

Differences and Similarities in Islamic and Conventional Banking

Muhammad Hanif

Assistant Professor, National University of Computer & Emerging Sciences, Islamabad

PhD-Finance Scholar at International Islamic University, Islamabad, Pakistan

E-mail: muhammad.hanif@nu.edu.pk

Abstract

Islamic Banking is growing at a rapid speed and has showed unprecedented growth and expansion in last two decades in spite of mismatching of existing financial framework and business practices. By the end of 2008 volume of Islamic banking has reached to US \$ 951 Billion with operation in more than 50 countries. Middle East is the centre of Islamic banking with contribution of approximately 80% while 20% share is contributed by rest of the world. In Pakistan Islamic banking is at infant stage although last 6 years growth is marvelous. Islamic banking has grown at an average annual rate of 76% in the last six and half years (12/03 - 06/10) in Pakistan. Although Islamic banking faces multi challenges however three of them are very vital for its existence. First is Sharia compliance in its operations in an environment which is dominated by interest based practices even in Muslim societies. Second is perception of financial industry practitioners about its performance whether the system is able to serve the total needs of trade and industry. Third is the perception of a large majority of Muslims whether existing practice of Islamic banking is Sharia compliant or mere copy of conventional practices under the banner of Sharia. This study is an attempt to address the perceptual issues by identifying the similarities and differences in Islamic and conventional banking. Evidences suggest Islamic banking is very much practiced like modern conventional banking with certain restrictions imposed by Sharia and addresses the large number of business requirements successfully hence perceiving Islamic banking as totally foreign to business world is not correct. It is further found in the study that Islamic banking is not a mere copy of conventional practices rather major differences exist in the operations of Islamic Financial Institutions (IFIs) in comparison with conventional banking. IFIs have succeeded in creating trust in the eyes of depositors and receive deposits on profit and loss sharing basis however investment and financing options available to Islamic banks are limited in comparison of conventional banks.

Keywords: Islamic banking, Pakistan, Islamic finance, Islamic modes of financing, Sharia compliant

JEL Classifications: G 21, G 24

1. Introduction

In the second half of 20th century liberation of Muslim world from colonial powers almost completed and widespread renaissance of Islamic ideology took its path in Muslim societies whereby the masses started looking at the existing social systems through Islamic lenses and proposed modifications and developments. The Muslim thinkers and philosophers challenged the world's ruling economic and social systems and uncovered their weaknesses. Capitalism was examined and criticized in detail due to its magnitude and general acceptability in majority of leading societies of the world.¹ Out of the four factors of production (as described in Capitalism) reward of three is fixed and all risk is born by the entrepreneur alone. In capitalism, capital is a factor of production and hence deserves the fixed reward in the form of interest --- a risk free reward.

As the bank is dealer of money; and reward for using money is interest according to capitalist system; so the prime source of revenue and cost of funds to conventional banks is charging interest through lending and accepting deposits for interest respectively. Interest is the major driver of operations of conventional banks although other valuable services including guarantees, funds transfers, safety of wealth, facilitation in international trade etc. are also provided for reward and form substantial part of income of banks. As the conventional banks are established under the principles of capitalism and transact business by charging interest, which is unacceptable (forbidden) in Islamic law, so Muslims left with no choice except to establish their own financial institutions under Islamic principles. The mile stone, in growth and popularity of Islamic Financial Institutions (IFIs), was the Conference of Foreign Ministers of Muslim countries (1973), where decision of establishment of Islamic Development Bank (IDB) was taken place. Islamic finance has shown tremendous growth in last two decades.

By the end of December 2008, in more than 50 countries approximately 300 institutions are operating and they manage funds of US\$ 951 billion. Persian Gulf Area is the centre of Islamic finance with a share of 82% followed by South Asia and Far East region 13% and balance from all over the world including Europe, North America and Africa (IFSL 2010). So for (June 10) six full-fledged Islamic banks and 13-conventional banks with Independent Islamic Branches are operating in Pakistan. Figure 1 depicts the growth in assets, deposits, and financial disbursements of IFIs working in Pakistan (SBP, 2010). Growth in Islamic banking industry in last six years is marvelous in Pakistan. Figure 1 displays growth in Islamic banking in Pakistan (appendix A). Number of branches has increased from 17 in 2003 to 667 within six and half years an average annual increase of 78%. Assets increased at average annual rate of 76% while deposits increased at average annual rate of 85% and financial disbursements and investments increased at average annual rate of 66% during the period (12/03 - 06/10).

