UCLA
UCLA Journal of Islamic and Near Eastern Law

Title
Islamic Banking in Perspective: Definition, Operation, and Comparison with Conventional Banks

Permalink
https://escholarship.org/uc/item/9pp4c4jf

Journal
UCLA Journal of Islamic and Near Eastern Law, 23(1)

Authors
Anas, Mohammad
Hasan, Kaif

Publication Date
2026-11-17

DOI
10.5070/N4.70349

Peer reviewed

eScholarship.org Powered by the California Digital Library
University of California

ISLAMIC BANKING IN PERSPECTIVE: Definition, Operation, and Comparison with Conventional Banks

Mohammad Anas & Kaif Hasan

Abstract

This paper delves into the principles and operational framework of Islamic banking, contrasting it with conventional banking practices. Islamic banking, rooted in *shari'a* law and ethical principles, encompasses not only the prohibition of interest but also a broader commitment to fairness, risk-sharing, and societal welfare. It operates under the guidance of *shari'a* supervisory boards, ensuring compliance with Islamic law in all financial activities. Unlike conventional banking, Islamic finance emphasizes partnership and cooperation between depositors and entrepreneurs, promoting investment in socially beneficial projects and minimizing exploitation. Central to Islamic banking is the concept of risk-sharing, which fosters a more equitable distribution of financial outcomes compared to conventional lending practices. Moreover, Islamic banks prioritize social responsibility through mechanisms such as zakat and ethical investment criteria, contributing to the reduction of income inequality and the promotion of economic justice. This abstract highlights Islamic banking as a holistic approach to finance that integrates religious values with modern financial systems, offering a viable alternative that resonates with the beliefs and principles of millions worldwide. As the global Islamic finance market continues to grow, Islamic banking stands as a testament to the compatibility of religious principles with contemporary economic practices, emphasizing ethics, fairness, and societal welfare.

About the Authors

Author 1 – Mohammad Anas, B.A.LL. B (Hons) Department of Law at the Aligarh Muslim University.

Email- anas20ballb@gmail.com

Author 2 – Kaif Hasan, LLM student at the Department of Law at the Aligarh Muslim University.

Email – kaifhasan98@gmail.com

© 2026 Mohammad Anas & Kaif Hasan

KEYWORDS

Islamic Banking and Finance, Riba, Risk Sharing, Profit and loss and Sharia

TABLE OF CONTENTS

I. INTRODUCTION 46
SIGNIFICANCE OF ISLAMIC WAY OF BANKING 48
II. OVERVIEW AND DEFINITION OF ISLAMIC BANKING AND FINANCE....51
III. DISTINCTIVE FEATURES OF ISLAMIC BANKING 53
IV. RISK SHARING....54
V. OPERATION OF ISLAMIC BANKS COMPARED TO CONVENTIONAL BANKS....56
VI. CONCLUSION 59

I. INTRODUCTION

Islam is based on the belief that God is one and has no partners. God's will is revealed in the Qur'an, which is the guide for all aspects of human life. The Prophet Mohammad showed how to follow God's commands, which make up the Islamic law or *shari'a* (Islamic law in Arabic).[1]

According to Islamic epistemology, *shari'a* is the basis of all ethics. It is the divine guidance that God reveals to all humans through the prophets and messengers He sends. It covers all aspects of life from birth to death as well as issues related to politics, law, war, economy, finance, diplomacy, etc. Islam aims to establish a society that is just, balanced, and fair by applying the rules of *shari'a*. Karen Armstrong opined:

> "In practical terms, Islam meant that Muslims had a duty to create a just, equitable society where the poor and vulnerable are treated decently. The early moral message of the Qur'an is simple: it is wrong to stockpile wealth and to build a private fortune and good to share the wealth of society fairly by giving a regular proportion of one's wealth to the poor."[2]

Islam means "to submit" or "peace." The core of Islam is to obey Allah and follow what the Messenger has taught. A person becomes a Muslim by believing in the oneness of God and the five pillars of Islam in their heart. A Muslim must accept and follow everything that God has revealed through *shari'a.* The principle of Islam that guides human acts is known as *shari'a,* which means "a well-trodden path."[3] *Shari'a* is based on the Qur'an, *Sunnah* (the words, actions, and silent consent of the Holy Prophet Mohammad), *ijma'* and *qiyas*.

1. Sayed Khatab, *Hakimiyyah and Jahiliyyah in the Thought of Sayyid Qutb*, in 38 ROUTLEDGE MIDDLE E. STUD. 145, 157 (2002).
2. KAREN ARMSTRONG, A HISTORY OF GOD 142–43 (Knopf Publishing, 1st ed.1993).
3. MOHAMMED ALI AL-BAR & HASSAN CHAMSI-PASHA, CONTEMPORARY BIOETHICS: ISLAMIC PERSPECTIVE 6–7 (2015).

