Fundamental Distinctions: Conventional vs. Islamic Banking

This table highlights the core differences between conventional and Islamic banking practices, emphasizing the Shariah-compliant principles that govern Islamic financial institutions.

Feature / Aspect	Conventional Banking	Islamic Banking	Key Difference
Financing Modality	Primarily utilizes debt-based loans. Products like credit cards and various loans are structured as debt instruments, accruing interest.	Operates on Shariah-compliant principles, avoiding interest (Riba). Offers diverse, asset-backed financing modes.	**Conventional banking is debt-centric and interest-based; Islamic banking avoids interest by focusing on real asset transactions and profit/loss sharing.**
Primary Modes of Finance	Offers various debt products (e.g., credit cards, running finance, loans) fundamentally structured as loans to individuals, businesses, and corporates.	Employs three primary modes: 1. **Rental Arrangement (Ijarah):** Leasing the right to use an asset for an agreed rental. 2. **Trade/Sale Basis:** Transactions based on the sale of goods (Murabaha, Musawamah, Salam, Istisna, Tijarah). 3. **Partnerships:** Profit-and-loss sharing models (Mudarabah, Musharakah).	**Conventional finance relies on a single, interest-bearing loan model; Islamic finance offers a diverse portfolio of Shariah-compliant, asset-backed, or partnership-based contracts.**
Risk Bearing (Example)	If an asset financed by a conventional bank (e.g., house, car) is destroyed, the customer remains obligated to continue payments until insurance settlement, or they face default.	This illustrates shared risk. In some Islamic finance structures, risk is shared differently, aligning with the concept of **risk and reward being interconnected**.	**Conventional banks primarily transfer risk to the borrower; Islamic finance emphasizes shared risk and reward between the bank and the client.**

By
Muhammad Fahad Saif Khan

Understanding Islamic Finance Modes

Mode	Description	Application / Significance
Ijarah	Leasing the benefit (usufruct) of an asset to a customer for a specified period and rental payment. Ownership remains with the bank during the lease, transferring to the customer via gift (Hiba) or sale at the end.	Allows for financing major assets while adhering to shared ownership principles and avoiding interest.
Murabaha	A sale where the bank (seller) explicitly discloses the cost and profit to the customer (buyer), embodying **transparency**.	A common mode for asset financing, ensuring clarity on cost and profit.
Musawamah	A sale where the bank (seller) does not disclose the exact cost and profit to the customer (buyer), relying on negotiation.	Provides flexibility in pricing through negotiation.
Salam	A sale with full advance payment for goods to be delivered in the future, typically applicable to homogenous goods.	Facilitates agricultural finance and aligns with the prohibition of **Gharar (undue uncertainty)**.
Istisna	A contract for manufacturing goods, with payment made in installments or upon completion.	Suitable for project finance and infrastructure development.
Tijarah	Financing based on sale and agency, where a seller sells finished goods to the bank to generate working capital.	Provides working capital solutions through asset sales.
Musharakah	A joint venture where all partners contribute capital and share profits and losses according to a pre-agreed ratio, reflecting **profit and loss sharing**.	Encourages equitable partnerships and shared responsibility.
Mudarabah	A partnership where one party (Rab ul Maal) provides capital, and the other (Mudarib) provides management expertise. Profits are shared by agreement, while losses are borne by the capital provider.	Islamic banks use Mudarabah for managing savings and term deposits, sharing profits with depositors.
Kafalah	A guarantee provided by an Islamic bank on behalf of its customer.	Offers security and assurance in transactions.
Wakalah	An agency contract where a customer appoints an Islamic bank to perform a specific task.	Facilitates various services where the bank acts as an agent.

By
Muhammad Fahad Saif Khan

Liability Side: Customer Deposits

This section details how conventional and Islamic banks handle their liabilities, particularly customer deposits.

