

Comparison of Islamic and Conventional Financial Systems: Advantages, Disadvantages and Integration Prospects

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ABSTRACT

This study compares the Islamic and conventional financial systems, highlighting their advantages, disadvantages, and prospects for integration. While conventional finance offers flexibility, product diversity, and accessibility, it is prone to financial instability and may contribute to socioeconomic inequalities. In contrast, Islamic finance emphasizes ethics, fairness, and stability through risk-sharing and asset-backed transactions, but faces limited product availability and regulatory challenges. Integrating both systems can enhance financial inclusion, promote ethical finance, and foster economic sustainability. This study suggests that regulatory support, infrastructure development, and public awareness are key to successful integration

INTRODUCTION

The financial system plays a crucial role in the global economy, with two primary approaches often discussed: the Islamic financial system and the conventional financial system. These two systems are fundamentally different in their underlying principles, which significantly impact their operations and outcomes. The Islamic financial system is governed by Shariah (Islamic law), which prohibits *riba* (interest), *gharar* (uncertainty), and *maysir* (speculation), emphasizing justice, ethical investment, and social welfare (Harun & Kasri, 2022). On the other hand, the conventional financial system is based on interest rates and free market mechanisms that aim to maximize profit, often without direct ethical considerations.

Islamic finance has witnessed substantial growth in various countries, including Indonesia, where it has been integrated into the national financial sector. This system prioritizes profit-and-loss sharing mechanisms, such as *mudharabah* (profit-sharing) and *musyarakah* (partnership), ensuring that both banks and customers share risks and rewards (Shaikh, 2025). Conversely, the conventional financial system, which dominates most global economies, follows a business model reliant on debt-based instruments and interest-bearing transactions. Despite its efficiency in capital allocation, this system has been criticized for its role in fostering financial instability, as evidenced by the 2008 global financial crisis, which exposed the risks of excessive leverage and speculation (Musari & Hidayat, 2023).

A notable advantage of Islamic finance is its focus on stability and ethical considerations, promoting fairness and reducing financial crises through risk-sharing and asset-backed transactions (Daoulhadj & Hussin, 2023). In contrast, conventional finance has been effective in rapid economic expansion but is often susceptible to financial bubbles and crises. This distinction highlights the growing interest in integrating the two systems to create a more resilient and inclusive financial model (Sakuntala et al., 2025). The push for Islamic green finance also demonstrates how Islamic finance can contribute to sustainable economic development by aligning financial activities with environmental and social governance (ESG) principles (Billah et al., 2024).

This discussion aims to provide a comprehensive comparison between Islamic and conventional financial systems, exploring their strengths and weaknesses while assessing the potential for integration. As ethical finance gains increasing global attention, understanding these two models becomes essential for policymakers, academics, and financial practitioners. The need for stability, inclusivity, and ethical governance in finance suggests that a hybrid approach combining elements of both systems could offer long-term economic benefits (Sharif & Daud, 2024).

LITERATURE REVIEW

Conventional Financial System

The conventional financial system is based on free-market economic principles, with the primary objective of maximizing profit. It encompasses various financial instruments, including interest rates, bonds, stocks, and

derivatives, all of which play a crucial role in allocating resources and facilitating economic transactions (Bonilla et al., 2022).

One of the core elements of the conventional financial system is the interest rate mechanism, which serves as a compensation for the risk of lending. Financial institutions, particularly banks, determine interest rates based on market conditions, supply and demand for credit, and inflationary expectations (Shirai, 2023). These rates significantly influence economic growth, as they affect borrowing costs for businesses and individuals. Central banks regulate interest rates to control inflation, stabilize financial markets, and support economic development (Lannoo & Thomadakis, 2024).

Additionally, derivatives – such as futures, options, and swaps – are widely utilized for risk management and speculative purposes. These instruments enable investors to hedge against fluctuations in interest rates, exchange rates, and commodity prices (Ojha & Hasan, 2024). However, derivatives have also been linked to systemic risks, particularly when they contribute to excessive financial speculation, as witnessed during the 2008 global financial crisis (Korobtsova & Fursa, 2023).

