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DIVERGENT PARADIGMS: A COMPARATIVE APPRAISAL OF OPERATIONAL MECHANICS AND RISK-SHARING IN ISLAMIC AND CONVENTIONAL BANKING.

1. Dr Abdul Waheed Memon
Assistant Professor Islamic Studies,Sukkur IBA University,BBSIMS Dadu Campus.
Email: abdulwaheed.dd@iba-suk.edu.pk.
2. Ejaz-ur-Rehman
Lecturer, Al Ghazali University.
Email: ijazfinance@gmail.com.
3. Syed Ali Abbas Abidi
Assistant Professor Shaheed Zulfiqar Ali Bhutto University of Law karachi

Abstract
This study provides a comprehensive comparative appraisal of the operational principles and risk-sharing paradigms within Islamic and conventional banking systems. Moving beyond theoretical descriptions, the research evaluates the systemic divergences between debt-based and equity-based intermediation, focusing on fiduciary stewardship, $Riba$-free capital usage, and Shari'ah-compliant governance. A specific focus is placed on the Pakistani dual-banking sector to analyze the gap between theoretical ideals and market realities. The findings reveal that while functional convergence is appearing in areas of Corporate Social Responsibility (CSR), profound systemic gaps remain in risk management and asset-liability parity. This research concludes that the Islamic model offers a resilient, asset-backed alternative to conventional debt-centricity. It proposes a "Collaborative Paradigm" integrating ethical risk-sharing with modern financial infrastructure as a blueprint for financial innovation and stability in emerging global markets.

Keyword: Islamic Banking , Maqāsid al-Shari'ah, Shariah Governance, Financial Stability, Risk-Sharing, Pakistan Banking Sector.

Introduction
Banking institutions form an important part of the international financial structure which is able to play the key role of driving the global economic growth. Whereas the traditional banking (CB) model has been the most dominant landscape, the Islamic banking (IB) has become a strong competitor. The Islamic model is based on the Shariah ethical and legal prescriptions and this makes it appealing to a wide range of people in the world, regardless of their religious affiliations[1]. IB, which is currently functioning in over eighty jurisdictions, has shown a high presence in dual-banking systems especially in the Southeast Asian and the Gulf Cooperation Council (GCC) regions where IB windows in traditional frameworks act as an interface to capital mobilization.[2].

Islamic financial operating philosophy is a paradigm shift opposite to the standard paradigm. The greatest point of disagreement is the absolute ban on Riba (usury) and compulsory application of profit-and-loss sharing (PLS) structures[3]. Furthermore, the IB framework is

[1]Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 2021. Shari'ah Standards. Manama: AAOIFI. https://www.aaoifi.com.
[2] Abdelsalam, Omneya, Marilyne Fethi, José Matallín, and Emili Tortosa-Ausina. 2014. "On the Comparative Performance of Socially Responsible and Islamic Mutual Funds." Journal of Economic Behavior & Organization 103: S108–S128.
[3] Aderemi, Abdullateef, and Mansur Ishak. 2023. "Qard Hasan as a Feasible Islamic Financial Instrument for

distinguished by specialized governance structures, unique asset-backed investment vehicles, and a distinct regulatory landscape designed to ensure Shari'ah compliance[4]. These core principles do not merely satisfy ethical requirements; they have been empirically linked to heightened resilience during global economic downturns, largely due to the system's inherent insulation from high-frequency speculative risks[5].

Contextual Relevance: Pakistan's Dual Banking Framework

Pakistan represents one of the most developed dual-banking systems among Muslim-majority economies. Under the regulatory supervision of the State Bank of Pakistan (SBP), Islamic banking has expanded significantly through both full-fledged Islamic banks and Islamic windows within conventional institutions. According to SBP Islamic Banking Bulletins, the sector has demonstrated consistent growth in assets, deposits, and branch networks, reflecting increasing public confidence in Shari'ah-compliant financial services. Despite this growth, structural challenges persist, including limited public understanding of profit-and-loss sharing mechanisms, heavy reliance on debt-mimicking instruments, and operational convergence with conventional practices. These challenges make Pakistan an especially relevant case for examining whether Islamic banking is achieving its foundational objectives or merely replicating conventional models under contractual restructuring.