Fiqh (literally means understanding or knowledge), which is derived from the Arabic word for deep comprehension or insight, denotes the process of deriving legal rulings that conform to *shari'a*.[4]

Islamic finance is the economic aspect of *shari'a* that adheres to the basic guidelines set forth by Islamic law. Islamic finance is entrenched in the principles espoused in the Qur'an and *Hadith* which provide tools such as *ijma'* (consensus), *qiyas* (analogical deductions), *ijtihad* (independent reasoning), *maslah-al-mursalah* (considerations of public interest), *istihsan* (juristic equity), the validity of *urf* (custom), etc. These are among the tools whose principles have been defined in Islamic law to consider and derive rulings on various matters.

Shari'a encompasses various designations of acts or things, such as *fardh/wajib* (mandatory), *mustahab* (desirable), *mubah* (neutral), and *makruh* (reprehensible). However, there is no consensus among scholars on whether *makruh* belongs to *halal* (permissible) or not. The experts of *fiqh* derive the rules of conduct that conform to *shari'a* and prevent people from engaging in *haram* (prohibited) acts. These responsibilities are entrusted to *'ulama* (Muslim scholars) who have the knowledge and authority in this field.[5] The sources of these rulings are legal principles derived from the Qur'an, *Sunnah, ijma', qiyas,* and some other subsidiary rules based upon these. These legal principles of Islamic jurisprudence are collectively called *usul* (principles). These *usul* have developed and guided the system of Islamic banking and finance on the aspects of permissibility and prohibition. The *usul e*ssentially regulate Islamic banks and the Islamic finance sector regarding which activities are or are not permissible for these institutions to be involved in. In Islamic finance, financial transactions adhere to *shari'a* which encapsulates Islamic legal reasoning and prohibits interest. Interest is considered *haram* so the activities involved in interest are prohibited to operate in Islamic Finance. Similarly, financial transactions are prohibited for activities or entities involved in other *haram* practices like gambling, alcohol production/consumption, etc.

Fiqh, or Islamic jurisprudence, is the interpretation and application of Islamic law from the Qur'an and *Hadith*. *Fiqh* is done by scholars or jurists who study the sources of Islamic law and derive legal rulings and guidelines for various aspects of life. They also provide further guidance on what is ethical and unethical in specific situations. Besides the Qur'an and *Hadith*, *fiqh* also relies on other sources of rules, such as *ijma'* (consensus) and *qiyas* (analogy), which determine morality based on changing times and circumstances. *Ijma'* and *qiyas* can be applied by qualified jurists of *fiqh*, such as *alim* (scholar of Islamic law) and *mufti* (interpreter of Islamic law), as long as they do not contradict the *Sunnah*,

4. Nesrine Badawi, *Introduction to Islamic Law,* Program on Humanitarian Policy and Conflict Research, Harvard University 2 (2009).

5. 1 Khalid Saifullah Rahmani, Jadeed Fiqhi Masail [Modern Jurisprudential Issues], at 22 (Zamzam Publishers 2006).

even if they differ in interpretation. When the Qur'an and *Sunnah* do not offer a direct solution for a particular situation, *ijma'* can be used in different ways, such as *ijma'* by people, *ijma'* by jurists, *ijma'* by the companions of Prophet Mohammad, and *ijma'* by scholars and jurists. *Qiyas* is the Arabic word for analogy. *Qiyas* is a method of *fiqh* that uses deductive reasoning to derive legal rulings and guidelines from the Qur'an and *Hadith*. Qiyas is used by Islamic scholars or jurists to address new issues or situations that are not covered by the existing rules. Their rulings and guidelines are based on an analogy with previous rulings and guidelines that have the same operative cause. Legal rulings and interpretation through *usul* have been derived and led to the development of Islamic banking and finance which is the financial aspect of Islamic law. The *ijma'* and *qiyas* are the prime sources in Islamic law for dynamic interpretation of Islamic banking and finance in the changing dimensions of society.

Significance of Islamic Way of Banking

Islamic finance has its genesis in the dawn of Islam, with its principles and values derived from the *Shari'a.*[6] It refers to financial transactions and banking conducted in accordance with *Shari'a* law, which prohibits interest (usury), promotes risk-sharing, and prohibits speculative behavior.[7] The industry's basic principles are rooted in justice, harmony with reality, and human nature.[8] Islamic finance encompasses various financing contracts. *Murabahah* (profit sale), a type of Islamic financing where the seller and buyer agree on the cost and markup of an asset, which the buyer pays in installments without interest, and *mudharabah* (traveling in search of livelihood), a type of Islamic financing contract where one party provides the capital and the other provides the management and expertise with profit sharing according to a pre-agreed ratio, are the most frequently used in Islamic financial institutions.[9] In *mudharabah,* the loss is borne only by the capital provider. And in *murabahah,* the seller must own and possess the asset before selling it to the buyer. The legal and regulatory mechanisms governing Islamic finance are crucial for ensuring compliance with *Shari'a* law. The early revelation about disliking of *riba* was revealed in the Quran: "Whatever loans you give, only seeking interest at the expense of people's wealth will not increase with Allah. But whatever charity you give, only seeking the pleasure

6. Muhammad Tariq Khan, Tariq Iqbal Khan, & Sheraz Ahmed, *Halal Products: Not Restricted to Food and Its Marketing Opportunity in the Muslim World*, 1 Rsch. J. Soc. Sci. & Econ. Rev. (RjssEr) 101 (2020).

