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Islamic Finance vs. Non-Islamic Finance: An Observation

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Abstract

Islamic finance and non-Islamic finance are two ways of structuring finance, in terms of allocating capital, managing risk and defining the relationship of finance to the real economy. This is a conceptual research paper which compares the Islamic and conventional or non-Islamic finance and investigates their philosophical foundations, goals, sources of legitimacy, positions on interest, risk and uncertainty, positions on speculation and ownership, positions on contracts, and investment activities, social responsibility, and mechanisms of financial intermediation. The key elements of Islamic financing are restrictions and permissions set forth in the Sharīʾah, such as ban on ribā, excessive gharar, maysir, financing of prohibited economic activities etc. It focuses on legal trade, ownership of assets, clarity of contracts, sharing of risks and links between monetary transactions and real economic activities. Conventional finance, on the other hand, is typically offered as part of secular legal and market-based structures: where interest-bearing loans, risk transfer, financial intermediation, and market-based allocation of funds are all legal. The paper does not take the stance that either system is superior on the economic front. Rather, it proposes topics of conceptual overlap and divergent thinking and explores the meaning of these for financial inclusion, distributive justice, entrepreneurship, stability, liquidity, innovation, and ethical investing. The paper also notes that today's Islamic financial institutions can often be seen as functioning in conventional regulatory and monetary systems, which poses practical issues related to standardization, liquidity management and benchmarking, governance, and the substance versus the form issue for financial contracts. The study's conclusion is that the main not only "interest versus no interest" but the more general difference involving the acceptable sources of return, relationship between finance and productive activity, risk distribution, contractual ethic and boundaries of social investiture are important.

Keywords: Islamic Finance; Conventional Finance; Ribā; Risk Sharing; Sharīʿah; Financial Ethics; Financial Intermediation

1. Introduction

Finance is one of the key ways that modern economies mobilize savings, allocate capital, facilitate investment, transfer resources over time, manage risks, move goods and services to market and allow households, businesses, governments and institutions to engage in economic activity. While in some technical aspects, the financial systems of today are similar, they do not necessarily have the same philosophical underpinnings or moral boundaries. Thus, the structure of finance cannot be seen as a purely technical issue of banks, money, loans, securities and investments. It's also a question about what's a justifiable financial return, how that economic risk should be shared, which activities can be funded, any contractual obligations between capital providers and capital consumers, and what are appropriate responsibilities of financial institutions to society. Islamic finance is a unique solution to these questions. It works within an environment more familiar with Sharīʾāt rules for the economy and finance. The International Monetary Fund (IMF) defines Islamic finance as the delivery of financial services subject to sharia principles and states that it has a number of important limitations: ribā, over-uncertainty or gharar, gharib and ghumar, short sales in certain scenarios and financing of restricted activities. IMF also stresses that Islamic financial transactions should be linked to real economic transactions and risk sharing is a key characteristic of the Islamic financial system (International Monetary Fund [IMF], 2015, 2018). But this should not be merely a matter of comparing between religious and secular institutions in order to distinguish between Islamic finance and non Islamic finance. Conventional financial institutions include a variety of institutions, instruments, markets, and practices and conventional finance's legal and regulatory environment varies significantly from country to country. Likewise, Islamic finance is not one standard institutional structure. Islamic banks, Islamic investment funds, sukūk markets, takaful operators and other Islamic financial institutions can adopt various contractual forms with varying national regulatory frameworks. The IMF has commented that a variation between interpretations and implementations of Islamic banking principles as it is understood may lead to differences between jurisdictions (Errico & Farahbaksh, 1998; IMF, 2002). Hence, the aim of this paper is to offer a conceptual gaze, not a simple binary verdict. Islamic and non-Islamic finance are explored under seven aspects, namely, the underlying principles, financial contracts, disposition to risk, mechanisms for return generation, investment restrictions, social objectives, and institutional challenges. The analysis takes into account that both systems serve important economic functions and it is not possible to understand either system by means of isolated examples.

1.1: Background of Islamic Finance

Islamic finance is rooted in Islamic commercial norms related to property, trading, partnership, debt, contract, trust and social responsibility. However, its modern institutional development is rather recent. The evolution of modern Islamic banking has been specifically witnessed in the second half of the twentieth century and later on, the spread of Islamic investment funds, sukūk, takaful and other financial products. The principles of Islamic finance are often linked to a few principles. These are: the prohibition of ribā, prohibition of excessive gharar, prohibition of maysir, the lawfulness of economic activity, the safeguarding of property rights, the fulfillment of contracts, and the relation between financing and an identifiable economic activity. The IMF says the fact that there is no predetermined interest does not mean that capital can no longer get a return. Islamic finance does not allow for this, but only returns on permissible trade, leasing, partnership, investment and other accepted contractual arrangements (IMF, 2015).

This is a very significant difference. Islamic finance can be termed as “interest-free finance,” although this is not a full description. An Islamic banking institution has the potential to make profits. It can enter into trade, lease any property, finance business activities, invest capital, and charge fees. The difference with the system is that it is the contractual nature and

the source of the return. Legitimacy of a return relates to the nature of the transaction, ownership, risk, asset, service and contractual relationship. The Qur'ān clearly differentiates between trade and ribā in Qur'ān 02:275, where trade is considered to be permissible, whilst riba' is prohibited. The Qur'an (4:29) also lays great stress on the point that wealth must not be squandered in an unjust fashion and that trading done with mutual consent is permissible. The emphasis of the Qur'an 5:1 is on fulfillment of contracts. Such principles determine the limits for economic exchange operating in an ethical and legal manner. The Qur'anic scaffolding thus links economic activity to the ideas of justice, consent, contractual obligations and legitimate possession. Islamic finance also embraces a social element. The handicapping is mentioned in the Qur'an 59:7 in the context of distribution of wealth in such a way that it does not flow from the rich to the rich. Often referred to in literature on Islamic economics, this verse is a prime sign-point that distribution and social welfare are both important factors to take into consideration when structuring economic arrangements. It doesn't imply that wealth is bad, it is asking whether there are any economic structures that help limit the accumulation of wealth.