Beyond its role as a niche religious alternative, Islamic finance has gained global traction through sophisticated instruments such as Sukuk (investment certificates) and Musharakah (equity partnerships). Despite this growth, a significant deficit remains in the general understanding of IB's internal mechanics, especially within non-Muslim majority markets. This research seeks to address this informational asymmetry by conducting a systematic comparative analysis of the operational principles, product architectures, and performance metrics of both systems. The objective is to provide stakeholders with a comprehensive framework for financial integration and to empower consumers with the analytical tools necessary for informed decision-making in a dual-banking environment.

Research Methodology

This study adopts a qualitative doctrinal research methodology, grounded in comparative analysis of Islamic and conventional banking frameworks. The research relies on secondary data sources, including classical Islamic jurisprudential literature, contemporary academic studies, regulatory guidelines, and international banking standards.

The analytical approach focuses on examining structural mechanisms rather than numerical performance indicators. Key areas of comparison include capital utilization, risk allocation, governance models, product architecture, and ethical mandates. This methodology is particularly suitable for financial systems rooted in normative and legal principles, such as Islamic banking, where operational legitimacy is derived from Shari'ah compliance rather than purely quantitative efficiency.

To contextualize the analysis, selected regulatory practices from Pakistan's dual-banking

Crowdfunding: Its Potential and Possible Application for Financing Micro-Enterprises in Malaysia." Qualitative Research in Financial Markets 15 (1): 58–76.

[4] Al-Augby, S., S. Majewski, K. Nermend, and K. Majewski. 2015. "Islamic Banking System as an Effective Element of Economy." Zeszyty Naukowe Uniwersytetu Szczecińskiego: Finanse, Rynki Finansowe, Ubezpieczenia 1: 7–18.

[5] Ali, Salman. 2004. "Islamic Modes of Finance and Associated Liquidity Risk." Paper presented at the Conference on Monetary Sector in Iran: Structure, Performance and Challenging Issues, Tehran, Iran.

environment particularly guidelines issued by the State Bank of Pakistan (SBP) are incorporated where relevant. This enables the study to bridge theoretical foundations with institutional realities, offering a comprehensive understanding of how divergent banking paradigms operate within emerging economies.

2. FUNCTIONAL CONVERGENCE: SHARED CHARACTERISTICS OF IB AND CB

2.1 Roles as Financial Intermediaries

Despite their divergent theological foundations, both Islamic and conventional banking systems function as the primary engines of economic facilitation. Both frameworks provide essential financial services, including credit mobilization for corporate operations, mortgage financing, and the issuance of securities to support market liquidity. While their methods differ, their macroeconomic objectives are aligned: fostering economic stability and achieving institutional profitability[6]. Both systems act as intermediaries that bridge the gap between surplus units (savers) and deficit units (investors), ensuring the efficient flow of capital within the global economy.

2.2 Global Proliferation and Cross-Border Viability

A significant contemporary trend is the geopolitical expansion of Islamic finance into traditional Western economies a phenomenon that represents a major shift in the global financial landscape. This growth is propelled by an escalating demand for ethical and Shari'ah-compliant instruments, leading many central banks to integrate Islamic "windows" within existing conventional structures to capture this burgeoning market[7].

Furthermore, the appeal of IB is no longer geographically or religiously confined to Muslim-majority jurisdictions. It is increasingly viewed as a competitive alternative to conventional banking, attracting a diverse global clientele due to its focus on asset-backed stability[8].

Both systems are characterized by open-access shareholder models, welcoming participation from various cultural and ethnic backgrounds. For example, the strategic initiatives in the United Kingdom to position London as a premier global center for Islamic finance highlight how conventional markets are actively diversifying their portfolios by incorporating Islamic banking subsidiaries and foreign participations[9].

2.3 ETHICAL CONGRUENCE: CORPORATE SOCIAL RESPONSIBILITY (CSR)

2.3.1 CSR as a Strategic Fiduciary Mandate

Modern banking institutions increasingly view Corporate Social Responsibility (CSR) not merely as a philanthropic gesture, but as a core strategic mandate essential for fostering long-term stakeholder trust. Both Islamic and conventional banks are under escalating pressure to

[6] Aris, Norashikin, Roszaini Othman, Radziah Azli, Mohd Sahri, Dzuljastri Razak, and Zulkifli Rahman. 2013. "Islamic Banking Products: Regulations, Issues and Challenges." Journal of Applied Business Research 29 (4): 1145–1156

[7] Ben Amar, Abderrazak, and Abdelkader El Alaoui. 2023. "Profit-and Loss-Sharing Partnership: The Case of the Two-Tier Mudharaba in Islamic Banking." International Journal of Islamic and Middle Eastern Finance and Management 16 (1): 81–102.