7. Arief Dwi Saputra & Alfina Rahmatia, *Islamic Financial Literacy Index of Students: Bridging SDGs of Islamic Finance*, 67 Econ. & Fin. Indon. 34, 38 (2021).

8. Murat Ustaoğlu, *Empirically Analyzing Public Views on Participation Banks in Turkey*, 34 Int'l J. Ethics & Sys. 510, 513 (2018).

9. Saputra & Rahmatia, *supra* note 7, at 34, 36.

of Allah—it is they whose reward will be multiplied."[10] *Riba* (interest) in Islam is considered to be profit which is unjust, exploitative, or excessive. Interest is considered as taking others' property unjustly. It was revealed in the Quran, "taking interest despite its prohibition, and consuming people's wealth unjustly. We have prepared for the disbelievers among them a painful punishment."[11] It is reported that "Jabir said that Allah's Messenger (ﷺ) cursed the accepter of interest and its payer, and one who records it, and the two witnesses. He said: "They are all equal."[12] Prophet Mohammad exhorted the Muslims to trade equally and justly amongst themselves, encouraged hand-to-hand (spot) transactions, and discouraged unequal transactions.[13] Interest creates social and economic inequality, which is why Islam completely prohibits it as harmful to the well-being of society. The Quran proclaims war against interest.[14] *Riba*, however, takes different forms such as interest, loans, unequal exchange of goods, speculation, etc. In order to prohibit *Riba*, Islamic finance provides various alternatives such as profit-loss sharing, cost-plus financing, and asset-backed financing.

Allama Iqbal (Sir Muhammad Iqbal, 1877–1938, a renowned South Asian Muslim philosopher, poet, and political thinker) criticized the system of interest. Lenders lend to desperate, underprivileged people which consequently allows lenders to lend at different interest rates depending on people's level of desperation. Higher rates for more desperate people, and lower rates for the less desperate. This is why lenders refrain from lending to people from different countries. They also do not lend to people from different countries due to the difficulty in retrieving money, lack of judicial enforcement, and lack of knowledge of foreign countries. Lenders also rely on charging higher interest rates where risk is high. However, in Islamic finance, the concept of risk-sharing exists. Risk in Islamic finance is not levied only against one desperate party furthering its predicament. People taking interest-based loans also tend to take them discreetly, which does not set competition among the lenders which could have consequently lowered the rates of interest. Therefore, discreet lending allows lenders to charge interest at different rates. Risk is the phenomenon which makes the interest rate different.[15] Risk-based liability is levied only against one party that lends.

The legal principles of Islamic finance are deeply rooted in the principles of *shari'a* law, which guide the practices and framework of Islamic finance.[16] The development of Islamic finance practices has evolved from a legalistic

10. *The Quran*, Surah ar-Rum 30:39.
11. *The Quran*, Surah an-Nisa 4:161.
12. Sahih Muslim, Book of Musaqah, Hadith No. 1598.
13. Sunan an-Nasa'i, Book of Financial Transactions, Hadith No. 4560.
14. *The Quran*, Surah al-Baqarah 2:278.
15. Allama Iqbal, *Ilm al Iqtisad* 162–65 (Iqbal Acad. Pakistan 1961).
16. Muhammad Shahrul Ifwat Ishak & Fathullah Asni, *The Role of Maqasid al-Shari'ah in Applying Fiqh Muamalat into Modern Islamic Banking in Malaysia*, 11 J. Islamic Acct. & Bus. Rsch. 2137, 2137 (2020).

approach to a value-oriented one, as seen in the experience of Malaysia in developing its Islamic finance framework.[17] The legal and regulatory framework for financial inclusion in Islamic finance is crucial for ensuring compliance with *shari'a* law and protecting consumers from unfair contract terms. The principles of *shari'a* play a fundamental role in guiding Islamic finance, ensuring adherence to ethical and moral values, and promoting financial inclusion.[18] In early societies, the practice of Islamic finance was based on the same fundamental concepts as current sustainable finance goals, focusing on financial stability, poverty reduction, wealth distribution, and environmental protection.[19] The legal and regulatory framework for Islamic finance is essential for ensuring end-to-end *shari'a* compliance in the offering of Islamic personal financing.[20] Additionally, the implementation of a robust risk-based *shari'a* audit framework is crucial for safeguarding Islamic financial institutions and promoting financial system stability.[21] The legal and regulatory framework for Islamic finance also encompasses the application of *maqasid al-shari'a* (objectives of Islamic law) to reconcile between rulings in *fiqh ma'amalat* (Islamic jurisprudence governing financial and commercial transactions) and banking environments, ensuring pragmatic adoption without compromising *shari'a* principles.[22] The legal principles of Islamic finance are deeply intertwined with the principles of *shari'a*, guiding the framework, practices, and regulatory mechanisms of Islamic finance. The development of Islamic finance practices has evolved from a legalistic approach to a value-oriented one, with a strong emphasis on *shari'a* compliance and consumer protection. However, there are concerns about the inadequacy of consumer protection from unfair contract terms in certain Islamic financing practices.[23] Additionally, the occurrence of so-called *'fatwā* shopping' (referring to the practice of seeking out favorable religious rulings from different scholars or *shari'a* boards to justify desired financial products or transactions) in the Islamic finance industry raises the need for proper legal mechanisms to regulate

