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COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL FINANCE IN MALAYSIA: A BRIEF VIEW

*Nor Hanim Abd Rahman¹ and Elly Johana Johana²
*norhanim@uitm.edu.my¹ and ellyjohana@uitm.edu.my²

^{1,2}Jabatan Sains Komputer & Matematik (JSKM),
Universiti Teknologi MARA Cawangan Pulau Pinang, Malaysia

*Corresponding author

ABSTRACT

This paper provides a comparative study of Islamic and conventional financial systems, focusing on their distinct philosophies, instruments, and demographic impact. While conventional finance relies on the time value of money and interest-based lending, Islamic finance is governed by Shariah principles, which prohibit Riba (interest) and Gharar (uncertainty). It emphasizes risk-sharing and asset-backed transactions through instruments like Sukuk, Murabahah, and Ijarah. The analysis highlights the sector's growth, now exceeding \$4 trillion in assets, driven by a global Muslim population of two billion and a rising demand for ethical, ESG-aligned investments. Furthermore, it examines the evolution of the industry in Malaysia, explaining the transition from "Islamic Windows" to independent subsidiaries and full-fledged Islamic banks. By contrasting the risk-transfer model of conventional banking with the risk-sharing framework of Islamic finance, the study concludes that the latter offers a stable, transparent, and ethically grounded alternative. This paradigm not only meets religious obligations but also contributes to global financial resilience and social justice through mechanisms like Zakat and Waqaf.

Keywords: *Islamic and Conventional Finance, Riba, Murabahah, Ijarah, Waqaf*

Introduction

In the modern global economy, two distinct financial systems operate side by side: Islamic Finance and Conventional Finance. While both aim to facilitate economic growth and provide liquidity, they are built on fundamentally different philosophies, legal frameworks, and ethical considerations. Understanding these differences is crucial for investors, policymakers, and consumers alike. Malaysia has one of the most advanced Islamic banking systems in the world. The industry evolved from a single pioneer (Bank Islam) to a "window" system in which conventional banks offered Islamic products, and finally to the current structure of full-fledged Islamic subsidiaries.

On Principles and Risk

The core of Islamic finance is built upon the prohibition of Riba (interest), Gharar (uncertainty), and Maysir (gambling), as standardized by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2024). Unlike conventional systems that focus on risk transfer, Shariah-compliant models utilize Shariah maxims to apply moral ethics to modern financial transactions (Mansoori, 2022).

On Demographics and Global Growth

The global demand for Shariah-compliant services is increasingly driven by a demographic transition within the Muslim world, which now represents a significant portion of the global emerging middle class (World Bank, 2024). This growth is not limited to religious practitioners; institutional interest is

rising as Islamic finance increasingly integrates with global Environmental, Social, and Governance (ESG) frameworks (International Monetary Fund [IMF], 2024). Projections suggest that this sector will continue to spur sustainable growth through 2025 and beyond (Standard & Poor's Global, 2025).

On the Malaysian Framework

Malaysia's leadership in the industry is a result of robust Shariah governance and clear operational guidelines established by the central bank (Bank Negara Malaysia, 2023). This regulated environment has allowed for the successful evolution of various banking models, ensuring that Islamic financial institutions remain resilient during periods of global market volatility (Hassan & Lewis, 2023). The key historical milestones:

- 1983: The Islamic Banking Act was passed, leading to the creation of Bank Islam.
- 1993: Bank Negara Malaysia introduced the Islamic Banking Scheme (IBS), allowing conventional banks to open "Islamic Windows."
- 2005 onwards: Following a liberalisation drive, many banks converted their windows into independent Islamic Subsidiaries to ensure a clearer separation of funds.

The following table lists the major licensed Islamic banks in Malaysia and the year they began offering Islamic financing (either as a window, a pioneer, or a full subsidiary):

Table 1. List of Banks Offering Islamic Financing in Malaysia

Ref.	Bank Name	Year Offer Islamic Financing	Note
1	Bank Islam Malaysia Berhad	1983	First full-fledged Islamic bank in Malaysia.
2	Maybank Islamic Berhad	1993	Started as an Islamic window; subsidiary in 2008.
3	Public Islamic Bank Berhad	1993	Started as an Islamic window; subsidiary in 2008.
4	CIMB Islamic Bank Berhad	1993	Started via BCB/Bumiputra window; subsidiary in 2005.
5	Bank Rakyat	1993	Converted into a full Islamic cooperative bank.
6	Bank Muamalat Malaysia Berhad	1999	Established following the merger of BBMB and BOCB.
7	RHB Islamic Bank Berhad	2005	First to convert the window to a subsidiary (March 2005).
8	Affin Islamic Bank Berhad	2006	Incorporated in 2005; officially launched in April 2006.