[8] Bitar, Mohammad, Kuntara Pukthuanthong, and Thomas Walker. 2020. "Efficiency in Islamic vs. Conventional Banking: The Role of Capital and Liquidity." Global Finance Journal 46: 100487. https://doi.org/10.1016/j.gfj.2019.100487.

[9] Carruthers, S. 2008. "Canada: Islamic Financial Services in Canada: Recent Developments and Long-Term Prospects." Mondaq. Accessed August 22, 2009. https://www.mondaq.com.

adopt socio-environmental policies that prioritize ethical standards over short-term profit maximization[10]. This shift is reflected in contemporary lending and investment criteria, where both systems increasingly avoid financing enterprises that violate fundamental human rights or contribute significantly to environmental degradation[11].

2.3.2 Islamic Banking: CSR through Moral Imperatives

In the Islamic framework, CSR is deeply rooted in the moral imperatives of the Shari'ah, which emphasize social justice, equity, and the preservation of future generations[12]. Historical instruments of social finance such as the mandatory Zakat (almsgiving), Sadaqat (voluntary charity), and Waqf (perpetual endowments) provide a structural basis for addressing socioeconomic disparities. These mechanisms serve as a primary vehicle for funding public infrastructure, healthcare, and educational initiatives, thereby augmenting government efforts in public welfare and contributing to the holistic moral and economic health of the state[13]. The Islamic ethos views the human as a Khalifah (trustee) of the earth, necessitating the responsible management of natural resources and environmental stewardship[14].

2.3.3 Conventional Banking: The Shift toward Sustainability

Parallel to the Islamic model, a global movement has pressured conventional banking institutions to integrate sustainable finance into their operational DNA. CBs are increasingly supporting cultural, educational, and ecological initiatives as part of their broader CSR portfolios[15]. By developing Green Finance products and implementing rigorous ESG (Environmental, Social, and Governance) criteria, conventional banks now play a pivotal role in the global transition toward ecological sustainability and social equity[16]. Consequently, while the theological motivations may differ, the functional outcomes of CSR in both systems are converging toward a shared goal of sustainable global development.

2.4 REGULATORY SYNCHRONICITY AND LEGAL COMPLIANCE

The full scope of macro-prudential regulation of national central banks applies to both the Islamic and conventional banking sector. These regulatory frameworks are aimed at

[10] Chhapra, Imran, Adeel Ahmed, Roohi Rehan, and Faraz Hussain. 2018. "Consumer's Preference and Awareness: Comparative Analysis Between Conventional and Islamic Ijarah Auto Financing in Pakistan." Al-Iqtishad: Jurnal Ilmu Ekonomi Syariah 10 (2): 389–402.
[11] Chiu, S., R. Newberger, and A. Paulson. 2005. "Islamic Finance in the United States: A Small but Growing Industry." Chicago Fed Letter 214: 1–4.
[12] Chong, Beng Soon, and Ming-Hua Liu. 2009. "Islamic Banking: Interest-Free or Interest-Based?" Pacific-Basin Finance Journal 17 (1): 125–144.
[13] Demirgüç-Kunt, Asli, Leora Klapper, and Dorothe Randall. 2014. "Islamic Finance and Financial Inclusion: Measuring Use of and Demand for Formal Financial Services Among Muslim Adults." Review of Middle East Economics and Finance 10 (2): 177–218.
[14] Doumpos, Michael, Iftekhar Hasan, and Fotios Pasiouras. 2017. "Bank Overall Financial Strength: Islamic Versus Conventional Banks." Economic Modelling 64: 513–523. https://doi.org/10.1016/j.econmod.2017.04.012.
[15] Duran, J. J., and M. J. Garcia-Lopez. 2012. "The Internationalization of Islamic Banking and Finance: The Co-Evolution of Institutional Changes and Financial Services Integration." International Journal of Business and Management 7 (13): 49–74. https://doi.org/10.5539/ijbm.v7n13p49.
[16] Dusuki, Asyraf Wajdi, and Nurdianawati Irwani Abdullah. 2007. "Why Do Malaysian Customers Patronise Islamic Banks?" International Journal of Bank Marketing 25 (3): 142–160. https://doi.org/10.1108/02652320710739850.

maintaining the stability of the system, implementing the strictest risk management measures, and providing the complete observance of the laws on the financial spectrum. Nonetheless, Islamic institutions have to inhabit a two-tiered regulatory environment; besides the usual financial regulations, they should comply with Shari'ah regulatory systems requiring operations to be interest-free and have a system of profit sharing.This two-tiered governance is what makes IB equal in terms of international financial regulation at the same time guarded by its own moral core.

