

A Comparative and Critical Review of Conventional Banking and Islamic Banking System

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Abstract

The modern financial system is predominantly governed by conventional banking, which is fundamentally based on interest (riba). In contrast, Islamic banking presents itself as a Shariah-compliant alternative that prohibits riba and promotes profit-and-loss sharing, asset-backed financing, and ethical investment. This research critically and comparatively examines conventional and Islamic banking systems from an Islamic studies perspective. By analyzing classical Islamic jurisprudence alongside contemporary economic discourse, the study evaluates the theoretical foundations, operational mechanisms, and socio-economic implications of both systems. The research argues that while Islamic banking offers a morally grounded and socially just framework, its practical implementation faces significant challenges that require structural and intellectual reform..

Keywords: Islamic Banking, Conventional Banking, Riba, Shariah, Islamic Economics.

Article Details:

Received on 29 Sept, 2025

Accepted on 20 Oct, 2025

Published on 21 Oct, 2025

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Background

Banking systems play a central role in modern economies by facilitating capital flow, trade, and investment. Conventional banking, based on interest (riba), dominates the global financial landscape but raises ethical and socio-economic concerns from an Islamic perspective. Islamic banking offers an alternative system rooted in Shariah principles, emphasizing justice, risk-sharing, and social welfare. This study critically examines and compares these two systems to evaluate their theoretical foundations and practical implications.

Introduction

Banking constitutes the backbone of any modern economy. It facilitates capital formation, mobilizes savings, and supports trade and industrial development. The contemporary global financial system is largely dominated by conventional banking institutions that operate on the basis of interest. Although this system has contributed to economic growth, it has also generated serious ethical, social, and financial concerns, particularly from an Islamic perspective.

Islamic banking has emerged as an alternative system that claims to align financial practices with Islamic moral and legal principles. Rooted in the prohibition of riba and the promotion of justice (‘adl), cooperation, and risk-sharing, Islamic banking seeks to integrate finance with real economic activity. This paper aims to provide a comprehensive comparative and critical analysis of conventional and Islamic banking systems within the framework of Islamic studies.

Research Background and Significance

The prohibition of riba occupies a central position in Islamic economic thought. Classical jurists unanimously agreed on the unlawfulness of riba due to its exploitative nature and its destructive impact on social justice. In the modern era, the expansion of interest-based banking posed a significant challenge to Muslim societies, prompting scholars to search for Shariah-compliant financial alternatives.

The significance of this research lies in its attempt to bridge classical Islamic jurisprudence with contemporary banking practices. It critically examines whether Islamic banking, as practiced today, truly fulfills the objectives of Shariah (Maqasid al-Shariah) or merely replicates conventional banking structures under Islamic nomenclature..

Review of Literature

Classical Islamic Scholarship on Riba

Classical jurists such as Imam Abu Hanifah, Imam Malik, Imam al-Shafi‘i, and Imam Ahmad ibn Hanbal defined riba as any predetermined increase over the principal of a loan. Ibn Qudamah emphasizes that riba leads to unjust enrichment and undermines mutual cooperation in society.

Al-Ghazali regarded riba as a violation of the natural function of money, which should serve as a medium of exchange rather than a tool for exploitation. Ibn Taymiyyah similarly argued that riba concentrates wealth in the hands of a few and disrupts economic balance.

Contemporary Islamic Economic Thought

Modern scholars like Muhammad Nejatullah Siddiqi, M. Umer Chapra, and Muhammad Taqi Usmani have extensively written on Islamic banking. Siddiqi views Islamic banking as a system rooted in risk-sharing and ethical responsibility rather than risk transfer. Chapra emphasizes that Islamic finance aims at socio-economic justice rather than profit maximization alone.

Research Questions

1. How does conventional banking operate, and what is its reliance on interest (riba)?

2. What are the key principles and instruments of Islamic banking?
3. How do conventional and Islamic banking systems differ in risk-sharing, ethics, and socio-economic impact?
4. What are the main challenges faced by Islamic banking in practice?
5. How can Islamic banking better achieve justice and social welfare in line with Maqasid al-Shariah?

Research Methodology

This study adopts a qualitative and analytical research methodology based on descriptive, comparative, and critical analysis. Primary sources include the Qur'an, Hadith, and classical Islamic jurisprudential texts, while secondary sources comprise contemporary scholarly works on Islamic economics and banking. The research employs a comparative approach to examine conventional and Islamic banking systems, analyzing their theoretical foundations, operational mechanisms, and socio-economic implications from an Islamic studies perspective. Critical evaluation is conducted in light of the objectives of Shariah (Maqasid al-Shariah) to assess the extent to which modern Islamic banking practices align with Islamic ethical and legal principles.

Aims & Objectives

- To critically and comparatively analyze conventional and Islamic banking systems from an Islamic studies perspective, assessing their alignment with Shariah principles and socio-economic justice.
- Examine the theoretical foundations of conventional banking and its reliance on interest (riba).
- Explore the principles, instruments, and operational mechanisms of Islamic banking.
- Compare and contrast conventional and Islamic banking systems in terms of risk-sharing, ethical compliance, and socio-economic impact.
- Evaluate contemporary challenges and limitations of Islamic banking in practical implementation.
- Provide recommendations to enhance the effectiveness, authenticity, and social relevance of Islamic banking.