9	Hong Leong Islamic Bank Berhad	2006	Converted from an Islamic window.
10	AmBank Islamic Berhad	2006	Formed as a subsidiary to manage Islamic operations.
11	Alliance Islamic Bank Berhad	2007	Subsidiary of Alliance Bank Malaysia Berhad.
12	HSBC Amanah Malaysia Berhad	2008	First foreign bank to receive an Islamic subsidiary license.
13	Standard Chartered Saadiq Berhad	2008	Foreign Islamic subsidiary.
14	OCBC Al-Amin Bank Berhad	2008	Foreign Islamic subsidiary.
15	MBSB Bank Berhad	2018	Received a full Islamic banking license in 2018.
16	Al Rajhi Banking & Investment (M)	2006	Foreign-owned full-fledged Islamic bank.
17	Kuwait Finance House (Malaysia)	2005	First foreign-owned Islamic bank in Malaysia.

Core Philosophies and Demographic Reach

The foundational difference between the two systems lies in the treatment of interest, known as *Riba*. In Islamic jurisprudence, money is viewed strictly as a medium of exchange rather than a commodity that can generate wealth on its own. The most significant divergence lies in the "why" behind the money.

Islamic Finance (Shariah-Compliant)

This system is rooted in the principles of Shariah (Islamic law), which are derived from the Quran and the Sunnah (teachings of the Prophet Muhammad). Its core pillars include:

- i. *Prohibition of Riba* (Interest/Usury): This is perhaps the most defining feature. In Islam, money is viewed as a medium of exchange, not a commodity to be sold at a profit (interest). Instead, profit must come from legitimate trade, investment, or services.
- ii. *Prohibition of Gharar* (Excessive Uncertainty/Speculation): Transactions must be clear and transparent, avoiding undue risk or ambiguity that could lead to dispute or unfair gain.
- iii. *Prohibition of Maysir* (Gambling): Speculative activities without a real economic purpose are forbidden.

- iv. *Emphasis on Profit and Loss Sharing (PLS)*: This principle ensures that the financier and the client share the risks and rewards of a venture, promoting a more equitable distribution of wealth. This means that if a business fails, both parties bear the loss, aligning incentives. This ensures that the financier and the entrepreneur are partners in an enterprise, aligning their incentives toward the success of the real economy.

Conventional Finance Principles

Conventional finance operates on a secular, market-driven basis. It utilizes interest as the primary incentive for lending and allows for complex speculative instruments. The "time value of money" is the central tenet, where a dollar today is worth more than a dollar tomorrow due to its potential earning capacity via interest.

Demographic Context

The demographic footprint of these systems is shifting. Conventional finance remains the global standard, serving a vast majority of the world's 8.2 billion people. However, Islamic finance is the fastest-growing sector in the financial world. Originally centered in the Middle East and Southeast Asia (specifically Malaysia and Indonesia), it now serves a global Muslim population of approximately 2 billion. Furthermore, the total assets of Islamic finance now exceed USD4 trillion globally. Ethical investors in Western markets are also increasingly drawn to this model due to its inherent alignment with Environmental, Social, and Governance (ESG) criteria.

Financial Instruments and Risk Management

The operational structures of these systems reflect their underlying values. Islamic finance requires all transactions to be backed by tangible assets, whereas conventional finance often deals in debt-based obligations.

Comparison of Instruments

Islamic institutions utilize contracts such as *Murabahah* (cost-plus financing) and *Ijarah* (leasing). In a *Murabahah* transaction, the bank purchases an asset and resells it to the client at a transparent profit margin, avoiding the concept of interest. Conversely, a conventional mortgage involves a loan where the borrower repays the principal plus interest over time. A critical distinction is found in the capital markets. Conventional bonds represent a debt obligation where the issuer must pay interest. In contrast, *Sukuk* (Islamic certificates) represent partial ownership in an underlying asset or project. The "interest" paid to *Sukuk* holders is actually a share of the profit generated by the asset.

Risk Allocation

Risk management in Islamic finance is rooted in risk-sharing. In a *Musharakah* (partnership) agreement, both the financier and the entrepreneur share the risks of the venture. This differs fundamentally from the conventional model of risk transfer, where interest is charged regardless of the borrower's business

success, effectively shifting the burden of failure onto the borrower while the lender remains protected by collateral.