17. Zulkifli Bin Hasan, *From Legalism to Value-Oriented Islamic Finance Practices*, 32 Humanomics 437, 437–38 (2016).

18. Siti Fariha Muhamad et al., *Measuring Sustainable Performance of Islamic Banks: Integrating the Principles of Environmental, Social and Governance (ESG) and Maqasid Shari'ah*, 1102 IOP Conf. Series: Earth & Env't Sci. 1 (2022).

19. *Id.*

20. Ibtisam @ Ilyana Ilias, Mastika Nasrun & Nurul Aini Muhamed, *Appraising Legal and Regulatory Framework for Personal Financing Offering by Islamic Banks and Non-Bank Institutions in Malaysia*, 12 Int'l J. Acad. Rsch. In Acct., Fin. & Mgmt. Sci. 449, 449 (2022).

21. Suleiman Dalhatu Sani & Mustapha Abubakar, *A Proposed Framework for Implementing Risk-Based Shari'ah Audit*, 19 J. Fin. Reporting & Acct. 349 (2021).

22. Ishak & Asni, *supra* note 16 at 2145–50.

23. Syuhaeda Aeni Mat Ali, Rusni Hassan & Ahmad Azam Othman, *Inadequacy of Consumer Protection from Unfair Contract Terms in Musharakah Mutanaqisah Home Financing in Malaysia*, 6 J. Islamic Fin. 231, 231 (2017).

this phenomenon.[24] Furthermore, the standardization of legal documentation in Islamic home financing is essential to ensure the spirit of Islamic contracts is preserved.[25] Enforcement of Islamic finance practices involves dispute resolution mechanisms unique to Islamic finance disputes, which require proper legal frameworks to regulate and resolve conflicts.[26] Alternative dispute resolution, including arbitration, plays a significant role in addressing disputes related to Islamic banking and finance.[27] Moreover, the comparative analysis of *sukuk* (Islamic financial certificates/bonds) default regulation in different jurisdictions highlights the challenges posed by uncertainties in legal regimes and *shari'a* interpretations.[28]

II. Overview and Definition of Islamic Banking and Finance

Islamic banking can be defined in two distinct ways. In a narrow sense, it refers to banking practices that do not involve the charging of interest. In a broader perspective, Islamic banking is characterized by adherence to the principles of *shari'a* and Islamic governance. A more comprehensive definition of Islamic banking and finance entails the operation of financial institutions in accordance with the Quranic verses and *shari'a* laws governing financial transactions.[29] This sets Islamic banking apart from traditional or conventional banking practices. Islamic finance is a branch of Islamic banking system which adheres to *shari'a* or Islamic law and its underlying principles. Contrary to the simplistic notion that Islamic finance is solely synonymous with an interest-free finance system, a more nuanced understanding recognizes that Islamic finance incorporates, at least, one of the following elements: prohibition of *riba* (interest), a fundamental concept in Islamic banking, which pertains to the prohibition of both the payment and receipt of interest, and *gharar* (uncertainty and speculation).[30]

24. Umar Aimhanosi Oseni, Abu Umar Faruq Ahmad & M. Kabir Hassan, *The Legal Implications of 'Fatwā Shopping' in the Islamic Finance Industry: Problems, Perceptions and Prospects*, 30 Arab L.Q. 107 (2016).

25. Syarah Syahira Mohd Yusoff & Umar Aimhanosi Oseni, *Standardisation of Legal Documentation in Islamic Home Financing in Malaysia*, 10 J. Islamic Acct. & Bus. Rsch. 448, 448–50 (2019).

26. Aishat Abdul-Qadir Zubair, *An Analysis of Dispute Resolution Mechanisms in the Islamic Banking and Finance Industry in Malaysia*, 11 J. Hukum Novelty 164, 166–70 (2020). The authors discuss further the court system, *id.* at 166–170, and discuss arbitration specifically, *id.* at 171–74.

27. Nur Khalidah Dahlan, *Alternative Dispute Resolution for Islamic Finance in Malaysia*, 150 MATEC Web Conf. 05077 (2018).