1.2: Background of Non-Islamic or Conventional Finance

The conventional finance as it is termed in comparative literature, that is, non-Islamic finance does not rely on one philosophy. It interacts, generally, with secular legal, commercial, monetary and regulatory frameworks. The conventional financial institutions can lend at interest, take deposits, invest in securities, offer payment services, act as facilitators of the capital market, insure risks and engage in many other activities. In the conventional finance world, interest is a huge factor. With a conventional loan, the buyer usually gets cash and agrees to pay back the amount borrowed plus a mutually agreed upon amount of interest. The interest rate reflects aspects like opportunity cost of capital, time preference, inflation, administrative expenses, liquidity, and credit risk. Interest rates also act as an important monetary and financial policy instrument. Today, the economic doctrine generally doesn't hold that interest itself is unethical. Instead, it is viewed as a borrowing and lending capital price. Credit rates might fluctuate depending on the market conditions, monetary policy, risk, maturity, collateral and liquidity among other factors. Interest rates are used in financial markets as mechanisms to force scarce capital to be allocated between competing uses (Mishkin & Eakins, 2018). Conventional finance also provides for a wide variety of financial instruments, such as loans, bonds, equities, derivatives, mortgages, credit facilities, futures, options and other contracts. These instruments are used for the transfer, sharing, hedging or the transformation of financial risks by economic actors. Some instruments have an explicit link to the real goods and productive activity, while other instruments are fundamentally linked to claims of a financial character. Therefore, the contrast between Islamic and conventional finance must not be presented as a finance system that does not consider ethics. There are laws that govern modern conventional financing systems related to fraud, disclosure, consumer protection, banking regulation, securities regulation, corporate governance, taxation, money laundering, bankruptcy and financial stability. The major distinction is that the ethics and/or law (jumʾah) is not usually based on Sharīʾah.

1.3 Conceptual Problem

One of the primary conceptual issues that this paper tries to tackle is that, Islamic and conventional finance have generally been described and contrasted in an oversimplified manner. Islamic finance is often portrayed simply as a conventional finance with Arabic flavour and conventional finance a loan with interest often is portrayed simply as Islamic finance. Both descriptions are insufficiently developed for the two systems, both institutional and conceptual.

For instance, murābaḥah is sometimes said to be an alternative to a conventional loan since both of these can lead to an agreed upon payment plan.

However a murābaḥah contract is in the manner of sale and not in the way of pure interest-bearing loan. The difference relates to ownership, how assets are acquired, their form, and where the money flows in the financial institution are generated. In a similar way, someone could be able to purchase a house through a conventional mortgage and someone through a diminishing mushārakah but the legal and economics may differ. Diminishing Mushārakah: Ownership is distributed between the parties and a customer's ownership may grow over time. The financier's return may consist of rent for its share, and other contractual payments. In a traditional loan, the bank will typically loan the amount of money used as a security for the property and interest will be charged on the amount that is outstanding. So, in the conceptual world the question is not necessarily whether two products have similar economic results. The nature of the return, title to the asset, risk ownership, and contract specificity must be considered.

1.4: Statement of the Research Problem

The growth of Islamic finance has led to an important scholarly enquiry which is what substantive differences lie beyond terminologies and contract form between Islamic and conventional financial systems? The next question is what are the economic consequences of these differences? Does the prohibition of ribā necessarily lead to greater risk sharing? Is there necessarily a greater degree of financial stability when they are backed by assets? Are Islamic investment restrictions per se better for social outcomes? On the other hand, does the traditional interest-based financing lead to higher efficiency necessarily by providing the credit with flexibility? Theological statements do not suffice to answer these questions. These need to be examined conceptually; and in cases where there is empirical evidence, economic outcomes need careful examination. The IMF acknowledges the unique nature and regulatory issues of Islamic finance. Islamic financial institutions face specific risks due to the differences between their balance-sheet structure, their contractual arrangements, and their liquidity-management mechanisms and those of conventional institutions (IMF, 2017, 2018). Meanwhile, traditional financing activities also have known issues including leverage, information asymmetry, moral hazard, liquidity risk, asset price bubbles, and systemic contagion (Stiglitz & Weiss, 1981; Minsky, 1986; Mishkin & Eakins, 2018). Thus, it is important to critically look at both systems rather than assuming one is always successful, or one is always a failure.

1.5: Research Objectives

The overall aim of this paper is to make a conceptual comparison between Islamic finance and non Islamic finance also known as conventional finance. To describe the philosophies and contractual basis of Islamic finance. To explain the key features of traditional finance. To make comparisons between the treatment under consideration and financial returns. To explore risk sharing and risk transfer in both systems. To compare the treatment of uncertainty and speculation. To analyze financial transactions in relation to real activity. To assess the distinction of investment Hindrances and moral screening.

To discuss the issuesofsocial justice and wealth distribution. To determine the institutional and regulatory issues in Islamic Finance. To find the points of similarity and differences between the two systems.