Overall an average growth of 76% per annum in the last six and half years (12/03-06/10) was achieved by Islamic banking in Pakistan. This study is an attempt to understand the mechanism of Islamic financial system and document the similarities and differences in comparison with conventional financial system. Study has documented the products (modes) used by Islamic Financial Institutions (IFIs) in their operations including deposit collection, servicing and provision of financing facilities, investments etc. and their applicability in competing with conventional modes of financing and deposit collections. Study has also uncovered the difficulties and hindrances being faced by Islamic financial system at operational level given the non conducive and fully dominated environment by interest based financing. Rest of the study is in following order. Section II discusses briefly background of the study focusing upon prohibition of interest and interest free modes of financing used by IFIs followed by differences and similarities in section III. Section VI concludes and offers recommendations.

2. Background

Modern commercial banking is based on interest which is against the Sharia (Islamic law) hence for all the believers in Allah SWT (God) dealings with these institutions do not suit well. Over the time role assumed by the banking sector has become vital for the growth and development of economies and societies (a jointly shared goal of humanity). A common man who is believer of any revealed religion including Judaism, Christianity and Islam is very much in a state of confusion. On one hand is the very cherishing dream of development while on the other hand is faith. Furthermore there is a reasonable number of experts who think and propagate that prohibited riba means *Usury* (additional amount charged on consumption loans) and not *interest* (additional amount charged on production loans) being charged by modern commercial banks. In this section I will analyze the term Riba (interest) and finally present the modes of financing free of interest being used by IFIs to service the needs of customers.

In Arabic term Riba is a synonym for the term interest used in conventional banking operations. Riba means charging predetermined additional amount on a loan extended based on length of credit period. In the words of Imam Abubakr Al-Jassas (D.380 AH)ⁱⁱ "The riba of Jahiliyya is a loan given for stipulated period with a stipulated increase on the principal payable by the loanee." Charging of interest on loans had never got support in ethics. Interest charging is forbidden by all revealed religions including Islam. According to Old Testament of The Bibleⁱⁱⁱ "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury." [Deuteronomy 23:19] In the wholly Qura'n four verses are about Riba (interest) revealed on different occasions. The first verse is in Surah **Al-Rum** 30:39^{iv} whereby displeasure of Allah is disclosed for interest based practices. The second verse is in Surah **An-Nisaa** 4:161 where interest charging was disclosed as sinful act of Jews. The third verse is part of Surah **Al-i-'Imran** 3:130 whereby prohibition of Riba (interest) was declared "*O those who believe do not eat up riba doubled and redoubled.*" The last verse revealed is reported in Surah **Al-Baqarah** 2:275 whereby severe punishment is declared for those dealing in interest

"Those who take interest will not stand but as stands whom the demon has driven crazy by his touch. That is because they have said: 'Trading is but like riba'. And Allah has permitted trading and prohibited riba. So, whoever receives an advice from his Lord and stops, he is allowed what has passed, and his matter is up to Allah. And the ones who revert back, those are the people of Fire. There they remain forever" (translation from Usmani, 1999).

Instructions are clear. No ambiguity is left. If a person believes in revelations then s/he should avoid charging interest and seek the pleasure of Allah (SWT).

It is the responsibility of all true believers in God (Jews, Christians and Muslims) to give up interest based transactions from their personal lives immediately and input their energies collectively to design promote and implement a financial system free of interest. Certain quarters are of the view that Riba which is prohibited by revelations is the Usury (interest charged on consumption loans) and banking interest (interest charged on productive loans) is not covered by the term. This point was debated in detail during the Supreme Court (Pakistan) hearing and concluded that there was no difference between usury and interest as for prohibition is concerned. Extract from the decision follows

“It is thus clear that the permissibility of interest can neither be based on the financial position of the debtor, nor on the purpose for which money is borrowed, and therefore the distinction between consumption loans and productive loans in this respect is contrary to the well-established principles” (Usmani, 1999 Para 72).

The consensus view of Muslims about the meaning of Riba is presented here under. Islamic Fiqh Academy India^v defines

“Riba (interest) is a very important term in the Islamic terminology showing disapproval and it refers to the instrument by which a loaner charges some amount lump sum or in installments over and above his principal amount from the loanee and thus increases his wealth manifold without participating in the business process of profit and loss”.