28. Saheed Abdullahi Busari, Luqman Zakariyah & Akhtarzaite Binti Abdul Aziz, *Sukuk Default Regulation in Malaysia and United Arab Emirates: Comparative Analysis*, 3 Int'l J. Fiqh & Usul al-Fiqh Stud. 90, 90 (2019).

29. Ibrahim Warde, Islamic Finance in the Global Economy (Edinburgh Univ. Press 2000).

30. Ahmed Abdel Aziz El-Nagar, One Hundred Questions & One Hundred Answers Concerning Islamic Banks at 20 (Int'l Ass'n of Islamic Banks 1980).

Islamic finance principles strictly forbid engagement in any unethical means that contravene the foundational principles of Islam. This underscores the holistic nature of Islamic finance, extending beyond the mere avoidance of interest to encompass a commitment to ethical conduct in financial transactions. The primary emphasis of these institutions is on engaging in *halal* activities, which, as per the Cambridge Dictionary, literally means activities that are "correct according to Islamic law."[31] In essence, Islamic banking institutions prioritize conducting financial operations and transactions that align with the principles outlined in Islamic law, ensuring that their activities are in accordance with the ethical standards prescribed by Islam. Before delving further into the domain of Islamic finance and banking, it is essential to comprehend the two main elements of the system.

The first element is the risk-sharing philosophy of Islamic finance, which stands in stark contrast to conventional banking practices. Unlike conventional banking, where the lender is assured a fixed interest return on the amount provided, the Islamic finance system views this as a form of exploitation and considers it unproductive for society. Instead, the Islamic financial system advocates for the concept of Profit and Loss Sharing (PLS) between the parties involved. In this arrangement, both the lender and the borrower mutually agree to share the rewards and losses of an investment, promoting a more equitable distribution of financial outcomes.

The second crucial element involves the promotion of economic and societal development through the implementation of incentives and bonuses, known as *zakat* (almsgiving)[32]. *Zakat* is a form of charity mandated for every Muslim, amounting to 2.5% of the wealth possessed above the *nisab* threshold. The *nisab*, equivalent to 85 grams of 24k gold[33], represents the minimum amount of wealth one must have before becoming liable to pay *zakat*. This obligatory contribution aligns directly with the broader objectives of Islamic finance, namely the promotion of social equity, economic justice, and equitable wealth distribution

In the realm of Islamic banking, many institutions retain a *shari'a* board composed of Islamic scholars in an advisory role. These advisors play a crucial role in guiding the bank on the adoption of new financial instruments and conducting regular audits of bank activities.[34] In essence, while conventional finance seeks to maximize profit within a given framework, Islamic finance is guided

31. *Halal,* Cambridge Dictionary*, https://dictionary.cambridge.org/dictionary/english/halal* (last visited Jan. 21, 2024).

32. Ibrahim, *supra* note 29.

33. Waqas Suboor, *A Beginner's Guide on How to Calculate Zakat*, What a Relief Blog (May 6, 2020), *https://blog.islamicreliefcanada.org/just-for-you/how-to-calculate-zakat/* (last visited Jan. 21, 2024).

34. Muhammad Bayu, *The Role of the Sharia Supervisory Board and the Size of the Islamic Bank on the Performance of Sharia Banks in Indonesia*, 3 J. Mgmt. & Islamic Fin. 108, 110 (2023).

and inspired by religious goals. Defining Islamic finance is a difficult task, but it generally involves criteria such as ownership by a Muslim adhering to *shari'a* principles and association with international bodies like the International Association of Islamic Banks. If the definition is limited to entities explicitly incorporating the term "Islamic" in their names, it would exclude examples such as the Turkish Finance House and Al Rajhi Banking of Saudi Arabia, both of which operate based on the Profit and Loss Sharing (PLS) system of finance.[35]

III. Distinctive Features of Islamic Banking

The primary distinguishing characteristic of an Islamic bank is the prohibition of fixed profit in the form of interest or *riba*, where the rate of increase is predetermined by the banks. There exists a common misconception that the Islamic finance system and banks, by prohibiting interest on loans, fail to acknowledge the time value of money. However, this notion is inaccurate. Islamic scholars do recognize the value of time in monetary transactions, albeit within certain limits.

The underlying principle is that simply holding onto money does not inherently generate additional wealth. Rather, wealth accrues through investment in economic activities. For example, when an individual invests money in a business venture or economic endeavor, they may realize either profit or loss. In Islamic finance, this outcome is considered fair compensation for active participation.[36]

Conversely, lending money without any form of participation is viewed as fulfilling the Islamic obligation of charity, rather than solely an act of goodwill. Exploiting the financial vulnerability of borrowers through such lending practices is strongly condemned within Islamic finance principles. The Quran unequivocally prohibits any unjust claim on another person's property and distinguishes between two types of property claims: those acquired through labor and resources, and those obtained through fair exchanges, grants, or inheritance.[37] Money, as a representation of these rights, must adhere to the principle that only the amount lent can be rightfully claimed back. Seeking an additional portion beyond the initial loan amount unlawfully encroaches upon the borrower's rights.