1.6: Research Questions

What are the principles of the Islamic finance? What are the principal characteristics of conventional finance? What about ribā in the light of Islamic finance as compared to conventional interest? What are the risk allocations under the two systems? What are the differences in their treatment of gharar and speculation? What are the impacts of asset ownership on Islamic financial contracts? Which of the following investments are prohibited in Islamic finance? What are the elements of social and ethical finance in Islam? What are the

major market practical problems of Islamic financial institutions? Are there areas of commonality between Islamic and conventional finance, even though there are differences in their concepts?

1.7: Significance of the Study

This study is relevant to Islamic economic and finance, banking, economics, business studies, development studies and comparative financial systems. It could also be beneficial to the academicians, policy makers, bankers, investors, researchers and those interested in understanding the contrast between Islamic and conventional financial institutions. Partly, the international expansion of Islamic finance is what imbues the research with its significance. According to the report by the Islamic Financial Services Board, the growth and expansion of the Islamic financial services industry is taking place in the various sectors of Islamic banking, Islamic capital markets and Islamic insurance. The Islamic Financial Services Board (IFSB) pointed out in its 2025 report that underdeveloped Islamic capital markets and Islamic liquidity-management instruments are still structural challenges. According to LSEG and Islamic Corporation for the Development of the Private Sector, the assets denominated as Islamic finance globally are approximately US$5.98 trillion in 2024, indicating that Islamic finance is no longer a niche sector but has grown to be a significant part of the global financial system (LSEG, 2025). As the sector expands there is a need for comparative academic research. Islamic financial institutions grow their increasing interaction with conventional banks, central banks, international financial markets, multinationals as well as global financial regulatory bodies. It is important, thus, to understand the differences and similarities between them, not just for predominantly Muslim economies. Write one on each side of the paper. These are: (a) Philosophical Foundations of Islamic Finance: Islamic finance is rooted in the Islamic vision of economic life where property rights, contracting, lawful earning, social responsibility and moral conduct interlace each other. An important principle is that no property can be obtained by unrighteous means. Qur'an 4:29 does not allow for the use of wealth in an unjust manner and considers trade with consents to be acceptable. This principle is putting consent and lawful exchange at the heart of economic activity. The second principle is contractual responsibility. The contract is a commandment of Qur'an 5:1 that says that believers must fulfill contracts. Thus, it is important to note that the Islamic finance gives much importance to the clarity and compliance of contracts. The third principle has to do with ribā. The Qur'an (2:275) makes a clear differentiation between trade and ribā. The Qur'ān also tells us to stop repeating the act of ribā: Qur'ān 2:278-279. This, in Islamic financial theory, establishes a new baseline between lawful return earned via lawful dealings and unlawful predetermined increases that certain debt deals entail. Uncertainty is a fourth principle. Gharar is not allowed in Islamic finance because it should be made clear the subject, obligation, rights and consideration in contracts.

The goal is not to remove all uncertainty from economic life (that's impracticable), but to avoid exorbitant uncertainty and ambiguity in contracts. The fifth principle has to do with maysir or gambling. Without economic activity, wealth should not be created through games of chance or what amounts to little more than one party sponging off another. (b) Philosophical views on conventional finance: The conventional finance is basically based on the different economic theories related to capital allocation, time preference, risk, rate of return, liquidity, market incentives, information, etc. It does not generally forbid interest per se. The time value of money is integral to traditional financial analysis. A monetary unit today may be invested and may yield profits, whereas a monetary unit received tomorrow is, obviously, of lesser value. It is the basis of discounted cash-flow analysis, bond pricing, present value, and investment appraisal. Thus there are several uses of interest. It can be a reflection of deferred consumption, opportunity cost, anticipated inflation, credit risk and liquidity. Central banks also control the state of the economy by the levels of policy interest rates, which have an impact on borrowing, saving, investment and aggregate demand. Risk pricing also plays a significant role in

conventional finance. Riskier borrowers may be charged higher interest rates, a higher amount of collateral, or only be eligible for certain types of credit. Financial institutions deal with risk through credit assessment, diversification, insurance, hedging, collateral, capital requirements, and other methods.

1.8: Ribā and Interest

One of the best distinctions between both systems is the method that treatment is performed. Islamic finance is riba-free and conventional finance is usually interest-bearing. The distinction is conceptual since Islamic finance does not preclude all lines of financial return. When the transaction meets the requirements it may be allowed, provided that there is profit in the trade and investment. Islamic finance aims to tie financial returns with economic activity and risk sharing, as opposed to just the passage of time on a monetary loan, the IMF (2015, 2018) explains. However, if it was a conventional loan, a lender could offer money and collect interest on the loan whether or not the investment resulted in profit. The borrower is generally liable to pay principal and interest as per contract subject to applicable bankruptcy and insolvency laws. It results in a radical change in the relationship of creditor to debtor. The classic loan is basically one wherein the loan provider will typically function as the creditor. It is a type of Islamic contract where the financier may be a partner or investor, depending on the contract.

1.8.1: Risk Sharing Versus Risk Transfer

Economic activity is always associated with risk. The issue at stake is thus the distribution and management of finance systems. In Islamic finance, risk sharing is something very important where it is highlighted in contracts such as mushārakah and muḍārabah. Mushārakah involves that parties contribute the capital and the profits are distributed based on the terms agreed, while losses are usually determined based on the contributed capital. Muḍārabah is such that one of the parties provides the capital and the other provides management, or entrepreneurial effort (shaibah), and the profits are divided between them in accordance with the contract, and the losses are retained by the capital provider, unless they resulted from negligence or misconduct or due to breach of contract. Risk transfer or risk pricing is commonly used in conventional finance. A lender may shift some of the risks of a business onto a borrower by enforcing the requirement to pay back the principal and interest, regardless of business profits. Other means, such as the transfer of risk through collateral, guarantees, insurance, derivatives, and securitization, also can create and move various kinds of risk. Risk sharing or risk transfer does not neutralize risk. Rather, distribution of risk in the contract varies.