Siddiqi, (2004) concluded that unanimous view of Muslims throughout history remained is--- any excess charge in a contract of loan is riba ---- and bank interest has no exception. Islamic Fiqh Academy (IFA) Jeddah of OIC representing the collective wisdom of Sharia experts is of the view that any increase stipulated in a contract of loan irrespective whether consumption loan or productive loan is Riba and prohibited by Allah (SWT).

“The equivalence of riba to interest has always been unanimously recognized in Muslim history by all schools of thought. In conformity with this consensus the Islamic Fiqh Academy of the Organization of the Islamic Conference (OIC) has recently issued a verdict in its Resolution No. 10(10/2) upholding the historical consensus on the prohibition of interest”. [Iqbal and Molyneux, p. 9; IFC/2000]^{vi}.

While deciding the issue of banking interest as permitted or prohibited in Islam, Supreme Court (Pakistan) declared that

“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).

Following conclusions are drawn from above citations; First Interest is prohibited by all revealed religions and charging of interest is Haram (unlawful) for Jews, Christians and Muslims. Second; as for prohibition of interest is concerned, there is no difference in commercial loans and consumption loans at all and bank interest is haram (unlawful). While it is clear from the above citations that dealing in interest is *Haram* (unlawful); and design of conventional banks is based on interest; important role of commercial banks cannot be rejected in the modern economy; so change in the philosophy and design of commercial banking is required to meet the religious obligation. Referring to the above citation it is concluded that what is prohibited through revelations is the pre determined charge on capital (risk free return) and not the profit on capital (involving risk). Muslim Jurists are of the view that reward for capital should be linked with the outcome of the underlying project if financing facility is being extended and/or reward should be obtained through trade involving sale and purchase.

Hanif & Iqbal, (2010), categorized Islamic modes of financing objectively in two heads; Sharia compliant and Sharia based. Table 1 displays Islamic modes of financing (appendix A). A brief introduction of the terms used for modes of financing is provided here.¹ Sharia compliant products mean the modes of financing where return of financier is predetermined and fixed but within Sharia constraints. The tools which are relatively harmonizing the operations of Islamic financial system with conventional banking includes Murabaha (cost plus profit sale), Ijara (a rental arrangement), Bai Salam (spot payment for future delivery), Bai Muajjal (sale on deferred payment), Istasna (order to manufacture) and Diminishing Musharaka (house financing) are all Sharia compliant products. Sharia based transactions means the financing modes adopted by IFIs on profit and loss sharing basis including Musharaka (partnership in capital) and Mudaraba (partnership of capital and skill). Under Sharia based modes of financing returns of financier are not fixed in advance rather it depends upon the outcome of the project.

¹ For details about Islamic modes of financing see appendix B.

However loss is to be shared according to capital contribution. Following the rule of substance over form one can conclude that the major difference between conventional and Islamic financing is Sharia based modes of financing.

3. Similarities and Differences

Islamic Financial Institutions (IFIs) are operating in the same society where conventional banks are operating and perform all those functions which are expected from a financial institution. IFIs are assisting business world by providing all the services required to run the economy smoothly, however, the philosophy and operations are different. In this section I will analyze the operations and products of IFIs in comparison with traditional conventional banks. Any financial system is expected to assist in running the economy by providing the following services grouped in two headings. First; Savings mobilization from savers to entrepreneurs and Second; Provision of general utility services including transfer of funds, facilitation in international trades, consultancy services, safekeeping of valuables, and any other service for a fee. There is no restriction on provision of such services by IFIs as for the service is not against the Sharia. However there exists difference in mechanism of funds mobilization from savers to entrepreneurs as described following. Savings mobilization consists of two phases i.e. accepting deposits and extending financing and investments.

3.1. Deposits

Deposits are collected from savers under both type of institutions for reward irrespective a bank is operating under conventional system or Islamic system. The difference lies in agreement of reward. Under conventional system reward is fixed and predetermined while under Islamic deposits are accepted through Musharaka and Mudaraba (appendix B) where reward is variable. Under conventional banking return is higher on long-term deposits and lower for short-term deposits. Same is the practice in Islamic banking to share profit with depositors. Higher weight for profit sharing is assigned to long-term deposits being available to bank for investing in longer term projects yielding superior returns and lower weight for short-term deposits which cannot be invested in long term projects. The only difference in conventional and Islamic system lies in sharing of risk and reward. Under conventional system total risk is born by the bank and total reward belongs to it after servicing the depositors at fixed rate while under Islamic system risk and reward both are shared with depositors. Reward of depositors is linked with outcomes of investments made by IFIs. Under Islamic financial system only those IFIs will be able to collect deposits who can establish trust in the eyes of masses hence leading to optimal performance by financial industry. So for IFIs working in Pakistan have succeeded in establishing their credibility in the eyes of savers as depicted in table 2 (appendix A) an increasing trend of deposits collection (SBP,2010).

