 15 when his father, Edward II, was overthrown. He proved himself a chivalrous knight rather than a great ruler. He loved warfare, like so many of his line, and tried to give it the glamour of the "good old days" by setting up a Round Table at Windsor Castle in imitation of King Arthur. He also organized the most famous of the English chivalric orders of knighthood, the Order of the Garter[17]

[18] Interest. (2009) "Wikipedia the free encyclopaedia" [Online] January 2009

[19] Bank and banking. (2009). Britannica Student Library. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica.

[20] Saeed, Prof M. "*Money Banking and Finance*.": Govt college of Commerce Islamabad., 2009.

According to Banking companies ordinance, 1962, Section 5(b) of Pakistan "Banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdraw able by cheques, drafts, order or otherwise" ([21])

1. Paying and Collecting Checks

Since the advent of EFTPOS (Electronic Funds Transfer at Point of Sale), direct credit, direct debit and internet banking, the cheque has lost its primacy in most banking systems as a payment instrument. This has led legal theorists to suggest that the cheque-based definition should be broadened to include financial institutions that conduct current accounts for customers and enable customers to pay and be paid by third parties, even if they do not pay and collect cheques.

2. Profitability

A bank generates a profit from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges in its lending activities. This difference is referred to as the *spread* between the cost of funds and the loan interest rate. Historically, profitability from lending activities has been cyclical and dependent on the needs and strengths of loan customers. In recent history, investors have demanded a more stable revenue stream and banks have therefore placed more emphasis on ***transaction fees,*** primarily loan fees but also including service charges on an array of deposit activities and ancillary services (international banking, foreign ***exchange,*** insurance, investments, ***wire transfers,*** etc.). Lending activities, however, still provide the bulk of a commercial bank's income.[22]

3. Common Instrument of Conventional Financing

Banks now a day's using different products for financing, these types difference usually base on based on the time and maturity. Each bank introduces different type of product according to their policy, which is mainly based on customers' demand and Banks profitability. As stated earlier that conventional banks charging interest on in different rate form the borrowers. By conventional banks we mean that the bank, which is practicing the interest, based principles. Banks usually designs product according to the demand of the business. Banks in Pakistan generally lend in the form of cash finance Overdraft and Loans.

In **cash finance** a borrower is allowed to borrow money from the Bank up to a certain limit, either at once or as and when required. Finance paying mark-up/service charges only on the amount he actually utilizes.[23]

In **Overdraft** form of Principle, the banker allows to withdrawal on his account in excess of the balance which the borrowing customer has in credit in Bank. Loan is the third form of lending borrower has to repay either in periodic instalment or in lump sum a fixed amount at a fixed future time. Some banks allow loan against collateral. This type of loan is called "Secured loan" when bank provides loan without collateral it is called "clean Loan"[24]

[21] Asrar H Siddiqi (1998) "*Practice and law of Banking in Pakistan*" Sixth revised and enlarged Edition. United Bank Ltd. P-39

[22] Capital and interest. (2009). *Encyclopaedia Britannica*. Encyclopaedia Britannica 2009 Student and Home Edition. Chicago: Encyclopaedia Britannica.

[23] Asrar H Siddiqi (1998) "*Practice and law of Banking in Pakistan*" Sixth revised and enlarged Edition. United Bank Ltd.

[24] Asrar H Siddiqi (1998) "*Practice and law of Banking in Pakistan*" Sixth revised and enlarged Edition. United Bank Ltd.

4. Term Financing

Commercial Banks using usually term financing, there are two features of a Term financing which distinguishes it from the other types of financing. The First think is this type of loan has maturity more than one year of final maturity. The second thing is it is extendible under a formal mutual agreement among borrower and the Bank.[25] This type of loan is availed by the borrower to acquire fixed assets (immovable properties i.e. land and buildings and vehicles for commercial use). The loan carries a predetermined length of time (tenure), with repayments done in instalments.