1. 8.2: Asset Backing and Real Economic Activity

Another key aspect of Islamic finance is its focus on real economy. Real economic activity is an important factor that is recognized by the IMF in Islamic finance (IMF, 2015, 2017). Contracts based on selling or leasing such as contracts of murābaḥah, istisnāʾ, mushrākah and muḍārabah. The goal is to make sure that only transactions of money do not become divorced from real economic transactions. Conventional finance allows for financial claims that can be way down the line from actual production. The financial markets today comprise bonds, shares, derivatives, structured products and securitized assets. These instruments can serve important roles when it comes to liquidity, risk management and the reduction of financing costs. But, financial innovation can also lead to complexity and interconnectedness. The global crisis of the years 2007-2009 spurred a vast amount of debate about the role of excessive leverage, a securitization culture, risk concentration, information asymmetry, and financial innovation. The crisis shows that the financial sector isn't necessarily bad in itself, but rather it is a good example about the significance of financial structure, regulation, transparency and incentives.

1. 8.3: Gharar and Financial Uncertainty

Islamic finance distinguishes Ordinary business risk and Excessive Gharar. All business transactions involve uncertainty due to the fact that future prices, demand, costs and profits are not known certainly. Islamic finance does not remove those risks in the business that are legal and allowable. The worry is that there is too much uncertainty in the contract, and that obligations or outcomes are not clearly defined. It's important to have contractual transparency, therefore. The traditional financial markets do not like uncertainty – they are in fact happy to commoditise it. Markets and financial instruments, such as options and futures, and insurance needs, are partly a response to the demand of market participants to deal with uncertain future outcomes. The distinction is not therefore merely that Islamic finance does not accept any uncertainty and conventional finance accepts whatever amount of uncertainty. The difference is with regard to the law and ethics that impose limits on uncertainty and speculation.

1.8.4: Maysir and Speculation

The activities of maysir and most of the forms of speculation in general, are not permitted in Islamic Finance. This concept helps define a perimeter of the financial transactions whose economic substance is mainly based on chance activities. There are two types of speculation that are considered productive: (1) the arbitrage trade that involves the purchase of a security for one price and its sale at a higher price, and (2) the hedging trade, in which a security is acquired to offset a risk associated with a different security. Speculation is a type of market activity, and in itself, outside of illegal market structures, it is thought to be a legitimate type of activity. Speculators can help provide liquidity and help determine the price. The Islamic critique is more a matter of whether financial gain is tied to legitimate risk, economic activity and ownership, not whether it's a zero-sumn game of chance. These are meaningful differences, particularly in the context of the highly leveraged derivatives and other structured financial products. Islamic scholars and standard setting bodies have therefore had extensive discussions about the permissibility or otherwise of financial engineering.

1.8.5: Ownership as a Foundation

In Islamic commercial law, ownership is of great significance. The idea is that a party ought to be able to have a reasonable ownership stake or legal rights prior to engaging in certain types of sales. This has an impact on Islamic financial products. For instance, if someone enters into a murābaḥah transaction, it is where one person buys an asset and sells it to another person. Ijārah involves leasing. Mushārakah involves partnership ownership. These arrangements establish a connection between monetary values and tangible assets or activities. Conventional finance does not normally mandate that all financing deals be in the form of a sale or ownership partnership. A bank can lend money when the bank gives a security and the bank can get some amount as interest. This difference can impact legal documentation, accounting and taxation and regulatory treatment and operational costs.

1.8.6: Islamic Investment Screening

Islamic finance has some restrictions for certain industry and activities. Alcohol and gambling, pork-related activities, some entertainment businesses and other businesses that are not allowed according to sharīʾah may be excluded from investment screening. Religious restrictions are not normally imposed on conventional investment funds, except for those set up with an ethical, environmental, social or governance mandate. Thus, Islamic Investment screening can be equated to social responsible investment, although it is not the same. There are a variety of ESG investment frameworks, such as environmental sustainability, social responsibility, governance, labour practices and climate related. Islamic screening is done according to the principles of the Sharīʾah, and it can encompass limitations on the types of business and financial-ratio criteria.

1.9: Social Justice and Wealth Distribution

The social issue in Islamic finance is a significant topic mentioned in Islamic economic literature. Sometimes, Zakat, prohibition of unjust enrichment, charitable giving and restriction on some types of exploitation is regarded as part of the whole Islamic economic system. Islamic finance should, however, not be equated completely with Islamic social finance. Commercial Islamic bank is still a financial institution that is still searching for financial sustainability. It does not necessarily have as its primary responsibility the same one as a government welfare programme. However, there are other possibilities for introducing social purposes into Islamic finance, such as those related to the concept of zakat, qard hasan, waqf-based finance, micro-finance, social sukūk, and other measures. Social value can be achieved through financial inclusion, community investment, impact investment, development finance, corporate social responsibility and government regulation using the conventional finance system. So, it is a matter of foundations, but not one of property rights to the idea of social responsibility.

1.9.1: Profit and Profitability

Profiting is not forbidden in Islamic finance. Instead, the right to profit is a crucial part of trading and investing. The important thing is where the profits are made. A profit that comes from a lawful sale, lease, partnership or investment may be acceptable. The financial institution could generate a return from ownership, financing, or asset management or from involvement in an economic activity. Profit is also one of the key economic goals for conventional finance. Banks make money from interest, fees, investment activity and trading, and other services. Thus, "Islamic versus conventional" should not be described as "profit versus no profit." More precisely, the distinction relates to the nature of the source of the return and contract of return.