3.2. Financing and Investments

The second phase in savings mobilization process is extension of credit facility to business and industry for return. Both types of institutions (Islamic and Conventional) are providing financing to productive channels for reward. The difference lies in financing agreement. Conventional banks are offering loan for a fixed reward while IFIs cannot do that because they cannot charge interest. IFIs can charge profit on investments but not interest on loans. In conventional banking three types of loans are issued to clients including short term loans, overdrafts and long-term loans. Islamic banks cannot issue loans except interest free loans (Qarz e Hasna) for any requirement however they can do business by providing the required asset to client. In following paragraphs I present the comparative working of different products (financing scheme) of both systems.

3.2.1. Overdrafts/Credit Cards etc.

Conventional banks offer the facility of overdrawing from account of the customer on interest. One of its form is use of credit card whereby limit of overdrawing for customer is set by the bank. Credit card provides dual facility to customer including financing as well as facility of plastic money whereby customer can meet his requirement without carrying cash. As for facility of financing is concerned that is not offered by Islamic banks except in the form of Murabaha (which means IFI shall deliver the desired commodity and not the cash) however facility to shop/meet requirement is provided through debit card whereby a customer can use his card if his account carries credit balance. Under conventional banking a customer is charged with interest once the facility availed however under Murabaha only profit is due when the commodity is delivered to the customer. Furthermore in case of default customer is charged with further interest for the extra period under conventional system however extra charging is not allowed under Murabaha.

Third under conventional system customer can avail the opportunity of rescheduling by entering into a new agreement to pay interest for extended period which is not the case under Murabaha. IFIs can claim only the original receivable amount agreed in initial contract. Another practical issue under Murabaha is how to deal with intentional defaulters. Different options are lying with IFIs including to blacklist the defaulter for any further financing facility, to stipulate in the contract that in case of default all installments will be due at once, to stipulate in the contract a penalty shall be imposed but the same shall not form income of IFIs rather it will go in charity (Usmani, 2002).

3.2.2. Short term loans

Short term and medium term loans are provided to customer to meet working capital requirements of firm by conventional banks. Working capital is required by firms to invest in inventories and accounts receivables and meet the expenses. As for inventory investment is concerned that is provided by Islamic banks through Murabaha. As for meeting of day to day expenses of business is concerned financing is provided through participation term certificates where by profit of a certain period (e.g. quarter, six month, one year) is shared by IFIs on prorata basis. However financing through participation term certificates is not as easy as a short term loan from conventional bank due to risk involved for IFIs in the transaction. Firm seeking short-term facility from IFIs has to prove the viability of the project/business to the satisfaction of investor. For meeting the working capital requirements of nonprofit organizations to date there is no arrangement under Islamic financial system. Personal consumption loans are also not issued by IFIs how ever any individual of sound financial position can acquire anything for his personal use under Murabaha financing whereby a certain percentage of profit is added on cost by IFIs.

Murabaha financing is very useful for short to medium term financial requirements of business/nonprofit organizations and individuals. Murabaha financing is asset based financing and anyone can request to an IFI for provision of an asset generally used for Halal (lawful) purposes. By default under Islamic financial system IFIs cannot lend cash for interest (only exception is Qarz e Hasna—Charity loan). One of the features of Murabaha is in case of delay in payment by customer IFI cannot ask for extra amount as time value of money like conventional banks. However penalty is imposed on defaulter if stipulated in original contract of Murabaha duly signed by the customer but same cannot be included in the income of IFI. This penalty must be spent for charitable purposes. Under Murabaha scheme of financing facility is linked with assets which leads to economic stability and creates linkage between real and financial sector.