Product Name/Type	Conventional (Underlying Mode)	Islamic (Underlying Mode)	Key Difference / Explanation
Current Accounts (All types)	Loan Based	**Qard (Loan) Based**	Islamic Current Accounts are based on **Qard**, where funds are held in trust and invested in Shariah-compliant avenues. Conventional banks use these funds for lending and **interest-based activities, which is prohibited in Islam.**
Savings Accounts & Term Deposits	Interest Based	**Mudarabah Based**	Conventional banks' savings accounts are loan-based, with interest paid to depositors. Islamic banks' savings accounts are based on **Mudarabah**, sharing profits from Shariah-compliant investments with depositors. This distinction is crucial as **Islam forbids Riba**. In Mudarabah, the bank acts as the **Mudarib** (manager), investing customer deposits (**Rab ul Maal**) in Shariah-compliant activities, sharing profits according to an agreed ratio. Losses are borne by the capital provider.
Interest Rate/Profit Rate/Running	Loan/revolving credit	**Running Musharakah/Salam/Istisna/Tijar**	The risk profiles differ significantly.

By
Muhammad Fahad Saif Khan

Product Name/Type	Conventional (Underlying Mode)	Islamic (Underlying Mode)	Key Difference / Explanation
Finance/Working Capital Limits	facility with interest.	**ah Finance/Murabaha Finance** (Underlying mode chosen as suitable for customer).	Conventional banks primarily face **credit risk (default)**. Islamic banks' risks vary by financing mode and they **share business risks with their customers**. For example, in trade modes like Murabaha/Musawamah, the Islamic bank owns the asset and bears associated risks before selling it to the customer, aligning with the principle that **'profit is with risk'**.
LCs/Contracts/Guarantees	Credit warranty against a fee (as per SOC) & mark-up on credit advanced.	Trade-based modes: Murabaha/Musawamah. Service-based modes: Wakala/Kafalah.	Both charge fees for non-funded facilities, permissible in Shariah. However, conventional banks charge interest on delayed payments. Islamic banks use profit on credit sales (Murabaha) for imported goods, reflecting the bank's risk-bearing in the transaction.

By
Muhammad Fahad Saif Khan

Asset Side: Long-Term Finance

This section compares how conventional and Islamic banks manage their assets, particularly in long-term finance.

Asset/Financing Type	Conventional Banking	Islamic Banking	Key Difference / Explanation
Long-Term Finance	A loan facility spread over years, with interest (potentially compounded) charged on the outstanding principal.	**Diminishing Musharakah / Ijarah**	Conventional banks charge **mark-up (interest)**, which may be compounded – a key divergence from Islamic finance where **Riba is prohibited**. In **Diminishing Musharakah**, the Islamic bank and customer jointly own an asset, with the bank gradually selling its share to the customer. In **Ijarah**, the bank purchases an asset and leases its usufruct (right to use) to the customer for a specified period, maintaining ownership during the lease.

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Muhammad Fahad Saif Khan

Key Differentiators

Key Difference	Conventional Banking	Islamic Banking	Explanation
Lending & Borrowing Mechanism	Borrow funds from depositors (often Qard-like) and lend them as loans. Profit is derived from the interest rate spread.	Collect deposits through **Qard** (current accounts) and **Mudarabah** (savings accounts). Provide financing via Shariah-compliant modes like Ijarah, Musharakah, and Mudarabah.	Conventional banks operate on a **debt-based, interest-driven system**. Islamic banks focus on **asset-backed financing and profit-and-loss sharing**, explicitly avoiding interest.
Treating Money/Currency as a Commodity	Treats currency/money as a commodity, enabling trading or lending to generate profit (interest).	Does not consider money as a commodity. Cannot generate profit by lending money itself, as this is considered **Riba**.	Conventional banking's interest-based transactions stem from treating money as a rentable commodity. Islamic banks recognize money as a medium of exchange, generating profit through trading in permissible (Halal) assets or leasing.
Risk Sharing	Primarily engages in debt-based transactions (loans), where the main risk is **credit risk (borrower default)**. Transfers the majority of financial risk to the borrower.	In modes like **Musharakah and Mudarabah**, shares business risks with customers. Participatory modes involve sharing profits (pre-agreed ratio) and losses (proportional to capital), embodying the principle of **risk and reward**.	Conventional banks offload most financial risk. Islamic banks emphasize **participatory financing**, sharing both potential profits and losses.
Late Payment Charges	Often derives significant income from late payment charges, which may compound, effectively increasing the interest amount.	Does not impose **interest-based penalties** for late payments. May require a penalty amount, but it is directed to **charitable causes**.	Conventional banks treat late payment charges as a revenue source. Islamic banks prioritize ethical considerations, discouraging late payments without resorting to exploitative (Riba) practices. The penalty is not recognized as bank income but used for social welfare.

By
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