1.9.2: Murābaḥah and Conventional Lending

Murābaḥah is one of the most talked about Islamic financing structures. The financier buys an asset and sells it on to the customer at an agreed cost, plus a margin of profit, and may offer delayed payment. The economic payment method may be similar to that of a traditional loan in that they're able to make regular payments. However, the form of the contract is tied to the sale–ownership of the housing and not a 100% interest bearing loan. Some critics of Islamic finance have reasoned that it is possible for some modern murābaḥah schemes to generate economic effects akin to those of conventional debt.

The supporters counter that they have to assess legal and economic substance by the nature of the contractual structure and the ownership of the investors, risk and compliance requirements. This debate is indicative of the crux of the matter in modern Islamic finance where it is debated whether conformance is enough or Islamic financial products should reflect distinct economic and social differences.

1.9.3: Mushārakah and Partnership Finance

Mushārakah is a financing model based on the principle of partnership whereby the parties put in their capital into a business or an asset for the implementation of a business project. Profits will be split up as per the agreed rules and losses will be distributed in the ratio of capital contribution. This type of structure is more likely to establish a strong link between financing and the performance of the business than a typical fixed-rate loan. The investor may lose money in the case where the enterprise earns little profit. However, partnership finance does present problems of information asymmetry, monitoring costs, moral hazard and managerial risk, as well as the difficulty in measuring profits accurately. These challenges can be used to explain the possibility of Islamic banks using more trade and lease based structures than the strict profit and loss sharing structure. Although the IMF considers mushaarakah and mudarabah to be potentially significant profit-and-loss-sharing instruments of Islamic banking, the IMF also acknowledges the specific risk characteristics of Islamic banking (IMF, 2017, 2018).

1.9.4: Muḍārabah and Entrepreneurial Finance

Muḍārabah is a contract in which one party gives capital and another party gives entrepreneurial effort. This setup has the potential to help entrepreneurs with skills and business ideas, but who may not have enough capital. Instead of interest payment, the financier will be paid a share of real profit. Losses are accounted for it in line with the contractual and Sharīʾah structure. Looking from the economic side, an important problem is that of access to capital by the entrepreneurs, which is solved by muḍārabah. It can also, however, create agency issues. Monitoring may be required as the entrepreneur will know more about the business than the financier. This is not an exclusive phenomenon of Islamic finance. There are some similar issues with conventional venture capital, private equity and equity financing.

1.9.5: Conventional Debt Finance

Conventional debt finance is well-established and enables borrowers to have access to capital, without giving up ownership to the lenders. Bonds, bank loans, mortgages, credit cards, corporate debt, and government securities are some of the big ones. Debt finance is beneficial for borrowers that need a predictable cost of finance and for the investors looking for relatively predictable cash flow. It also provides in a position to perform huge scale financing for infrastructure and corporations. But if you have too much debt, your finances may be vulnerable. A highly leveraged borrower could end up having to pay on the loan even if revenues decline. Macro-leverage can add more financial strain. That is where the emphasis of the modern financial regulation on capital adequacy, liquidity, stress tests, risk management and supervision come in.

1.9.6: Financial Stability

Islamic finance is also linked to more financial stability due to its emphasis on asset-based and risk-sharing. There are some theoretical arguments that these features could limit some types of "excessive leverage" or speculative finance.Islamic financial institutions can also experience financial instability, however. Such risks as credit risk, market risk, liquidity risk, operating risk, risk of displacement of commerce, risk of return, and risk of Sharīʾah-compliance exist. In its 2025 report, the IFSB actually highlights the following weak points in the Islamic capital markets: Lack of depth and liquidity-management instruments. That's as continuing structural problems. Additionally, it highlights the need for a more vibrant and fluid sukūk market as a crucial element for the industry's progression (IFSB, 2025). So, assume financial stability as a result of Islamic status is an incorrect assumption.

1.9.7: Liquidity Management

One of the most significant practical issues in the Islamic financial institutions is liquidity management. Conventional banks participate in well-developed money markets with a wide variety of interest-based liquidity instruments. Islamic banks are in no position to simply adopt the conventional interest-bearing instruments without taking care of Sharīʾah requirements. This can cause liquidity management to be more difficult. Sukūk can be a significant tool for liquidity management; however, there is a different liquidity and depth of sukūk markets across jurisdictions. The role of the deepening of Islamic capital markets and enhancing liquidity instruments has been emphasized by the IFSB (IFSB, 2025). This issue is an example of Islamic financial institutions functioning in a financial system which is by and large dominated by conventional monetary system.

2. Monetary Policy

Interest rates are an important part of the conventional monetary policy. The policy rates are tools central banks employ to affect borrowing, saving, investment, inflation, exchange rates and economic activity. Islamic financial institutions, however, are in countries where conventional interest-rate benchmarks have commonly been employed by monetary authorities. Therefore, it would be profitable for Islamic banks to adopt conventional benchmark rates as pricing instruments even though they offer different structures of contracts. This poses a

significant theoretical and practical issue. If a financing product offered by Islamic banks is benchmarked using an interest rate, then does it mean that it is conceptually similar to the conventional interest? That will depend on the contract and the interpretation interpreted by the competent Sharīʾah authority. Even if a benchmark is not a contractual basis, it can still be used as a mechanism to provide a price reference. But the traditional indicators still do not have a unanimous backing from the academia and the profession.

2.1: Standardization

Another major challenge is the standardization. Differences in the interpretations of Islamic financial contracts are also due to varying views on jurisprudence, laws and regulations, and Sharīʾah bodies. Organizations like Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have made efforts toward standardization, governance, accounting, risk management and development of supervisors. The more standardized the better, which will lower the transaction cost and boost investor confidence. Meanwhile, too much standardization would possibly limit flexibility and innovation.