5. Lease Financing:

This type of facility helps the borrowers to acquire equipment and machineries for their businesses on lease. This type of finance is long Term in nature and as such, the repayment is made in instalments.

6. Overdraft (OD)

This is the most common form of financing Borrower requires temporary accommodation, his bank allows withdrawals on his account in excess of the balance which the borrowing customer has in credit, and an overdraft thus occurs. This is usually allowed against collateral securities. When against collateral securities, is called "Secured Overdraft."[26] is a short-term facility which is granted to the borrower to enable him meeting his day to day funding needs; like payment of salaries, utilities and purchases of inventories etc. An agreed limit is sanctioned by the bank and the borrower is allowed to draw that amount through his current account.

7. Revolving Credit

This type of loan is also short-term in nature and is used to meet short-term funding requirements of the borrowers. This type of loan does not have a fixed number of payments, as in the case of instalment loan.

Cash Finance and *Running Finance* are types of revolving loans. Once the loan limit is approved, then the borrower is free to withdraw amounts to the extent of that limit. The borrower can withdraw and repay the amount as many times as he wishes to; but he has to pay mark-up on the amount which he has actually used.

8. Letter of Credit (LC) or Documentary Credit (DC)

Letter of Credit is a written undertaking by a financial institution in favour of the supplier/seller to pay him the amount of imported/purchased goods, in case the actual importer/buyer fails to pay the liability. It is a facility which enables a customer to import/purchase goods without making advance or immediate payment from his own resources; i.e. the payment is made by the importer only on receipt of documents and actual goods.

9. Bills of Exchange Purchased (BEP)

A short-term facility that is provided to exporters against purchase of export bills on discounted price.

10. Finance against Imported Merchandize (FIM)

This is a short-term facility which is granted by banks normally to the importers against the security of Trust Receipt (Letter of Trust). Through signing the Trust Receipt, the borrower undertakes to repay the loan as soon as the he sells the goods. It is noteworthy that the default by the borrower is treated as breach of the trust, and is considered as criminal offense under the law.

---

[25] James C Van Horne. (1998) "*Fundamental of Financial Management*" Temth Edition Prentice- Hall Incorporation ISBN Page-562

[26] Ibid P-255

1. **Clean/unsecured financing**

Unsecured/clean loans are those where the banks do not demand tangible securities such as land, building, fixed/current assets, tradable inventory etc. as security; whereas, in secured financing, the banks demand any of the security as mentioned above. Secured financing is also called collateralized financing.

2. **Demand Finance:**

Demand Finance may either be short term or long term; however, its repayment is done normally through instalments.[27]

Differences between Products of Islamic microfinance institutes and Banks & Conventional microfinance institutes and Banks

Sr #	Islamic Microfinance and Banking	Conventional Microfinance and Banking
1	In Islamic microfinance and banks, all forms of contracts and transactions are free from ***Riba*** because the holy Quran declares trade to be lawful means of livelihood as opposed to ***Riba***, which is forbidden for being oppressive and exploitative. It exhorts believers to shun Riba and embrace charity.	It is no doubt that the base of conventional banking and microfinance is on interest and *Riba*.
2	In Islamic microfinance system mostly depends on charity basis.	Whereas conventional banks and microfinance totally run on business and interest point of view.
3	Islam permits debt (***Qard e Hasanah***). However, it recommends debt only as a last resort and not as a means to finance one's growing lifestyle needs.	Conventional banks and microfinance persuade the customers to give debt as possible because they get interest on it, in some cases the interest rate proceeds to 50% or above.
4	Islamic microfinance system promotes mutual cooperation and solidarity is a norm central to Islamic social behaviour and collective ethics.	Conventional banking and microfinance system have no facility for their customers.