Concept of Riba in Islamic Law

Riba, linguistically meaning “increase” or “excess,” refers in Islamic law to any unjustified increment in exchange or loan contracts. The Qur'an unequivocally prohibits riba: “Allah has permitted trade and forbidden riba.” (Al-Baqarah 2:275)

The prohibition is further reinforced by numerous hadiths, including the Prophet Muhammad's (ﷺ) declaration that all forms of riba were abolished during the Farewell Sermon.⁶ The underlying rationale for this prohibition is the prevention of injustice, exploitation, and unearned income.

Conventional Banking: Theory and Structure

Conventional banking operates on the principle of interest-based lending. Depositors receive a fixed return on their deposits, while borrowers are charged interest on loans. The bank acts as an intermediary, earning profit through the interest rate spread.

- From an Islamic perspective, this system raises several concerns:
- Money is treated as a commodity.
- Risk is transferred entirely to the borrower.
- Profit is guaranteed regardless of economic outcome.

Critical Evaluation of Conventional Banking

Islamic scholars argue that conventional banking perpetuates economic injustice by ensuring risk-free returns for capital owners while exposing entrepreneurs to full risk. The 2008 global financial crisis further exposed the fragility of an interest-based, debt-driven financial system.⁷ Speculative practices and excessive leverage detached finance from the real economy, leading to widespread instability.

Islamic Banking: Principles and Objectives

Islamic banking is guided by Shariah principles, the most important of which include:

- ❖ Prohibition of riba
- ❖ Avoidance of gharar (excessive uncertainty)
- ❖ Prohibition of maysir (gambling)
- ❖ Promotion of profit-and-loss sharing
- ❖ Asset-backed financing

The ultimate objective is the realization of Maqasid al-Shariah, particularly justice, welfare, and economic balance.

Islamic Banking Instruments

Mudarabah (Profit-Sharing Partnership)

Definition and Concept

Mudarabah is a Shariah-compliant partnership in Islamic finance in which one party, called the Rab-ul-Maal, provides the capital, while the other party, called the Mudarib, provides labor, expertise, and management. This partnership is based on trust and mutual agreement, emphasizing ethical and fair participation in business. Unlike conventional loans, Mudarabah does not guarantee a fixed return for the capital provider; instead, profit is shared according to a pre-agreed ratio, and any loss (financial) is borne solely by the provider of the capital, as long as the Mudarib has acted honestly and without negligence.

Types of Mudarabah

Restricted Mudarabah (Mudarabah Muqayyadah)

The capital provided is to be invested in a specific project or sector defined by the capital provider. The Mudarib cannot change the investment domain without the provider's permission.

Unrestricted Mudarabah (Mudarabah Mutlaqah)

The Mudarib has full discretion to invest the capital in any Shariah-compliant business or venture. This type allows greater flexibility but requires a high level of trust.

Profit and Loss Sharing

Profit: Distributed according to the ratio agreed upon in advance, regardless of the capital or effort contributed by each party.

Loss: Financial loss is borne entirely by the capital provider, unless it occurs due to the Mudarib's negligence, misconduct, or violation of the agreed terms. This ensures risk-sharing and prevents exploitation.

Advantages of Mudarabah

- Promotes investment in productive activities without relying on interest.
- Encourages entrepreneurship and professional management.
- Ensures ethical financing aligned with Shariah principles, avoiding unjust enrichment.

Challenges in Modern Banking

- Monitoring and auditing the Mudarib's activities can be complex.
- Requires a high level of transparency and trust, which may be difficult in large-scale operations.

○ Regulatory and legal frameworks may need adaptation for institutional-level Mudarabah financing.

Practical Applications

- Commonly used in Islamic banks for investment accounts.
- Can finance startups, joint ventures, and project-based investments.
- Forms the basis for many modern Islamic financial instruments that aim to balance risk, profit, and ethical compliance.

Musharakah (Equity Partnership)

Definition and Concept

Musharakah is a Shariah-compliant partnership in which all partners contribute capital and share both profits and losses according to mutually agreed ratios. Unlike Mudarabah, where only one party provides capital and the other provides expertise, in Musharakah all partners have both capital at stake and a role in management (if agreed). It is a flexible instrument used for joint business ventures, trade, and project financing, emphasizing shared risk, ethical investment, and mutual cooperation.

Types of Musharakah

1. Permanent Musharakah (Musharakah Dhamanah)

A long-term partnership where capital remains invested for an extended period, typically in business ventures, and profits and losses are shared as per the agreement.

2. Diminishing Musharakah (Musharakah Mutanaqisah)

A partnership where one partner gradually buys the equity share of the other partner over time, eventually obtaining full ownership. This form is commonly used in **Islamic home financing**, where the bank and customer jointly own the property and the customer gradually buys the bank's share while paying rent for the remaining portion.