2.2: Conventional Financial Innovation

The conventional finance has grown a vast ecosystem of financial innovations. Today's financial markets are diverse, encompassing the likes of derivatives, securitization, structured finance, algorithmic trading, exchange-traded products, digital banking, fintech and cryptocurrencies. Islamic finance also has created innovative financial products such as Islamic funds and Sharīʾah-compliant investment products, Islamic fintech, digital Islamic banking and sukūk. What is different, however, is that Islamic innovations do have to be within frame-work of contracts and ethics. So there's also a compliance aspect to financial engineering.

The question is whether innovation is going to be innovation that just masks transactions that are already prohibited. This has helped to sustain the ongoing discussion about form and substance, maqāṣid al-Sharīʾah, and social goals of Islamic finance.

2.3: Financial Inclusion

Financial services are useful and affordable financial services, which are what are meant by financial inclusion. Financial inclusion can be achieved both through Islamic and conventional finance. In particular, there are customers who may have a religious objection to interest-based banking that Islamic banking could be particularly relevant. Sharīʾah compliant accounts, financing, investment products, and the provision of payment services can help to promote engagement with the formal financial system. Conventional finance has further enhanced financial inclusion by making use of mobile banking, microfinance, digital payments, simplified bank accounts and fintech. The right policy goal could thus be the financial pluralism or the ability of individuals and businesses to obtain financial services, while staying within their legal, economic, ethical and religious choices.

2.4: Islamic Finance and Ethical Finance

The Islamic finance bears some attributes of ethical and socially responsible finance. Both may take social risks into account in the investment decision-making process. But Islamic finance is not quite synonymous with ethical finance. Ethical finance can be rooted in secular philosophy, environmental and social impact, environmental targets, ESG frameworks or human-rights principles. The fundamental limits for Islamic finance come from Sharīʾah. There are opportunities for cooperation in the overlap however. The tenets of Islamic finance which focus on asset-based transactions, responsible investments, social finance and the banning of certain harmful activities can overlap with current sustainable finance goals.

2.5: Islamic Finance and Sustainable Development

In the international finance arena, sustainable development is increasingly gaining importance. Climate risk, environmental sustainability, social inclusion and governance should be taken into consideration by financial institutions. Islamic finance can be related to SD via

ethical investing, the concepts of zakat, waqf, social finance, green sukūk and impact investing. But being Islamic does not necessarily mean environmentally or socially sustainable. The real impact, governance and economic implications of each financial product should be assessed.

2.6: Regulation

There is a need for effective regulation in both Islamic and conventional finance. The traditional approach to banking regulation emphasizes capital adequacy, liquidity, risk management, consumer protection, deposit protection, anti-money-laundering controls and systemic stability. Along with regulation for Sharīʾah governance, compliance with contracts, restriction on investment and special balance-sheet risk, Islamic banking needs this type of regulation. The Core Principles of Banking Supervision for Islamic Finance (IMF, 2018) highlight that Islamic banking supervision should be commensurate with the bank's unique business model, and compatible with the overall financial stability framework.

3. Corporate Governance

Corporate governance is related to the direction, monitoring and accountability of the financial institutions. Conventional governance mechanisms are needed in the Islamic financial institutions as Sharīʾah governance mechanisms. Products, contracts, policies and transactions can be reviewed by sharīʾah boards or other similar entities. This added feature can boost customer confidence in a case where Sharīʾah compliance is a requirement. But, independence, expertise, transparency, consistency and institutional accountability are essential parts of governance quality. Conventional institutions also need to have good boards, auditors, regulators, risk committees, and compliance systems.

3.1: Information Asymmetry

Asymmetry of information exists when one of the parties of a trade has more information than the other party. It's a basic matter of finance. Stiglitz and Weiss (1981) showed that information asymmetry may lead to adverse selection, and credit rationing in credit markets. Depending on the nature of the business, Islamic partnership financing can be highly information sensitive as returns may be linked to business performance. That means that there is a need for reliable accounting, auditing, monitoring and disclosure on the part of the financier. There is information asymmetry also in conventional lending, but this can be mitigated by having collateral or contractual repayment requirement.

3.2: Moral Hazard

Moral Hazard occurs when after a contract is signed, the parties alter their behaviors because the other part of the contract take the consequences. With a conventional loan, the borrower might take undue risk since the lender has minimal information on business decisions. Similarly in Islamic profit sharing, the entrepreneur may have an incentive to underreport profits or take excessive risks. Thus, there is no moral hazard in either system. Good governance, transparency, auditing, monitoring, incentives and legal enforcement are still required.

3.3: Comparative Observation

This comparison is to show that Islamic finance and conventional finance are very similar in their functions with a different manner of organizing relationship.Both systems are to mobilize savings; finance businesses and households; facilitate payments; manage financial risk; support investment; provide financial intermediation; require regulation; depend on information and governance; face credit and liquidity risks; and, use technology and financial innovation. Their key differences are in relation to the treatment of ribā and interest, the types of contract utilised, the requirement of risk sharing, the treatment of excessive uncertainty, the prohibition of gambling and speculation, the screening of investments, the treatment of ownership of assets, the relationship between finance and real economic activity and the social and ethical bases. This shows that it is not a difference in terminology but structure.