Despite its efficiency in capital allocation, the conventional financial system faces key challenges, including income inequality, financial crises, and regulatory inefficiencies. Critics argue that excessive reliance on interest-based lending and speculative trading exacerbates financial instability and economic disparities (Robins et al., 2021). Consequently, there is growing interest in financial innovations and sustainable finance, which aim to address these limitations by integrating ethical, social, and environmental considerations into conventional finance (Shala & Berisha, 2024).

To ensure long-term financial stability, continuous regulatory advancements and financial innovations are essential. Governments and financial institutions are increasingly adopting sustainable finance practices to create a more inclusive and resilient financial ecosystem (Yorio et al., 2022). These reforms aim to balance profitability with social responsibility, fostering economic growth while minimizing systemic risks (Petrukha & Petrukha, 2024).

Islamic Financial System

The Islamic financial system is founded on Shariah (Islamic law) principles, emphasizing justice, ethics, and social welfare in all financial transactions. Unlike the conventional financial system, which relies on interest-based transactions (*riba*), excessive uncertainty (*gharar*), and speculative activities (*maysir*), Islamic finance strictly prohibits these elements and promotes risk-sharing and ethical investing (Migdad & Babangida, 2022).

One of the core principles of Islamic finance is the prohibition of *riba* (interest), as charging interest is considered exploitative and unjust. Instead of earning profits through fixed interest, Islamic financial institutions engage in profit-and-loss sharing mechanisms, such as *mudharabah* (profit-sharing agreements) and *musyarakah* (joint ventures) (Budhijana, 2023). These structures align the interests of investors, businesses, and financial institutions, fostering economic fairness and reducing financial instability (Sakuntala et al., 2025).

Moreover, Islamic finance prohibits speculative transactions and excessive uncertainty to ensure fairness and transparency. All financial agreements must be clear, well-defined, and backed by tangible assets, reducing the risk of financial crises associated with speculative markets (Sarif et al., 2024). This ethical foundation enhances trust and stability in financial markets, making Islamic finance an attractive alternative for ethical and sustainable investment practices (Hussin, 2023).

Islamic finance has also played a significant role in financial inclusion, particularly in Muslim-majority countries, by providing Shariah-compliant banking services that cater to religiously conscious investors (Migdad & Babangida, 2022). Furthermore, Islamic green finance is emerging as a vital sector that integrates sustainability and environmental, social, and governance (ESG) criteria into financial decision-making (Billah et al., 2024). These developments position Islamic finance as a resilient and ethical financial model capable of addressing global economic and environmental challenges (Masood et al., 2024).

Despite its potential, Islamic finance faces challenges related to regulatory frameworks, market acceptance, and innovation. However, with increased financial literacy, supportive regulations, and innovative product development, Islamic finance is poised to play a crucial role in shaping a more sustainable and just global economy (Sukmaningrum & Rusmita, 2024).

METHODOLOGY

This study employs the Systematic Literature Review (SLR) methodology to comprehensively examine existing academic research on financial systems and sustainable investment. The SLR approach ensures a structured, transparent, and replicable method for identifying, evaluating, and synthesizing relevant literature (Abdullah et al., 2024). The review process follows the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) guidelines, which enhance rigor and reliability in selecting and analyzing research papers (Dordi et al., 2023). The research process consists of three main stages: identification, screening & eligibility, and analysis & synthesis.

In the identification stage, relevant articles are retrieved from reputable databases such as Scopus, Web of Science, and Google Scholar using predefined search keywords. The selection criteria include studies published between 2021 and 2025, focusing on financial systems, Islamic finance, and sustainable investment (Kamal et al., 2023). During the screening & eligibility stage, the collected studies undergo a rigorous screening process based on inclusion and exclusion criteria to ensure the relevance and quality of the selected literature. Duplicate records and papers lacking empirical evidence or peer review are removed (Myeong et al., 2022). Finally, in the analysis & synthesis stage, the final set of articles is examined using qualitative content analysis to extract key themes, trends, and research gaps. A bibliometric approach may also be used to map research trends and identify influential authors and institutions in the field (Bidin et al., 2021).

By adopting the SLR methodology, this study eliminates bias and subjectivity, offering a holistic understanding of financial research developments over the past five years. This systematic approach provides valuable insights for

policymakers, academicians, and practitioners in shaping future financial models that integrate ethical considerations, sustainability, and financial stability (Pradini & Faozan, 2023).