Table 1: Comparative Synthesis of Functional Congruence

No.	Domain	Islamic Banking (IB)	Conventional Banking (CB)
1	**Financial Intermediation**	Facilitates economic activity via asset-backed financing and trade-based credit.	Facilitates economic growth through debt-based credit and loan facilities.
2	**Market Reach**	Expanding rapidly in Western and non-Muslim markets through "Islamic Windows."	Dominates the global landscape but is increasingly adopting Shariah-compliant subsidiaries.
3	**Ethical Mandate (CSR)**	Guided by Maqasid (Social Justice), utilizing Zakat, Sadaqat, and Waqf.	Guided by ESG (Environmental, Social, Governance) and sustainability standards.
4	**Regulatory Supervision**	Operates under Central Bank mandates with additional Shariah Board oversight.	Operates under Central Bank mandates and international Basel standards.

3. SYSTEMIC DIVERGENCES: THE CONCEPTUAL DIVIDE

3.1 Paradigms of Capital Usage: Interest vs. Trade

The most profound distinction between the two systems lies in the treatment of capital and the generation of returns. Islamic banking is fundamentally an interest-free system, predicated on the categorical prohibition of Riba (usury). Under Shari'ah law, the accrual or payment of interest is viewed as an exploitative mechanism that unfairly transfers wealth from the borrower to the financier without a corresponding exchange of value[17]. Consequently, IB functions as a trade-oriented institution rather than a mere money-lending entity. Financial decisions are dictated by equity and tangible asset participation rather than the fixed cost of capital. Islamic jurisprudence forbids interest on both commercial and consumer credit, ensuring that financial relationships are based on risk-sharing rather than risk-transfer[18].

3.2 Conventional Banking: The Interest-Centric

Model In contrast, conventional banking is architecturally dependent on interest, which

[17] Ganouati, J., and H. Essid. 2017. "The Sources of Productivity Change and Efficiency in Islamic Banking: Application of Malmquist Productivity Index." Central European Review of Economics & Management (CEREM) 1 (4): 35–68. https://doi.org/10.29015/cerem.586

[18] Ghannadian, Farhad F., and Gautam Goswami. 2004. "Developing Economy Banking: The Case of Islamic Banks." International Journal of Social Economics 31 (8): 740–752. https://doi.org/10.1108/03068290410550652.

serves as its primary revenue stream and funding mechanism. Operating under a capitalistic framework, CB treats money as a commodity that can be rented out for a profit[19]. In this model:

- Guaranteed Returns: Deposit structures, such as savings accounts, offer guaranteed returns through pre-determined interest rates[20].
- Risk Asymmetry: The relationship is strictly between a creditor and a debtor. The bank (investor) is repaid the principal plus fixed interest, while the beneficiary (borrower) remains solely liable for the operational risks associated with the capital's usage[21]

This creates a risk-return decoupling, where the financier's profit is secured regardless of the borrower's business outcome a dynamic that stands in direct opposition to the Islamic profit-and-loss sharing (PLS) ethos.

3.3 SYSTEMIC DIVERGENCES IN RISK AND UNCERTAINTY

3.3.1 Risk-Sharing vs. Risk-Transfer

A fundamental operational distinction lies in the management of financial risk. In the conventional system, risk is treated as a commodity to be transferred or mitigated through interest-based hedging. The bank acts as a lender of capital and expects its return (interest) regardless of the project's success, effectively transferring the majority of operational risk to the borrower[22]. Conversely, Islamic banking is predicated on the principle of Risk-Sharing. In models such as Mudarabah and Musharakah, the bank and the entrepreneur are partners. This alignment of interests ensures that the bank does not profit from the client’s failure, creating a more stable and ethically grounded financial relationship[23].