It is not zero sum game because utility is created through services and products and not by mere building the blocks of wealth through dealing in paper money. Although Murabaha is being used by IFIs successfully and have succeeded in meeting short to medium term requirements of firms by providing a successful replacement of conventional loans yet certain differences exist in both type of financing. First is one cannot get cash under Murabaha. Second asset is purchased by IFI initially then transferred to customer hence IFI participate in risk. Third refinancing facility is not available under Murabaha. Fourth in case of default price of the commodity cannot be enhanced however penalty may be imposed if stipulated in original contract of Murabaha however same cannot be included in income of IFI. Fifth only those assets can be supplied by IFIs under Murabaha whose general and/or intended use is not against the injunctions of Sharia (e.g. supply of a machine to produce liquor)

3.2.3. Medium to long term loans

Medium to long-term loans are provided for purchase or building of fixed assets by firms to expand or replace the existing assets. Under Islamic financial system requirement of firms and individuals are fulfilled through Murabaha, Bai Muajjal and Istasna (discussed in appendix B). Another financing option for long-term financing is profit sharing under Musharaka and Mudaraba (discussed in appendix B). Although financing under Murabaha, Bai Muajjal and Istasna is very much look like conventional loans with the only difference of provision of asset and not cash to client however differences exist in the contracts which alter the nature of risks and returns. Financing under Musharaka and Mudaraba is challenging for IFIs and firms as well. Under Sharia based financing schemes firms have to prove the viability/profitability of the project/business to the satisfaction of IFIs to get the finance because risk of losing the amount is involved.

3.2.4. Leasing

Leasing is relatively recent source of financing whereby usufruct of an asset is transferred to lessee for agreed amounts of rentals. Under leasing ownership may or may not be transferred.

Same facility is provided by IFIs under agreement of Ijara. Under Ijara asset is provided to customer for use with out transfer of ownership for a specific period of time in exchange for agreed rentals. Ownership of asset can be transferred to customer through mutual agreement at the completion of lease term. All ownership risks are born by IFIs during Ijara tenure. Certain differences exist in the transaction under both systems. First is rental under Ijara are not due until asset is delivered to the lessee for use. Second additional rent cannot be demanded in case of default except a penalty (if stipulated in original contract of lease) which is not the income of IFI. Third during period of major repair rent cannot be demanded by IFI. Fourth if asset is lost or destroyed IFI cannot claim further installments hence all risks of ownership are born by IFI.

3.2.5. Agricultural Loans

Agricultural loans include both types of loans short-term as well as long-term. Short-term loans are required by farmers for seeds and fertilizers and long-term loans are required to develop additional lands and purchase of equipments. Normally farmers return these loans after selling the finished crops. Conventional banks are providing credit facility by charging interest. Same facility is provided by IFIs to the farmers under Bai Slam, Bai Murabaha Musharaka and Mudaraba (discussed in appendix B). Under Bai Salam cash is provided to farmers for purchase of seeds and fertilizers however this is not loan rather purchase of finished crops to be delivered by farmers. For purchase of equipments Murabaha facility is used and for development of additional land Musharaka and Mudaraba is used by IFIs. To get finance for land development farmers have to convince the IFIs about profitability of the venture due to risk involved in the transaction.

3.2.6. House financing

Housing finance/Mortgages is the more secured form of financing for both conventional banks and IFIs. Under conventional system loan is provided for interest while under Islamic financial system facility is provided through diminishing Musharaka. Under diminishing Musharaka house is purchased jointly by IFI and customer. IFI rents out its share in property to customer for an agreed amount of rent. Share of financier is divided in units of small denomination. Customer pays the installments to IFI consist of rentals plus purchase price of a unit. Stake of customer in property is increasing while of IFI is decreasing with payment of every installment. Finally with the payment of last installment stake of IFI reaches to zero and property is transferred in the name of customer. Diminishing Musharaka model can help out in avoiding the real estate crisis (like of 2008) because when market value of property decreases both IFI and customer suffers according to their share in property and whole burden is not shifted on customer alone. Hijazi, & Hanif (2010) have raised certain questions about the existing practice of IFIs working in Pakistan and needs to be addressed by policymakers, Sharia boards and management of IFIs.

3.2.7. Investments

In order to maintain liquidity conventional banks have many avenues including government securities, shorter term loans and money at call and short notices, leasing companies' bonds, investment in shares etc. Interestingly mandatory reserve maintenance by conventional banks with central banks is also rewarded in the form of interest. Conventional banks can also create liquidity by issuing the bonds against their receivables. Commercial banks are also protected by central bank by providing liquidity in rainy days for interest. Interbank deposits are also rewarded in the form of interest by commercial banks. For IFIs avenues are very limited to create required liquidity at the same time to earn some revenue by investing in short term and liquid securities. IFIs cannot invest in government securities, short term loans, bonds and money at call and short notices because of interest based transactions.