Islamic scholars argue against *riba* on the basis that conventional economic theories fail to provide a satisfactory explanation for interest, and there are no legitimate grounds for the lender to benefit from a fixed amount regardless of the outcome of the borrower's use of the money. In the conventional system of banking and finance, two typical arguments in favor of interest are that it serves as a reward for saving and reflects the marginal productivity and time value of

35. Ibrahim, *supra* note 29.

36. Hossein Askari, Zamir Iqbal & Abbas Mirakhor, Introduction to Islamic Economics: Theory and Application 83–85 (John Wiley & Sons ed., 2015).

37. Al-Ghamadi, *Verse (2:188) – English Translation*, The Quranic Arabic Corpus, https://corpus.quran.com/translation.jsp?chapter=2&verse=188.

capital.[38] However, Islamic scholars counter these arguments by asserting that rewarding saving alone does not involve active investment, and interest is not directly linked to the productivity of capital. They argue that interest is based on the amount lent to the borrower rather than the actual productivity of the invested capital. Therefore, Islamic finance advocates for a system where rewards are earned through active investment and its resulting productivity.

In Islamic banking, alternatives such as profit and loss sharing, along with the sale and purchase of goods and services, are embraced. Moreover, charging a fee for services provided is also permissible. In the Islamic banking concept of sale and resale, profit is generated through a markup determined on the sale, similar to the the London Interbank Offered Rate (LIBOR), a benchmark interest rate at which major global banks lend to one another in the international interbank market. This markup on the resale constitutes the profit of the bank.[39]

Another feature of Islamic banking is offering a range of contracts depending on the rights of investors in project management and the timing of cash flow. Islamic banks are prohibited from trading in financial risk (which is seen as a form of gambling) and investing in goods and services prohibited by *shari'a.*[40]

IV. Risk Sharing

In Islamic banking, risk-sharing in economic activities, where parties collectively bear the risks of investment, takes precedence over traditional interest-based contracts. In such economic endeavors, all involved parties share both the losses and gains of pursued activities. Islam emphasizes sharing risks with those in need, such as the poor and disabled, to facilitate their stability without having them resort to borrowing money. Moreover, Islam strongly discourages the hoarding of wealth and promotes using wealth to support the economy and society as a whole. This approach views wealth not merely as something to accumulate, but as a resource to strengthen communities and aid those in need.[41]

Non-circulation of wealth acts as a blockage in the economic system, preventing wealth from reaching where it needs to in order to foster growth. Islam suggests a system where all parties involved in the economic activity share the risk rather than one bearing all the loss and the other gaining reward in the form of interest. In an ideal Islamic financial system, there would be a wide range of tools compatible with Islamic principles. These principles stem from the Quran and were implemented by the Prophet Mohammad. The primary objective of these financial tools would be to distribute risk evenly among all parties involved, rather than allowing the borrower to solely accumulate wealth. This ensures that

38. Ustaoğlu, *supra* note 8.

39. Martin Čihák & Heiko Hesse, *Islamic Banks and Financial Stability: An Empirical Analysis* at 3 (IMF Working Paper, Paper No. 08/16, 2008).

40. Mohamed Ariff, *Islamic Banking*, Asian-Pac. Econ. Literature 48 (1988).

41. Askari et al., *supra* note 36.

risk is shared equitably among all stakeholders.[42] Islam proposes three methods of risk sharing:

1. Risk sharing tools in the financial sector;
2. Redistributive risk sharing instruments through which the economically more able segments of society share the risks facing the less able segment of the population; and
3. The inheritance rules specified in the Quran through which an individual's wealth at the time of death is distributed among present and future generations of inheritors.

Another set of instruments aim to rectify societal imbalances by redistributing wealth away from those with abundance to those in need. Unlike acts of charity, these instruments focus more on fulfilling societal obligations and ensuring that everyone receives what they are entitled to. This method centers on addressing inequalities and ensuring fair resource distribution. In the Holy Quran, exchange contracts (*bay*) are permissible and *riba* is impermissible.[43] This verse forms the foundation of Islamic economic theory and establishes guidelines for conducting economic activities in accordance with Islamic principles.[44] Most translations of the Quran render *bay* as "trade," while *tijarah* is often translated as "commerce" or "trade" as well. However, a closer examination of Arabic lexicons reveals a significant distinction between *bay* and *tijarah*. According to the Quran, trade contracts (*tijarah*) are made with the expectation of making a profit (*riba*). Conversely, contracts of exchange (*bay*) involve swapping property without a profit motive. In modern economic terms, this is understood as the exchange of property rights claims. Moreover, those engaging in exchange contracts anticipate gains but are also cognizant of their potential for losses (*khisarah*).