RESULT AND DISCUSSION

The conventional financial system offers several advantages, particularly in product diversity and flexibility. The wide range of available financial products allows customers to choose solutions that best suit their needs (Ali et al., 2021). Additionally, the flexibility in interest rate determination, loan tenure, and financing structures provides a competitive edge for this system (Rabbani et al., 2021). The high accessibility and scalability further enable financial institutions to reach a broader customer base across different locations and economic scales (Abasimel, 2023).

However, conventional finance also presents significant drawbacks. The risks associated with interest-based transactions can be burdensome for borrowers, especially in times of high interest rates (Bilgin et al., 2021). The system is also prone to financial instability and crises, as seen in the 2008 financial crisis (Trinugroho et al., 2021). Furthermore, the strong profit-oriented focus may contribute to widening socioeconomic inequalities, as financial institutions may prioritize profit maximization over social justice (Saleem et al., 2021).

On the other hand, the Islamic financial system offers several key benefits. First, the principle of profit and risk-sharing fosters fairness and reduces the risk of moral hazard and speculation, which are common in conventional finance (Hassan et al., 2022). Second, its emphasis on social justice and well-being makes Islamic finance more inclusive and ethical (Darmawan & Fakhri, 2021). Third, the prohibition of interest (riba) and speculative transactions ensures that the Islamic financial system remains more stable and resilient against financial crises (Rabbani et al., 2021).

However, Islamic finance also has limitations. The lack of awareness and education among the public and business actors hinders its growth (Junaidi et al., 2023). Moreover, compared to conventional finance, the range of Islamic financial products is more limited, making investment and financing choices more restricted (Sakti et al., 2021). In addition, regulatory and legal infrastructure gaps in some countries pose challenges to the development of the industry (Labidi & Grira, 2021).

The prospect of integrating Islamic and conventional finance offers an exciting opportunity. Such integration can create more diverse and inclusive financial products, combining the ethical and justice-oriented principles of Islamic finance with the innovation and flexibility of conventional finance (Safiullah, 2021). Supportive regulations and adequate infrastructure will play a crucial role in facilitating this integration, ultimately leading to a more stable and sustainable financial environment (Bilgin et al., 2021).

Advantages of the Islamic Financial System

1. **Ethics and Justice:** The Islamic financial system emphasizes justice, ethics, and social welfare. Every transaction must be fair and must not harm any party (Chapra, 2008). Islamic finance is based on principles of justice and

social balance. Financial transactions must be free from *riba* (interest) and *gharar* (uncertainty) to ensure transparency and fairness in financial dealings. This system aims to prevent exploitation and promote a fairer wealth distribution. Profit-sharing mechanisms such as *mudharabah* and *musyarakah* ensure that profits and risks are shared proportionally, fostering active and fair participation between capital providers and entrepreneurs.

2. **Risk-Sharing:** In Islamic financing, risks and profits are shared among the involved parties, reducing moral hazards and speculation (Iqbal & Mirakhor, 2011).
3. **Financial Stability:** As it does not engage in speculative practices and interest-based transactions, the Islamic financial system is considered more stable and resilient against financial crises (Askari et al., 2011). It avoids excessive speculation and derivative transactions, which are often major causes of instability in the conventional financial system. Instead, Islamic finance focuses more on real economic activities, supporting direct investment in productive and sustainable projects. For instance, *sukuk* (Islamic bonds) are backed by tangible assets, reducing default risks and speculation.

Advantages of the Conventional Financial System

1. **Diverse Financial Products:** The conventional financial system offers a wide variety of financial products that can be tailored to customer needs, whether for investment, financing, or risk management (Beck et al., 2010).
2. **Flexibility:** This system provides flexibility in determining interest rates, loan tenure, and financing structures, which can be adjusted to market conditions and customer preferences (Warde, 2010).
3. **Accessibility and Scalability:** The extensive financial network in conventional finance allows for easier access to financial services across various locations and economic scales, catering to both individuals and corporations (Kuran, 2004). Conventional financial institutions are often more accessible to the general public due to their global network and a variety of services tailored to consumer needs. The rapid product innovation in this system enables the development of complex and sophisticated financial instruments, such as derivatives, which can be used for risk management.