3.3.2 Uncertainty (Gharar) and Speculation

Islamic jurisprudence strictly prohibits Gharar (excessive uncertainty) and Maisir (gambling/speculation). This operational principle prevents Islamic banks from engaging in highly speculative derivative markets and toxic subprime assets, which were primary drivers of the 2008 global financial crisis[24]. Conventional banking, while regulated, allows for significant speculative trading and derivative contracts that rely on the pricing of risk itself rather than the performance of a physical asset. This Asset-Backing Requirement in IB ensures that every financial transaction is linked to a real, productive economic activity, providing an inherent safety net against systemic financial bubbles[25].

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[19] Haddad, Alice. 2023. "Does the Country’s Religion Affect the Financial Performance of Conventional and Islamic Banks? Comparative Study in the International Framework." Journal of Islamic Marketing 14 (2): 410–434. https://doi.org/10.1108/JIMA-04-2020-0120.

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[21] Hanif, Muhammad. 2014. "Differences and Similarities in Islamic and Conventional Banking." International Journal of Business and Social Sciences 2 (2): 166–174.

[22] Hasan, Maher, and Jemma Dridi. 2011. "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study." Journal of International Commerce, Economics and Policy 2 (2): 163–200. https://doi.org/10.1142/S1793993311000270.

[23] Higgins, Julian P., Douglas G. Altman, Peter C. Gøtzsche, Peter Jüni, David Moher, Andrew D. Oxman, and Jonathan A. Sterne. 2011. "The Cochrane Collaboration’s Tool for Assessing Risk of Bias in Randomized Trials." BMJ 343: d5928. https://doi.org/10.1136/bmj.d5928.

[24] Ismail, H. 2020. "The Legal Basis of Depositor's Fund in Banking Systems: A Comparative Analysis." Beijing Law Review 11 (3): 602–616. https://doi.org/10.4236/blr.2020.113036.

[25] Johnes, Jill, Marwan Izzeldin, and Vasileios Pappas. 2014. "A Comparison of Performance of Islamic and

3.3 THE PROFIT-AND-LOSS SHARING (PLS) PARADIGM

The operational centerpiece of Islamic finance is the Profit-and-Loss Sharing (PLS) model, which functions as a direct alternative to the interest-based intermediation of conventional systems. In this framework, the relationship between the bank and its depositors shifts from a lender-debtor dynamic to a fiduciary partnership[26]. Unlike conventional lenders who transfer nearly all operational risk to the borrower, IB depositors assume the role of equity participants. Consequently, investment accounts in IB offer no guarantee of principal or fixed returns; instead, rewards are contingent upon the actual performance of the underlying venture[27].

While the primary objective of conventional banking remains the maximization of shareholder wealth through fixed interest spreads, Islamic banking seeks to balance profit maximization with the broader Maqasid al-Shari'ah (objectives of Islamic law), focusing on wealth distribution and risk-mitigation through ethical partnership[28]. In the conventional model, the risk of borrower default is borne solely by the beneficiary, while the bank maintains a secure claim on the principal plus interest, a structure that critics argue decouples financial returns from real economic risk.

REGULATORY FRAMEWORKS AND GOVERNANCE STRUCTURES

4.1 Dual-Governance and Shari'ah Oversight

The security and stability of Islamic banking are maintained through a robust, multi-layered regulatory architecture. Given the diversity of legal traditions globally, IB must navigate a dual-governance landscape[29]. In addition to the prudential regulations of national central banks, IB institutions are governed by a Shari'ah Supervisory Board (SSB).

This board of specialized scholars serves as the cornerstone of IB operations, ensuring that every financial product adheres to Islamic legal principles[30]. Furthermore, global standard-setting bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) play a critical role in harmonizing governance, auditing, and accounting practices across jurisdictions[31]. This contrasts with conventional banking, which operates strictly under commercial law and international Basel standards without the requirement for religious or ethical oversight boards[32].

Conventional Banks 2004-2009." Journal of Economic Behavior & Organization 103: S93–S107. https://doi.org/10.1016/j.jebo.2012.06.007.

[26] Ibid (Hasan, Maher, and Jemma Dridi. 2011. "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study." Journal of International Commerce, Economics and Policy 2 (2))

[27] Ismail, H. 2020. "The Legal Basis of Depositor's Fund in Banking Systems: A Comparative Analysis." Beijing Law Review 11 (3): 602–616. https://doi.org/10.4236/blr.2020.113036.