Mandatory reserve with central bank is maintained by IFIs but they are not rewarded like conventional banks. Looking towards central bank in rainy days to maintain liquidity is also not as straightforward due to interest demand of central bank. IFIs cannot demand interest on interbank deposits. As for investment in market able securities are concerned again IFIs are not free to invest in any equity security due to two reasons. First Halal business of the underlying firm is required. Second financial operations of underlying firm should be interest free. Keeping in view the dominance of conventional banking and existing business practices one can conclude safely that a very negligible number of firms meet both conditions. The much appreciable job has been done by Almeezan investment management limited (AIML) a subsidiary of leading Islamic bank in Pakistan (Meezan bank) in this regard. A list of Sharia compliant securities is being maintained and updated every six monthly out of which 30 companies are selected for Kse Meezan Index (KMI). KMI was established in June 2008. IFIs can invest only in those securities which are declared Sharia compliant securities through filtering of Sharia compliance criteria.

Listing here the major conditions to qualify a security as Sharia compliant is worth mentioning as follow. Meeting of following tests is required to declare a security as Sharia compliant (KMI-2008). First the core business of the company should be Halal (not prohibited by Islamic Law such as liquor, pork and pornography etc). Second illiquid assets should be equal to 20% of total assets of the company. Shares of a company merely dealing in liquid assets are not Sharia compliant hence IFIs cannot invest. Third ratio of all interest based debts including preferred stock should be less than 40% of total assets of the company. Fourth ratio of non Sharia compliant investments to total assets of the company should be less than 33%. Fifth revenue from non compliant investments should be less than 5% of total revenue of the company and even then IFIs are required to purify their earnings by spending this non compliant revenue as charity. Finally market price per share should be greater than the net liquid assets per share.

Recently IFIs have created an avenue to meet their liquidity requirement in the form of Skuks (Islamic Bonds) whereby servicing is fixed like conventional bonds however such types of Skuks can be issued against Ijara receivables. Under Ijara Skuks initially asset is given on rent to the customer for an agreed period and rentals while ownership remains with IFI. To meet liquidity requirements IFI issues Skuks (bonds) to the investors equal to the value of asset, hence ownership of the asset is transferred to Skukholders. While it is known the rentals of the asset so the return on investment is predetermined and known with certainty to the investors. Skuks of Murabaha cannot be sold except at par being sale of loans. Other types of Skuks (Musharaka etc) are not carrying fixed return although tradable in secondary security market. Underlying principle in issue of Skuks is that illiquid assets should dominate in the portfolio against which Skuks are issued. Under Islamic financial system Skuks are ownership certificates and not mere debt securities hence all risks and rewards are shared by Skukholders.

4. Conclusion

Islamic financing is working within the Sharia frame work following certain restrictions including following. First IFIs cannot provide finance for an activity which is prohibited by Sharia (Islamic law) irrespective of its profitability and economic viability e.g. business of liquor, pork and pornography. Second IFIs cannot lend any amount in cash for interest however need is fulfilled either through supply of required asset or through profit and loss sharing. Consequently certain financial needs of some sections of the society are ignored in financing including personal loans and working capital requirements of not for profit organizations. Third under Islamic financial system when financing is provided under profit and loss sharing although profit can be shared as per agreement between the parties involved however loss must be shared according to capital contribution/ownership. Islamic banking is not as foreign to business world as it is perceived by certain quarters. It is a business very much like conventional banking within certain restrictions imposed by Islamic law. All business needs are being fulfilled by IFIs in efficient ways through Murabaha, Ijara, Bai Muajjal, Bai Salam, Istasna, Musharaka and Mudaraba. Two features of Islamic financial system are worth mentioning.

First is linkage between financial and real sector as IFIs cannot extend credit facility without having support from real sector. Financing is either made through sharing risk and reward or must be asset backed. Second a unique feature of Islamic financial system is in the form of Mudaraba which can play role of catalyst for transforming society into prosperity by extending capital facility to skilful persons lacking capital. Under Mudaraba mode of financing partnership between capital and skill is formed hence it can be used to provide self employment to jobless skilful citizens. Islamic banking is not a mere copy of conventional banks as perceived by certain Muslims. It has its own way of doing business and all operations are duly certified by Sharia experts ranging from Sharia advisor to Sharia boards and finally Islamic Fiqh Academy (IFA). Portfolios of IFIs are dominated by Sharia compliant modes of financing and negligible investments are being made under Musharaka and Mudaraba.