Profit and Loss Sharing

- **Profit:** Distributed according to the pre-agreed ratio, which does not necessarily have to match the capital contribution.
- **Loss:** Must be borne **proportionally to the capital contributed** by each partner. Loss sharing ensures fairness and discourages undue risk-taking or exploitation.

Advantages of Musharakah:

- Encourages equitable sharing of risk and profit.
- Promotes entrepreneurship and collaboration.
- Aligns financial activity with the ethical and moral principles of Shariah.
- Can be used for long-term investment and project financing, supporting economic development.

Challenges in Modern Banking

- Requires careful monitoring to prevent mismanagement and disputes among partners.
- Determining the profit-sharing ratio and managing losses in large-scale operations can be complex.
- Regulatory frameworks in some countries may not fully accommodate Musharakah-based financing models.

Practical Applications:

- Used in Islamic banks for project financing, trade partnerships, and investment accounts.
- Basis for Islamic home financing (diminishing Musharakah).
- Can finance startups, joint ventures, and large-scale infrastructure projects where shared risk is essential.

Murabaha (Cost-Plus Sale)

Definition and Concept

Murabaha is a Shariah-compliant cost-plus sale contract in which the seller discloses the cost of the asset and adds a known profit margin agreed upon with the buyer. Unlike conventional interest-based lending, Murabaha involves the sale of a tangible asset rather than a loan. It is one of the most widely used instruments in Islamic banking due to its simplicity and compliance with Shariah principles, particularly the prohibition of *riba* (interest).

Mechanism

- The bank or financier purchases the required asset on behalf of the client.
- The asset is sold to the client at an agreed **cost-plus-profit price**, which can be paid immediately or in installments.
- Ownership of the asset is transferred to the client at the time of the sale.

Profit and Risk

- **Profit:** The bank earns a pre-agreed profit margin instead of interest.
- **Risk:** Since the bank first purchases the asset, it bears the **ownership and delivery risk** until the asset is transferred to the client. However, after transfer, the risk shifts to the client. This ensures that the transaction is asset-backed and avoids speculation or uncertainty (*gharar*).

Advantages of Murabaha

- Provides a **Shariah-compliant alternative to conventional loans**.
- Simple and widely accepted for financing trade, consumer goods, and working capital.
- Reduces risk of non-compliance with *riba* prohibition.

Challenges and Criticism

- Critics argue that excessive reliance on Murabaha may **replicate conventional debt structures** under Shariah terminology, limiting the transformative potential of Islamic finance.
- Less risk-sharing compared to **Mudarabah or Musharakah**, which may reduce the ethical and economic benefits of true Islamic finance.
- Requires strong transparency in **cost disclosure** and contractual clarity to avoid disputes.

Practical Applications

- Used extensively for **consumer financing** (e.g., automobiles, appliances) in Islamic banks.
- Applied in **trade and working capital financing**, allowing businesses to acquire assets without conventional loans.
- Forms a key component of Islamic banking portfolios, providing **predictable returns** while remaining Shariah-compliant.

Comparative Analysis: Islamic vs Conventional Banking

Aspect	Conventional Banking	Islamic Banking
Foundation	Interest	Sharia
Risk	Borrower bears risk	Shared risk
Money	Commodity	Medium of exchange
Social Justice	Secondary	Core objective

Contemporary Challenges Facing Islamic Banking

Despite its ethical appeal, Islamic banking faces numerous challenges:

- Replication of conventional products
- Weak Shariah governance
- Lack of skilled human resources
- Regulatory constraints

Usmani notes that Islamic banking has yet to fully realize its transformative potential.

Analytical Discussion (Islamic Studies Perspective)

From an Islamic studies perspective, the true success of Islamic banking depends on its ability to move beyond legal formalism toward substantive compliance with Islamic ethical objectives. Merely avoiding *riba* in form while retaining its economic substance undermines the credibility of Islamic finance.

Conclusion

This study concludes that while conventional banking remains efficient and globally dominant, its interest-based foundation conflicts with Islamic ethical principles. Islamic banking offers a morally grounded alternative that emphasizes justice, cooperation, and real economic activity. However, for Islamic banking to serve as a genuine alternative, significant reforms are required at both conceptual and institutional levels.

Suggestions and Recommendations

This study recommends that Islamic banking should move beyond formal Shariah compliance toward substantive realization of the objectives of Shariah (*Maqasid al-Shariah*), particularly justice, risk-sharing, and social welfare. Greater emphasis should be placed on profit-and-loss sharing modes such as *musharakah* and *mudharabah* rather than excessive reliance on debt-like instruments. Strengthening Shariah governance, enhancing interdisciplinary education in Islamic law and finance, and integrating Islamic banking with social finance instruments such as *zakat*, *waqf*, and *qard hasan* are essential. Moreover, supportive regulatory frameworks and ethical accountability mechanisms are necessary for Islamic banking to emerge as a genuine and sustainable alternative to conventional interest-based finance.

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