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[32] Ledhem, Mohammed A., and Mohammed Mekidiche. 2020. "Economic Growth and Financial Performance of Islamic Banks: A CAMELS Approach." Islamic Economic Studies 28 (1): 47–62. https://doi.org/10.1108/IES-05-2020-0011.

DEPOSIT STRUCTURES: SAVINGS AND CURRENT ACCOUNTS

The operational mechanics of deposit accounts highlight the final systemic divergence between the two models:

1. **Islamic Banking (IB):** Under the Wadi'ah or Qard principles, current accounts are held for safekeeping; the bank guarantees the principal but provides no interest. Savings accounts are managed via Mudarabah or Musharakah, where depositors allow the bank to invest funds in Shari'ah-compliant ventures. Profits are distributed according to a pre-agreed ratio, while losses are shared in proportion to capital contribution[33].
2. **Conventional Banking (CB):** Operates on the lender-borrower model. The bank creates money by accepting deposits at a low fixed interest rate and lending them out at a higher rate. Fixed deposits (Term Deposits) offer a guaranteed, pre-determined return upon maturity, where interest is viewed simply as the "cost of capital"[34].

7. PRODUCT ARCHITECTURE: EQUITY AND DEBT ALTERNATIVES

7.1 Equity-Based Financing: The Risk-Sharing Core

Islamic banking (IB) distinguishes itself through equity-based models where the financier and entrepreneur share operational risks.

- Muḍārabah: A fiduciary contract between the capital provider (Rabb-ul-Māl) and the manager (Muḍārib). The bank provides the liquidity while the entrepreneur contributes expertise. Financial losses are borne exclusively by the capital provider, while the manager forfeits their labor and time[35].
- Mushārakah: A partnership where multiple parties contribute both capital and management. It is considered the "purest" form of Islamic finance as it aligns perfectly with the prohibition of interest and ensures a direct link between investment and tangible assets[36].

In contrast, conventional banking (CB) relies on a debt-centric model. Investment portfolios are bank-managed with no depositor participation in decision-making. Returns are guaranteed through fixed interest rates, and risk is mitigated through government securities, bonds, and money market instruments options largely unavailable to IB due to their interest-bearing nature[37].

7.2 Trade and Lease Financing: The Debt Alternatives

For customers seeking asset acquisition without interest, IB utilizes trade-based and leasing

[33] Mohanty, A., and A. Saini. 2014. "A Comparison of Islamic Banking and Conventional Banking System in India: A Conceptual Approach." Al-Barkaat Journal of Finance & Management 6 (1): 1–8. https://doi.org/10.5958/2229-4503.2014.00001.6.

[34] Musa, Hussam, and Zuzana Musová. 2010. "Islamic Finance and Banking: Challenges and Perspectives." Paper presented at the 5th International Scientific Conference on Managing and Modelling of Financial Risk, Ostrava, Czech Republic.

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[37] Polychronidou, P., E. Ioannidou, A. Kipouros, L. Tsourgiannis, and G. Simet. 2014. "Corporate Social Responsibility in Greek Banking Sector: An Empirical Research." Procedia Economics & Finance 9: 193–199. https://doi.org/10.1016/S2212-5671(14)00021-0.

contracts:

- Murābaḥah (Cost-Plus): The bank purchases an asset and resells it to the client at a transparent, pre-agreed profit margin. Unlike CB loans, where costs are often obscured in interest calculations, Murābaḥah requires full disclosure of the original cost and the markup[38].
- Ijārah (Leasing): IB exclusively permits operating leases, where the bank maintains ownership and assumes the risk of the asset, charging rent rather than interest. Conventional banking, however, frequently utilizes capital leases, where the risks and rewards of ownership are transferred to the lessee[39].
- Forward Financing (Salam & Istiṣnā'): These facilitate liquidity for agriculture (Salam) and manufacturing/construction (Istiṣnā'). They require upfront payment for future delivery of goods with strictly defined specifications to avoid Gharar (uncertainty)[40]
- **8. SOCIALLY DRIVEN TOOLS AND INSURANCE MODELS**

8.1 Takaful: Mutual Protection vs. Risk Transfer

The Islamic alternative to insurance, Takaful, is rooted in the Quranic principle of mutual assistance (Ta'awun). Participants pool funds into a shared chest to protect each other against loss. Unlike conventional insurance, which is a risk-transfer mechanism where the insurer profits from unpaid claims, Takaful is a risk-sharing model where any surplus is returned to the participants[41]. Furthermore, Takaful funds are strictly prohibited from being invested in non-halal industries, ensuring ethical consistency[42].