Sharia based modes of financing which can create a real difference in the society are not getting momentum in the operations of IFIs. Hanif, & Iqbal, (2010) have identified the hindrances (e.g. profit manipulation, riskiness of financing under sharing, lack of awareness, widespread conventional banking, lack of skilled human resources etc.) in the way of popularity of Sharia based financing and concluded that existing accounting and business frame work is not conducive for application of Musharaka and Mudaraba. Islamic banks are doing business in a nonconductive environment which makes operations challenging. IFIs cannot claim interest on their balances with other banks, on mandatory cash reserve maintained with central bank, cannot invest in government securities, interest based bonds, cannot claim time value of money from defaulters, bear risks in sale and lease transactions, can only invest in Sharia compliant securities and not in all available equities and finally have to compete with conventional banks in deposit servicing as well as in financing.

In spite of these difficulties growth of Islamic financial system world over in general and marvelous growth of 76% (average annual) in Pakistan in last six and half years suggests a bright and promising future of this financing system. Two issues at hand demands attention of policy makers immediately including a separate law of Islamic banking to regulate the industry and implementation of accounting standards issued by Auditing & Accounting Organization of Islamic Financial Institutions (AAOIFI) for preparation of annual reports of IFIs.

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Appendix A. Figures and Tables

Figure 1: depicts growth in Islamic Banking in Pakistan Rs. Billions

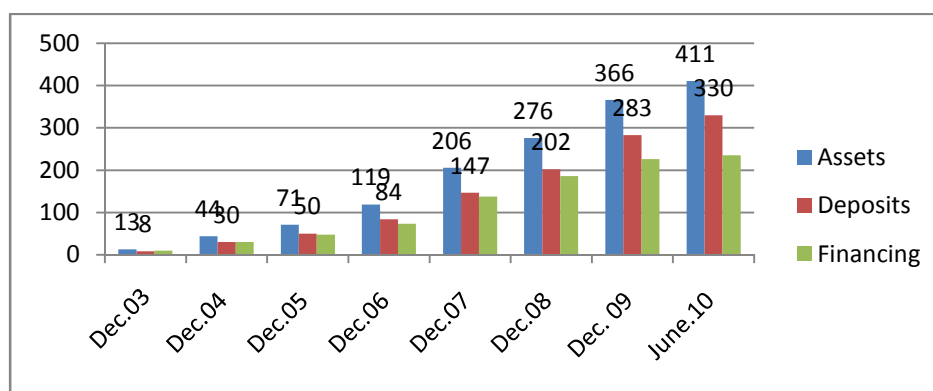


Table 1 displaying Islamic modes of financing categorized objectively.

Sharia Based	Sharia Compliance
Musharaka	Murabaha
Mudaraba	Ijara
	Diminishing Musharaka
	Bai Salam
	Bai Muajjal
	Istasna

Table 2: Industry Progress and market share Rupees in billion & shares and growth in percent

	June.10	Dec. 09	Dec.08	Dec.07	Dec.06	Dec.05	Dec.04	Dec.03
Deposits	330	283	202	147	84	50	30	8
Share in industry	6.4	5.9	4.8	3.8	2.6	1.8	1.3	0.4
Growth	38.6	39.9	37.4	75	68	66.7	275	

Appendix B. Islamic Modes of Financing^{vii}

Sharia Compliant

1. Murabaha

Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary. Under Murabaha arrangement customer requests to the Islamic Financial Institution (IFI) to purchase an asset for him (customer) and sell on deferred payment. An essential feature of Murabaha is that IFI must purchase the required commodity from supplier first and then sell to customer. Bank charges a certain profit usually linked with Inter Bank Offered Rate. Recovery could be agreed in installments or Balloon payment. Amount of installment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment (Sharia standard 8). In order to create pressure on client for prompt payment a penalty is imposed upon customer as agreed in Murabaha contract. Amount of penalty for default in prompt payment recovered cannot be included in income of IFI in any case and must be spent for charity (Usmani, 2002). Murabaha has successfully replaced the overdraft and short term loans facility under conventional banking.