[27] Siddiqi, Mansoor Hassan. (2008) SME department. State Bank of Pakistan. 2008

5	Freedom from ***Gharar***[28] is compulsory in Islamic Banking and Microfinance System.	But in the conventional system of marketing and institutions, there is no security in this purpose.
6	Islamic microfinance products and services are essentially in the nature Of contracts. All contracts in *Shariah* must be free from certain forbidden Elements.	The Conventional banking and microfinance system do not pay focus on the lawful and unlawful elements.
7	The relation between the Bank & microfinance and its Depositors is that of ***Mudarib and Rab-ul-Maal*** (in case of Savings Account and Term Deposits).	The relation between Bank & microfinance and Depositors that Borrower and Lenders.
8	The Bank & microfinance invests the funds it receives at the depositors' own risk (in case of Savings Account and Term Deposits) but being a trustee, is accountable to the depositors in case of its negligence resulting in loss.	Conventional Banks & microfinance provide guarantee of the capital to their depositors.
9	Profit is shared with the ***Rab-ul-Maal*** at a pre agreed ratio, that is, the Bank & microfinance institutes pay a share of the profits it actually earns from its operations to its depositors.	Depositors are paid at a pre-agreed interest rate.
10	Profit payment to depositors cannot be of fixed nature. Islamic Banks & microfinance cannot pre-advice rate of return to depositors	Interest payment is fixed.

[28] *Gharar* does not have a single definition and is a fairly broad concept. In modern parlance, *Gharar* may simply refer to settlement risk. It may refer to inadequacy of information shared between parties to a transaction, such as, when the price, characteristics of object of transaction etc. are not known to both the parties at the time of transaction. It may refer to misspecification and inaccuracy of information shared between parties to a transaction owing to fraud or deceit. It may also refer to undue complexity in transactions or simply games of chance. It may be noted that *Gharar* matters in the context of commercial transactions only. Similar conditions of *Gharar* prevailing in the context of non-commercial transactions without a consideration, such as, grants, gifts, guarantees do not make the contract unlawful. For this reason, while commercial insurance is deemed unlawful because it involves *Gharar*, mutual cooperative insurance is an acceptable product for Islamic microfinance.

	but may indicate a range based on their past performance with no guarantee of the principal or profit.	
11	The relation between the Bank and its customers can vary (on the asset side).	The relation between the Bank and its customers is also based on lending and borrowing.
12	Transactions are real asset-based (on the asset side).	Transactions are financial asset-based, that may not be physical assets.
13	Real Asset is a product. Money is just a medium of exchange.	Money is a product besides medium of exchange and store of value.
14	Profit on exchange of goods & services are the basis for earning profit.	Time value is the basis for charging interest on capital.
15	Balance budget is the outcome of no expansion of money.	The expanded money in the money market without backing the real assets, results deficit financing.
	Loss is shared when the organization suffers loss.	Interest is charged even in case; the organization suffers losses. Thus, no concept of sharing loss.
16	The execution of agreements for the exchange of goods & services is must, while disbursing funds under ***Murabahah, Salam & Istisna contracts***.	While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.
17	Due to existence of goods & services no expansion of money takes place and thus no inflation is created.	Due to nonexistence of goods & services behind the money while disbursing funds, the expansion of money takes place, which creates inflation.
18	Due to control over inflation, no extra price is charged by the entrepreneur.	Due to inflation the entrepreneur increases prices of his goods & services, due to incorporating inflationary effect into cost of product.
19	*Musharakah* & Diminishing *Musharakah* agreements are made after making sure the existence of capital good before disbursing funds for a capital project.	Bridge financing and long-term loans lending are not made on the basis of existence of capital goods.
20	Government cannot obtain loans from the **Monetary Agency** without	Government very easily obtains loans from Central Bank through