Governance and Ethical Frameworks

The governance of these systems determines their social impact and long-term stability. Islamic financial institutions are subject to a dual-regulatory layer. In addition to national central bank regulations, they must adhere to the oversight of a Shariah Supervisory Board. This board, comprised of scholars, ensures that all products from savings accounts to complex investment funds remain compliant with religious ethics.

Social Impact and ESG

Islamic finance integrates social welfare through *Zakat* (mandatory almsgiving) and *Waqaf* (charitable endowments). It strictly prohibits investment in "Haram" (forbidden) industries, such as tobacco, gambling, and weapons. While conventional finance has recently adopted ESG frameworks as a voluntary measure to satisfy modern investors, these ethical constraints are mandatory and foundational in the Islamic model. This "built-in" ethics layer often makes Islamic banks more resilient during global financial crises, as they avoid the high-leverage and speculative derivatives that often trigger market collapses.

Next, Figure 1 represents the summary of the two concepts, the Islamic Finance versus the Conventional Finance, while Table 2 lists the comparison of Islamic and Conventional Finance in terms of the Principles, Structures, and Demographics of major licensed Islamic banks in Malaysia:

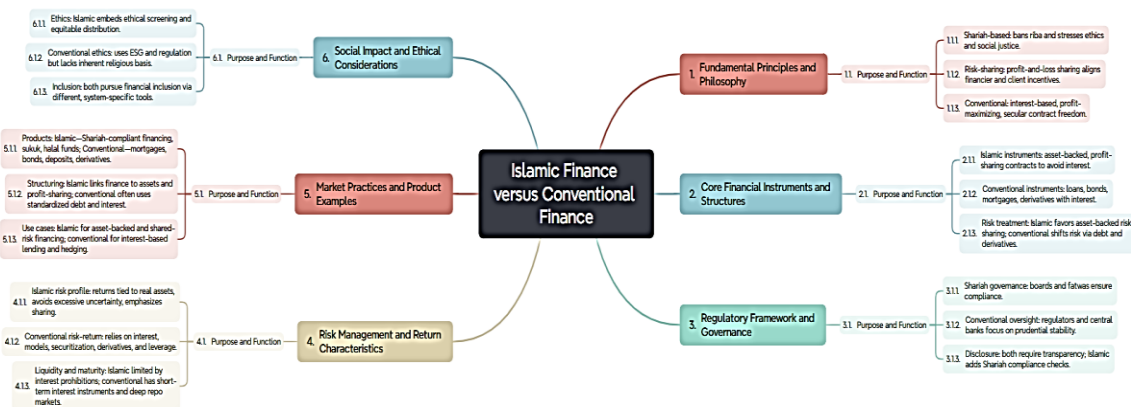


Figure 1. Summary using mind-map: Islamic Finance versus Conventional Finance

Table 2. Comparison of Islamic and Conventional Finance (Principles, Structures, and Demographics)

Feature	Islamic Finance	Conventional Finance
Core Principle	Shariah-compliant, ethical, social justice, risk-sharing	Profit maximisation, time value of money, risk transfer
Interest (Riba)	Prohibited	Core component, charged on loans and deposits
Speculation (Gharar/Maysir)	Prohibited/Restricted (focus on real assets)	Allowed, derivatives are widely used for speculation
Asset Backing	Mandatory, transactions linked to tangible assets/services	Not always mandatory, can be purely debt-based
Key Instruments	<i>Murabahah, Ijarah, Musharakah, Mudarabah, Sukuk</i>	Loans, mortgages, bonds, shares, derivatives
Risk Bearing	Shared between the financier and the client	Primarily borne by the borrower (interest paid regardless of profit)
Governance	Shariah Supervisory Board (additional layer)	Regulatory bodies (Central Banks, Financial Authorities)
Ethical/Social Focus	Inherent ESG, <i>Zakat, Waqf</i> , and the prohibition of 'Haram' investments	Often an 'add-on' through ESG funds, profit-driven
Target Demographics	Global Muslim population, ethical investors	Global population
Market Share (Approx.)	~\$4 trillion assets (growing)	~\$300 trillion assets (dominant)

Conclusion

While conventional finance provides the liquidity and scale necessary for global trade, Islamic finance offers a better alternative that focuses on stability, equity, and ethical responsibility. As the global Muslim population continues to grow and the demand for socially responsible investing rises among all

demographics, the integration of Islamic financial principles into the mainstream global market is likely to accelerate.

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