3.4: Areas of Convergence

Although they may differ, Islamic and conventional finance have now started to converge in real-life. Islamic banks can apply exactly the same IT tools, accounting tools, credit assessment tools, risk management tools, payment systems and regulations as conventional banks. Islamic finance also exists in the international capital markets, and there are interactions between conventional banks and Islamic financial institutions. Sukūks can have similar uses to some types of bonds but the contract is different. Likewise, Islamic investment funds can adopt Sharīʾah screening in conjunction with conventional portfolio-management techniques. As such modern Islamic finance can be viewed as an alternative financial structure in a largely conventional world.

3.4.1: Areas of Divergence

The most prominent discrepancy is with respect to ribā. seconda is the difference in contractual philosophy. In short, conventional finance could consider money itself as a financial asset that can be lent out and present interest. In the general Islamic Finance, financial return is supposed to come from legitimate trading, investment, leasing or risk-bearing activity. A third difference is on issues of restrictions on investment. Islamic finance has restrictions that are Sharīʾah based, where conventional finance does not have such restrictions.

The fourth difference relates to risk. Islamic finance offers more conceptual risk sharing between capital and entrepreneurship, whereas conventional finance often involves contractual repayments and the transfer of risk. The fifth divergence is regarding social philosophy. Islamic finance, by contrast, clearly ushered in moral and social rules in the financial framework, and conventional finance, in general, distinguished between financial law and religious rulings.

4. Critical Issues in Contemporary Islamic Finance

Several key debates have arisen in the context of the development of Islamic finance. There are doubts whether Islamic banking today fulfills the risk sharing in its operation. Thus, many Islamic banks extensively utilize murābaḥah and ijārah instead of mushārakah and mudārabah. Some Islamic financial products have been discussed by scholars and scholars hold different views as to whether some of them are replicating the economic consequences of conventional debt but have a different legal framework. Fragmented standards of Sharīʾah are an issue. Due to the predominance of interest-based securities in many markets, Islamic financial institutions are challenged in managing their liquidity. The industry also needs to maintain the balance between commercial competitiveness and its ethical and social goals.In fact, it is these debates which will be crucial to secure the future credibility of Islamic finance not only because of its formal compliance, but also its transparency, economic substance, governance and demonstrable social value.

4.1: The Question of Economic Efficiency

Efficiency is not a straight-forward term. Conventional finance can offer benefits in terms of depth of market, standardized contracts, liquidity, a significant number of risk-transfer instruments, and a large financial infrastructure. The unique features of Islamic finance, including ethicability screening, financing based on assets, partnership financing and financial services to customers who seek Sharīʾah compliance, may yield unique benefits. The two systems should not be judged from their ideological assumptions only. Efficiency depends on: Institutional quality, Regulation, Depth of markets, Information, Governance, Technology, Human capital, and macroeconomic conditions. A bank using Islamic banking could do well under a weak regulatory environment and a conventional bank could do well under a strong regulatory environment. The opposite can happen, as well. The quality of institutions is thus a crucial variable aside from the formal financial model.

4.2: The Question of Social Justice

Sharia finance explicitly establishes the concepts of justice and how to acquire lawfully. The Holy Book called Qur'an presents a total ban on wrongful appropriation of property, and

acknowledges trade by consent. Qur'ān 59:7 states that money should not be allowed to flow only among the rich. These principles are the ethical ones for taking into account distributional outcomes. Inequality, poverty, market power and distribution are also topics of conventional economics. But the moral underpinnings are different. The traditional approach to distribution tends to be achieved via taxation, social policy, regulation, welfare payments, competition law and public investment. Four mechanisms can make contribution to distribution possible by means of Islamic finance, which are: distribution by means of charities funds, distribution by Qard hasan, distribution by waqf, and distribution by social investment which is directly or indirectly related to zakat. However, commercial Islamic banking is not an answer to the structural poverty.

4.3: Financial Crises and Lessons

Leverage, liquidity, incentives, information, and regulation have been shown to be critical in times of financial crisis. The worldwide economical recession has reignited the interest in financial security and the connection between financial claims and the underlying assets. Some scholars suggested that the vulnerabilities of Islamic finance may be diminished by the ban on certain kinds of speculation and leverage. Islamic financial institutions were also impacted, however, by conditions in the world economy. They are tied to international trade, property prices, commodity prices, currencies and international financial systems. As such, it would be derogatory to conclude that Islamic finance is crisis-proof. Instead, contractual arrangements can lead to varying arrangements of exposure to some risks.

4.4: Global Development of Islamic Finance

Islamic finance has developed and extended beyond countries dominated by Muslims. Islamic banking, sukūk, Islamic funds and takaful are found in a number of regions. Expansion of the industry provides evidence of the possibility of Islamic finance functioning under different legal frameworks. It is also a reflection of the growing demand for financial products, which include religious, ethical, and risk-sharing preferences, throughout the world. The Islamic Finance Development Report 2025 reported that the Islamic finance industry has matured from a niche sector to becoming a strong part of the global finance sector with around US$5.98 trillion in assets in 2024 (LSEG, 2025). This development brings opportunities, but also a need for enhanced governance, standardisation, transparency, qualified workforce and globally valid regulation.

4.5: The Role of Technology

In both of these, financial technology is playing a major role in the transformation. Digital banking, mobile payments, AI, blockchain, compliance automation, digital identity and online investment platforms lower the costs of transactions and improve accessibility. The next challenge Islamic fintech must overcome is that digital financial products must comply with relevant Sharīʾah requirements. Thus technology can be used to create new financial models in Islam and not necessarily to have conventional financial models in digital mode.

4.6: Consumer Choice

There are various types of consumers of financial systems. Others are focused on low cost, convenience, liquidity and sure payment. Others also take into consideration religious or moral issues.The existence of Islamic finance provides consumers with an alternative framework. This is therefore one of the key aspects of financial pluralism: the choice of the consumers. Whenever there's competition between financial models, institutions are more likely to take steps to boost transparency, service quality, innovation and customer protection.