In Islamic contracts, except for immediate exchanges, time is an important factor. Whenever time is part of a transaction, uncertainty arises, which can lead to risk and multiple potential outcomes. For instance, if a seller commits to delivering a product in the future in exchange for payments made today, both the buyer and the seller face risks. One significant risk is price: the future price of the product may be higher or lower than today's price. By entering into the contract, both parties agree to share this price risk. If the future price rises, the buyer benefits, but if it falls, the seller benefits. Additionally, other risks exist including late delivery or disappointing quality. The seller may also encounter risks like the future price increases of raw materials or higher transportation costs. Once again, these risks are shared through the contract agreement. Even though buying

42. Zamir Iqbal & Abbas Mirakhor, An Introduction to Islamic Finance: Theory and Practice 38–39, 49–50 (John Wiley & Sons ed., 2nd ed. 2011).

43. *The Quran*, Surah Al-Baqarah, 2:275.

44. Iqbal & Mirakhor, *supra* note 42, at 103–05.

and selling commodities for immediate payment may appear to be risk-free, both parties still risk the possibility of price fluctuations post transaction.

In addition, sellers that specialize in particular goods or services can yield trade advantages; yet, it can also render dependency on others for non-specialized items, thereby introducing additional risks. Prior to the exchange of goods, risks associated with production and transportation are inherent, and these perils are distributed throughout the exchange process. In Islamic finance, contracts such as *mudharabah* and *musharakah* underscore the significance of profit and loss sharing among parties, a concept divinely mandated through the Quranic stipulation of exchange.

The prohibition of *riba* stems from its lack of risk-sharing options for both the lender and borrower. Proponents of interest may argue that the lender assumes the risk of the borrower defaulting on repayment, but this risk alone does not render the transaction permissible. Even in gambling, where there exists a risk of gain or loss, Islam prohibits such activities. *Riba* unfairly shifts all the risk onto the borrower, rather than onto both parties equally.[45] The prohibition of the contract of *riba* and promotion of *bay* is mentioned in the Quran: "They say that indeed an exchange transaction (*bay*) is like *riba* [interest-based] transaction. But Allah has permitted exchange transactions and forbidden interest-based transactions."[46]

Another implication of Islamic risk-sharing contracts arises from the investor's profit deriving directly from the business's operations. Here, the borrower's primary focus shifts to production and distribution rather concern about fixed interest rates eating into potential profits. Borrowers can concentrate on generating income initially. They can then share a fixed portion of the profits with their investors. Engaging in exchange contracts enables individuals to specialize in their areas of expertise and share risks associated with production, transportation, marketing, and sales. From an economic perspective, the Quran encourages risk-sharing while prohibiting risk shedding, transfer, and shifting. Islam's principle of risk sharing promotes a fair and stable financial system where risks are equitably distributed among participants.[47]

V. Operation of Islamic Banks Compared to Conventional Banks

The number of Islamic banks is rapidly growing; however, their prevalence still lags behind traditional banks, even in countries with a Muslim-majority population, such as Indonesia.[48] Nevertheless, Islamic banks are gaining widespread

45. Kabir Hassan & Mervyn K. Lewis, Handbook of Islamic Banking 2–3 (Edward Elgar ed., 2007).

46. *The Quran*, Surah Al-Baqarah 2:275.

47. Hassan & Lewis, *supra* note 45.

48. Kym Brown, M. Kabir Hassan & Michael Skully, *Operational Efficiency and Performance of Islamic Banks*, Handbook of Islamic Banking 96, 96 (2007)

acceptance, as the Islamic Finance Market is anticipated to register a Compound Annual Growth Rate (CAGR) exceeding 10% during the 2024–2029 forecast period.[49] Conventional banks are acknowledging the rapid growth of Islamic banking, prompting them to integrate Islamic financial practices into their lending procedures or establish dedicated Islamic banking departments. The primary distinction between an Islamic bank and a traditional bank lies in their overarching objectives. Islamic banks aim to adhere to Quranic principles that align with Islamic law, while traditional banking centers around financing lucrative ventures through interest-based lending.

Conventional banks typically require the borrower to bring capital or collateral before being granted a loan; in contrast, Islamic banks focus on the ethical nature of the project rather than tangible assets. Furthermore, while conventional banks charge interest regardless of the profitability of the project, Islamic banks avoid *riba* altogether and engage in a profit and loss sharing arrangement, aligning the client's interests with their own. This collective approach fosters long-term relations with the client and ensures the client's project is intertwined with the bank's own success.[50] Similar to conventional banks, Islamic banks can maintain both a banking and trading book, enabling them to engage in off-balance sheet activities such as letters of credit, foreign exchange transactions, and financial advising.