	making sure the delivery of goods to National Investment fund.	Money Market Operations without initiating capital development expenditure.
21	Real growth in the wealth of the people of the society takes place, due to multiplier effect and real wealth goes into the ownership of lot of hands.	Real growth of wealth does not take place, as the money remains in few hands.
22	Due to failure of the project, the management of the organization can be taken over to hand over to a better management.	Due to failure of the projects the loan is written off as it becomes non-performing loan.
23	Sharing profits in case of ***Mudarabah*** and sharing in the organization of business venture in case of *Musharakah*, provides extra tax to Federal Government. This leads to minimize the tax burden over salaried persons. Due to which savings & disposable income of the people is increased, this results the increase in the real gross domestic product.	Debts financing gets the advantage of leverage for an enterprise, due to interest expense as deductible item form taxable profits. This causes huge burden of taxes on salaried persons. Thus, the saving and disposable income of the people is affected badly. This result decrease in the real gross domestic product.
24	Due to increase in the real GDP, the net exports amount becomes positive, this reduces foreign debts burden and local-currency becomes stronger.	Due to decrease in the real GDP, the net exports amount becomes negative. This invites further foreign debts and the local-currency becomes weaker.
25	A mission-based approach to poverty alleviation and development in Islam involves several not-for-profit mechanisms, such as, ***Sadaqa, Zakah, awqaf and qard-hasan***. Islamic Microfinance Institution (IMFI) or Programme creates a *Zakah* Fund with contribution from *Muzakki*. So Islamic Microfinance is totally mission based.	Whereas conventional microfinance and banking system is not mission based but is profit based.
26	The poor need a range of microfinance services, such as, ***micro-savings, micro-credit, and***	The conventional micro- finance and banking give this facility at some extent. ***Wadiah*** is an Islamic

	micro-equity, micro-takaful and micro-remittance. In the context of mainstream Islamic finance, we come across a host of for-profit modes through which such services may be provided to the poor. These could be used for microfinance with minor modifications wherever needed. A detailed discussion of the modes is beyond the scope of this monograph. A reader interested for the same may find it in the accompanying text Introduction to Islamic Finance. In this monograph we focus on specific applications of these modes in microfinance and the issues therein. We begin with micro-savings products.	deposit. Under this mechanism, the deposits are held as ***Amana*** or in trust and utilized by the microfinance institution at its own risk. The depositor does not share in the risk or return in any form. Any profit or loss resulting from the investment of these funds accrues entirely to the microfinance institution. Another feature of such deposits is the absence of any condition with regard to deposits and withdrawals. The term "*Wadiah* account" or "trust account" is used for such deposits. These are variously known as "sight deposits" or current accounts (giro *Wadiah* in Indonesian institutions). Another view is to treat these deposits as *Qard Hasan* or benevolent loan by the depositor. As in above, the microfinance institution is free to utilize these funds at its own Risk. The depositor in its role as the lender is not entitled to any return as the latter would constitute *Riba*. In fact, any kind of benefit passed on to the depositor that is a part of the agreement, is deemed to be *Riba*. Notwithstanding the absence of returns, such deposits form the basis of Iranian ***Qard Hasan***.

Conclusion

In comparing Islamic and conventional banks, this study highlights the fundamental differences in principles, operations, and impact. Conventional banking operates on an interest-based model focused on profit maximization and shareholder returns, often involving debt structures that can lead to financial exclusion or burden for some borrowers. Islamic banking, by contrast, is grounded in Shariah principles, prohibiting *riba* (interest) and prioritizing ethical practices such as risk-sharing, asset-backed transactions, and investment in socially responsible ventures.Islamic banking's unique models, including *mudarabah* (profit-sharing), *musharakah* (partnership), and *ijarah* (leasing), promote fairness, mutual benefit, and social responsibility. These models offer an alternative for individuals and businesses seeking financing options that align with both financial goals and ethical values. The commitment to transparency and shared risk in Islamic finance further supports financial inclusion and seeks to empower economically marginalized populations.While Islamic banking faces challenges like regulatory limitations, standardization issues, and scalability concerns, its growth reflects a demand for ethical banking solutions in both Muslim-majority and diverse markets. In conclusion, Islamic banks present a viable, values-driven alternative to conventional banks, with the potential to support sustainable economic growth, promote financial equity, and advance social welfare through a framework aligned with ethical and spiritual values.