4.7: Methodological Position of the Present Study

This paper is based on the qualitative, conceptual-comparative approach. It does not pretend to be a measure of the economic effects of causes. Rather, it draws its comparisons from the academic literature, international financial-sector reports, and primary Islamic textual principles. The research can thus be characterized as interpretative rather than econometric. It

focuses on conceptual differences and practical implications. The methodological stance is reflected in the word "observation" in the title. The paper merely observes and compares and does not try to prove by statistical testing one financial system is superior in general.

4.8: Scope and Limitations

The study is mainly on Islamic finance and conventional finance aspects at banking, investment, financing contract and financial intermediation levels.

Does not go to the extent of a jurisprudential analysis of all Islamic financial contracts. Nor does it make empirical checks on the profitability or stability of individual banks. Another constraint is the variety of traditional banking and finance. Conventional finance is extremely diverse between countries. The differences in Islamic finance also stem from the differences in Sharīʾah requirements, national legislation, regulatory framework, and institutional practices. Thus, conclusions are simply general conceptual observations, not universal statements.

5. Research Gap

There has thus been a gap in research between the theoretical aspects of Islamic economics and the functioning of contemporary Islamic financial institutions. The partnership, the sharing of risks, the justice, and the linkage to productive activity are often stressed in the theoretical model. But modern Islamic banking is more often found in banking contracts where the rate of return and payments is more likely to be predetermined. This constitutes an important research field on the link between normative principles and institutional practice. Future studies may undertake empirical analysis of the Islamic and conventional banks based on the proxy indicators of profitability, financial stability, credit growth, non-performing financing, liquidity, capital adequacy, financial inclusion, poverty reduction and customer satisfaction.

5.1: Theoretical Framework

This study is structured into six comparisons: Source of legitimacy. As a result, Islamic finance has rules that are rooted in the principles of Sharīʾah, while conventional finance is governed mainly by secular laws and economic institutions. Source of financial return. In Islamic finance, the sources of return in the contract must be considered as permissible and in conventional finance, interest is permissible. Risk allocation. Islamic finance places a lot of importance on risk participation in the right type of contracts, whereas conventional finance often focuses on debt repayment and risk transfer. Correlation with actual activities. The key concept in Islamic finance is linked to finance and assets, services or productive activity. Axiological boundaries. Islamic finance has certain sectors and activities that are excluded. Islamic economic thought gives an explicit importance to justice, proper earnings and social responsibility. These dimensions take the analytical framework for the comparative observation.

6. Expected Contribution

So, the major value of this paper lies in the comparison and presentation of the institutional structures of two financial approaches, namely Islamic and conventional finance, instead of a comparison on slogans. It is important to note in the study that Islamic finance is not conventional banking without interest. It is a contractual system which has special regulations about ownership, risk, uncertainty, investment and financial ethics. Meanwhile, the study fails to depict conventional finance as a system that is without ethics and economic value. The key role of conventional finance is in the mechanisms of saving, investing, liquidity, risk management and economic development. The most helpful comparative framework thus identifies both the strengths and weaknesses of both systems and institutional variations as well as actual interactions between them.

7. Conclusion of the Introduction

The analysis shows that there is a fundamental similarity between Islamic and conventional finance in the economic aim of facilitating capital transfer between anyone who saves, anyone who invests, business entities, government and consumers; yet there are basic

differences in how capital is supposed to flow between savers and investors. Islamic finance has an integrated approach to ribā, gharar, maysir, investment, ownership, contractualing, risk sharing and social responsibility. In the West, the prevailing attitude is that interest, credit, financial markets, financial prices of risk, and financial innovation are an integral part of a legitimate economic organization, subject to legal and regulatory frameworks.Thus, there is a more basic distinction than interest or no interest. It is a question about the form of the monetary contract, and about money, property, risk, productive activity, and moral responsibility. The unique system of Islamic finance opens the way for financial inclusion, ethical investment, risk sharing and financial services which are in line with the Islamic faith. On the other hand, it poses real issues in terms of liquidity management, standardization, regulatory integration, governance, benchmarking and financial innovation. The characteristics of conventional finance include well-established financial markets, standardized instruments, considerable liquidity, an advanced risk management system, and a well-regulatory framework. Facing challenges relating problems of leverage, problems of information asymmetry, systemic risk, moral hazard, financial concentration and financial crises. The comparison consequently does not lead to a simplified conclusion of which one of the systems should be used instead of the other. It rather suggests that financial systems should be judged on the basis of their aims, institutional organization, regulatory standards, economic performance, moral responsibilities and impact on various stakeholders. Today's recent developments of Islamic finance have added more relevance to this comparative research. The role of Islamic principles and the modern financial technology, financial regulation, capital markets or even sustainable finance will undoubtedly be more prominent as Islamic financial institutions become more integrated with global markets. Finally, the difference between Islamic and conventional finance is more of a difference in the organization and ethic limits of financial relationship. In general, while conventional finance mechanisms allow broader set of interest-based and market-based financial relationships, Islamic finance aims to define permissible financial returns via contracts related to trade, assets, investment and risk-bearing. They are both reliant on good governance, transparency, competent institutions, good regulation, and responsible economic conduct. There is a need for future empirical studies to go beyond theoretical comparison and look at measurable outcomes. A comparative study between financial institutions in Islamic and conventional financial institutions can be studied in terms of profitability, stability, liquidity, financial inclusion, entrepreneurship, inequality, sustainability and customer welfare. This evidence could better inform analysis of the real-life implications of each of the two strategies.

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