Regarding funding, Islamic banks rely on customer deposits. Unlike conventional banks, Islamic banks do not offer interest-based rewards on deposits but rather use deposits for liquidity purposes i.e., to ensure the bank maintains sufficient cash reserves to meet short-term obligations and customer withdrawal requests. However, savings account holders may receive a reward, or a gift (*hiba*), for their investments. Additionally, Islamic banks provide investment accounts that offer potentially higher returns but also entail the risk of loss, often with a specified time requirement, typically ranging from one month to five years, during which the depositor agrees not to withdraw funds. Furthermore, Islamic banks offer customized accounts for large investors, where funds are allocated to specific projects and rewards are based on the project's performance. Overall, Islamic banks offer off-balance sheet (financial activities not recorded directly on the bank's balance sheet, such as letters of credit, guarantees, and foreign exchange transactions) activities in compliance with *shari'a* law, while also prohibiting *riba*.[51]

Islamic banks adhere to an ethical investment charter: investment in industries like pornography, alcohol, and gambling are prohibited. Moreover, Islamic

49. *Islamic Finance Market Size & Share Analysis - Growth Trends and Forecast (2025–2030)*, Mordor Intelligence, *https://www.mordorintelligence.com/industry-reports/global-islamic-finance-market* (last visited Feb. 3, 2024).

50. *See supra* note 43.

51. *See supra* note 43.

banks consider social responsibility to be integral to their operations. Like corporate social responsibility, this notion of social responsibility mandates *zakat*, which entails bank donations for charitable purposes and is reflected in banks' financial statements. Thus, for Muslim consumers, the appeal of Islamic banking lies in its adherence to religious beliefs.

By engaging in financial activities with Islamic banks, Muslims can ensure that their financial transactions comply with Quranic rules, which is imperative for many Muslim consumers. The "*shari'a* board" in these banks, comprising of Islamic scholars, oversees and approves banking practices. Islamic banking represents a significant stride towards realizing the principles of Islamic economics, contrasted with conventional banking, which utilizes interest-based financial systems. While Islamic banking prioritizes social justice and welfare aligned with *shari'a* objectives, conventional banking is primarily profit oriented.

In Islamic banking, the flow of financial resources tends to favor the poor and disadvantaged, whereas conventional banking's financial flow does not. Moreover, Islamic banking aims to reduce income inequality and wealth disparity through investment plans tailored to benefit the less fortunate, whereas conventional banking tends to widen this gap by catering primarily to the wealthy.

Islamic banking adheres strictly to *shari'a* principles, ensuring investments comply with legitimate criteria, while conventional banking lacks such regulations. Islamic banks implement investment plans like *mudharabah* and *musharakah* to uplift those below the poverty line, a feature absent in conventional banking. Interest and usury are strictly avoided in Islamic banking, unlike conventional banking where they form the basis of financial transactions.

Additionally, Islamic banking fosters a cooperative relationship between depositors and entrepreneurs, focusing on socially needed investment projects and eliminating exploitation on interest-based loans. Islamic banks also bear a partnership role in client businesses and absorb losses, contrasting with conventional banks' ex-ante commitment to avoid losses.

Islamic banking is firmly committed to welfare-oriented financing principles, in contrast to conventional banking's lack of such commitment. Islamic inter-bank transactions operate on a profit and loss sharing basis, while conventional banking transactions rely on interest, leading to speculative bubbles.

Islamic banks operate under the supervision of *shari'a* supervisory Boards to ensure compliance with Quranic principles, while conventional banks lack such oversight. Due to the brotherly relationship between Islamic banks and customers, there is a lower rate of moral hazard compared to conventional banking, where transactions are purely monetary driven. Lastly, Islamic banking prohibits speculation-related financial activities, whereas conventional banking's main functions often involve speculation.

VI. Conclusion

In conclusion, Islamic banking represents a paradigm shift in the world of finance, embodying principles deeply rooted in Islamic law and ethics. It encompasses not only the prohibition of interest but also a broader commitment to ethical conduct, risk-sharing, and societal welfare. Unlike conventional banking, Islamic finance operates on principles of fairness, justice, and mutual benefit.

One of the fundamental distinctions of Islamic banking is its adherence to *shari'a* principles, which guide every aspect of Islamic financial transactions. This adherence is overseen by *shari'a* supervisory Boards comprised of Islamic scholars. Moreover, Islamic banking fosters a sense of partnership between depositors and entrepreneurs, which promotes investment in socially beneficial projects and minimizes the exploitation inherent in interest-based lending.

Another hallmark of Islamic banking is its emphasis on risk sharing. Instead of transferring risk solely to borrowers, Islamic finance advocates for a shared risk and reward, promoting a more equitable distribution of financial outcomes. This not only aligns with Islamic principles but also encourages a more stable and sustainable financial system.

Furthermore, Islamic banking places a strong emphasis on social welfare. Through mechanisms such as *zakat* and ethical investment criteria, Islamic banks contribute to reducing income inequality and promoting economic justice. By adhering to these principles, Islamic banking serves not only individual financial needs but also promotes the broader goals of societal welfare and prosperity.

In essence, Islamic banking represents a holistic approach to finance, integrating religious principles with economic practices to create a system that prioritizes ethical conduct, fairness, and social welfare. As the global Islamic finance market continues to grow, Islamic banking stands as a testament to the compatibility of religious values with modern financial systems, offering a viable alternative to conventional banking that resonates with the beliefs and principles of millions around the world.