8.2 Qarḍ al-Ḥasan: The Benevolent Loan

IB offers Qarḍ al-Ḥasan, an interest-free (and often collateral-free) loan designed for social welfare, such as assisting students or low-income individuals. The bank derives zero financial benefit from this, as the borrower only repays the principal, fulfilling the Shari'ah's mandate for social equity[43].

9. SECURITY MANDATES AND DEFAULT DISCIPLINE

9.1 Collateral Dynamics

In Islamic banking, the requirement for collateral varies based on the contract's risk profile. For non-PLS products (such as Murābaḥah), security is standard practice to mitigate credit risk. However, in equity-based partnerships (Muḍārabah or Mushārakah), collateral is generally discouraged, as it contradicts the spirit of risk-sharing. It is only utilized in exceptional circumstances to protect against willful default or negligence by the entrepreneur[44]. Conversely, conventional banking views collateral as a foundational prerequisite for credit eligibility. The CB model prioritizes borrowers with significant internal savings and tangible

[38] Rafay, Abdul, Ramla Sadiq, and Mobeen Ajmal. 2017. "Uniform Framework for Sukuk al-Ijarah: A Proposed Model for All Madhahib." Journal of Islamic Accounting & Business Research 8 (3): 242–259. https://doi.org/10.1108/JIABR-03-2016-0041.

[39] Rahman, A. 2007. "Islamic Banking & Finance: Between Ideals & Realities." International Journal of Economics, Management & Accounting 15 (2): 149–169.

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[44] Stagg-Macey, C. 2007. An Overview of Islamic Insurance. Kuala Lumpur: ICMIF Takaful.

assets to ensure debt servicing, regardless of the venture's performance[45].

9.2 Penalties and Late Payments

A significant ethical divergence exists in the treatment of overdue payments. Islamic Banking: IB avoids the accrual of additional interest on defaults, as this would constitute Riba. Instead, late payment fees are often applied solely as a disciplinary mechanism to encourage timely fulfillment of obligations. In many jurisdictions, these fees are not recognized as bank income but are diverted to charitable causes to ensure the bank does not profit from a client's hardship[46]. Conventional Banking: CB treats late payment charges as a standard revenue stream. Overdue payments trigger additional interest, providing a financial benefit to the bank and increasing the total debt burden on the customer[47].

9.3 Institutional Implications for Pakistan's Banking Sector

Within Pakistan's financial ecosystem, the dominance of Murābaḥah-based financing and diminishing use of equity-based instruments such as Mushārakah raise critical questions regarding the practical realization of risk-sharing ideals. While regulatory frameworks emphasize Shari'ah compliance, operational pressures, such as liquidity management, capital adequacy requirements, and risk aversion have constrained broader adoption of participatory finance. These realities highlight the need for policy-driven incentives, enhanced Shari'ah governance harmonization, and greater integration between academic research and banking practice. Strengthening capacity-building programs for Islamic finance professionals and expanding public awareness initiatives may play a pivotal role in aligning operational practice with the philosophical objectives of Islamic finance in Pakistan.

10. CONCLUSION

The systematic comparative analysis conducted in this research underscores that while Islamic banking (IB) and conventional banking (CB) share a functional identity as financial intermediaries, they remain architecturally distinct. The core of this divergence lies in the transition from the conventional debt-based interest model to the Islamic paradigm of equity-oriented risk-sharing.By evaluating themes from fiduciary stewardship to default management, this study confirms that IB's reliance on tangible asset-backing and the prohibition of Riba offers a resilient alternative to the speculative risks inherent in conventional frameworks. However, the successful proliferation of IB in dual-banking environments like Pakistan is currently hindered by structural impediments, including a shortage of Shari'ah-trained professionals and a heavy reliance on debt-mimicking instruments.

Looking toward the future, this study proposes a "Collaborative Paradigm" as a strategic solution. By merging the ethical, risk-sharing foundations of Islamic finance with the established scale of conventional banking, institutions can develop hybrid solutions such as Green Sukuk for sustainable infrastructure and income-sharing education funds. Ultimately, bridging the moral foundations of Islamic finance with conventional reach offers a unique opportunity to enhance financial inclusion, providing a blueprint for a sustainable financial future that serves a diverse global society.

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