2. Ijara

Ijara is a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are born by IFI while expenses relating to use the asset are the responsibility of client. The difference between Ijara and sale is that ownership in Ijara remains with lesser while in case of sales it is transferred to purchaser. Ending Ijara in sale of asset is allowed by IFA through a separate contract at completion of term of lease. Contract can be executed prior to purchase and possession of asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or/and as per normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the co partner. Inter Bank Rate can be used as a benchmark for amount of rentals. At the completion of Ijara term either asset is returned to IFI or purchased by client (Sharia standard 9). Ijara has replaced successfully the facility of leasing under conventional financial system.

3. Diminishing Musharaka

Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset IFI participates in the ownership of asset by contributing required finance. Certain portion (e.g.20%) must be contributed by customer. Total equity of bank is divided into units of smaller amounts which are purchased by client in installments. Under this mode of financing one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally IFI rent out his share to client and earns rentals. Any profit accruing on property is distributed among the co owners according to agreed ratio however losses must be shared in proportion of equity (Sharia standard 12). Diminishing Musharaka is used for house financing by IFIs and has replaced successfully conventional mortgages.

4. Bai Salam

Bai e Salam is a form of sale contract where by IFIs purchase goods for spot payment with deferred delivery. Practically it is used in financing of agricultural needs of farmers. Farmers sell their crops prior to harvesting to IFIs in order to get money to purchase seeds and fertilizers. Generally spot price agreed is lesser than future the actual date of delivery, hence IFIs are making profit. As a matter of practice IFIs are entering into a parallel Salam contract with third party to sell the proceeds once taken over however execution of second contract is not conditional to the fulfillment of first (Sharia standard 10).

5. Bai Muajjal

Literal meaning is deferred / credit sales. Islamic financial Institutions (IFIs) are using this mode to finance the customers' needs by supply of desired commodities. The difference between Murabaha and Bai Muajjal lies in disclosure of cost. Under Bai Muajjal cost may or may not be disclosed. All other features are same as discussed in Murabaha.

6. Istasna

This mode of financing is designed to transect business through an order to manufacture and/or supply. It is a sales contract with the exception of existence of subject matter. This tool of financing is useful for infrastructure projects. Parallel Istasna contract is allowed however performance of second Istasna contract must not be conditional on the fulfillment of first contract (Sharia standard 11).

Sharia Based

1. Musharaka

According to Hadith Qudasi (revelation reported by Prophet Muhammad PBUH) *“Indeed, Allah the Exalted says: I am the third of the two partners so long as the one does not cheat the other, and when he cheats, I withdraw myself”* (Khan, 1989). Literal meaning of Musharaka is sharing. Its root in Arabic language “Shirka” means being a partner. Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre agreed ratio while loss is shared according to the ratio of contribution (Meezan bank guide 2002). For a valid Musharaka fulfillment of certain conditions required. First is there must be an agreement written (verbal) among the partners stating clearly the terms and conditions including management, capital contributions, profit and loss sharing among the partners. Second capital can be contributed in cash as well as in assets. However once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached with ownership. Third profit is distributed according to agreement of partnership however sleeping partner cannot claim share in profit more than his proportionate share in equity. None of the partner can guarantee the capital or profit share to any other partner (Sharia standard 12). Under Musharaka IFIs are receiving deposits and finances business requirements for profit and loss sharing.

2. Mudaraba

Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to agreement while loss is born by capital provider only. Under this scheme of financing IFIs provide capital to financially weak but skilful people to do the business and share outcome with IFIs. This scheme is also used in deposit collection. Mudaraba contract can be restricted or unrestricted. No one can claim a lump sum amount of profit it must be based on actual outcome (Sharia standard 13).

Notes

ⁱ For example Writings of Syed A.A. Maudoodi, Umer Chapra, Prof. Khurshid Ahmed, Justice ® Taqi Usmani, Justice ® Tanzeel ur Rehman, Dr. Shah Ul Hameed, reports of Council of Islamic Ideology (Pak), decisions on Riba by Federal Sharia Court 1991 and Supreme Court Sharia Appellant Bench 1999, Nijatullah Sidiqi and Dr. Asad Zaman.

ⁱⁱ As cited by Usmani, (1999)

ⁱⁱⁱ This verse along five others relating to interest / usury from The Bible are reported by Usmani, (1999) in paragraph 37.

^{iv} Sura Number then Verse Number.

^v http://ifa-india.org/english/arabic_Words.html accessed on 20th March, 2010.

^{vi} <http://www.globalwebpost.com/farooqm/writings/islamic/r-i-consensus.html> accessed on March 20th 2010.

^{vii} Adopted from Hanif, & Iqbal (2010).