Disadvantages of the Islamic Financial System

1. **Lack of Awareness and Education:** Many people and businesses still lack understanding of Islamic finance principles and products, which limits the adoption and use of Islamic financial services (Dusuki & Abdullah, 2007).
2. **Limited Financial Products:** Islamic financial products remain more limited compared to conventional finance, leading to fewer investment and financing options for customers (Ahmed, 2011). Although Islamic finance has seen significant growth, its product offerings are still relatively restricted compared to the conventional system. This can limit liquidity and flexibility for Islamic financial institutions in responding to dynamic market demands. Additionally, the secondary market for Islamic financial instruments such as *sukuk* is still developing, making it less liquid compared to conventional financial instruments.
3. **Lack of Supportive Regulations:** In some countries, regulations and legal infrastructure for supporting Islamic finance remain underdeveloped,

hindering the industry's growth (Khan & Bhatti, 2008). The implementation of Shariah-compliant financial principles requires strict adherence to Islamic legal frameworks, adding legal and operational complexities for financial institutions. Furthermore, the lack of harmonization in Shariah interpretations across different countries poses a challenge in developing standardized Islamic financial products.

Disadvantages of the Conventional Financial System

1. **Interest Rate and Riba Risks:** The interest-based nature of conventional finance can be burdensome for borrowers, particularly when interest rates are high, and it contradicts Islamic financial principles that prohibit riba (usury) (Chapra, 1992).
2. **Financial Instability:** The conventional financial system tends to be more vulnerable to financial instability and crises, as evidenced by the 2008 global financial crisis (El-Gamal, 2006).
3. **Social Inequality:** The profit-oriented focus of conventional finance can contribute to widening socio-economic gaps, as interest-based mechanisms do not always consider social justice (Haniffa & Hudaib, 2007). The fixed-interest system in conventional finance can lead to social injustice, where borrowers must pay interest regardless of their business outcomes. This can exacerbate economic inequality and foster exploitation.

Prospects of Integration

The integration of Islamic and conventional financial systems presents various exciting opportunities:

1. **Product Complementarity:** Integrating Islamic financial products into the conventional financial system can provide fairer and more ethical alternatives for customers while expanding the range of available products (El-Hawary et al., 2007). Hybrid financial products that combine Islamic and conventional principles can offer innovative solutions. For instance, conventional banks can introduce Shariah-compliant products such as sukuk (Islamic bonds) or Islamic savings accounts to attract customers seeking ethical and stable investment options.
2. **Regulatory and Infrastructure Strengthening:** Supportive regulations and adequate financial infrastructure can enhance the integration of both systems, such as implementing financial reporting standards that align with both Islamic and conventional principles (Archer & Karim, 2002). Governments and financial authorities need to develop regulatory frameworks that facilitate this integration. Harmonizing international Shariah standards and promoting regulations that encourage product innovation can accelerate the growth of the Islamic financial industry.
3. **Enhancing Financial Inclusion:** By incorporating Islamic financial services into the conventional financial system, financial inclusion can be improved, particularly in countries with large Muslim populations (Beck et al., 2010).
4. **Public Education and Awareness:** Education about the benefits and mechanisms of Islamic financial products must be enhanced to increase awareness and acceptance among the public. Training and certification

programs for finance professionals are also crucial to ensure a comprehensive understanding of Shariah principles.

CONCLUSION AND RECOMMENDATIONS

This discussion highlights that while both financial systems have their own strengths and weaknesses, their integration can offer a more comprehensive and sustainable solution. By combining the ethical and justice-oriented principles of Islamic finance with the flexibility and innovation of conventional finance, the global financial system can become more inclusive, stable, and fair.

Suggestion

To enhance the integration of Islamic and conventional financial systems, it is essential to develop supportive regulatory frameworks, improve financial literacy, and foster innovation in financial products. Regulatory bodies should implement standardized guidelines that accommodate both systems while maintaining compliance with ethical and legal principles. Additionally, increasing public awareness through educational campaigns can facilitate better understanding and acceptance of Islamic financial instruments. Encouraging collaboration between financial institutions, policymakers, and academic researchers will also contribute to the development of hybrid financial solutions that promote financial stability and inclusivity (Sakuntala et al., 2025). Furthermore, sustainable finance practices should be integrated into both systems to ensure long-term economic resilience and environmental responsibility (Billah et al., 2024). Strengthening these aspects can create a more diversified and ethical financial landscape that benefits both investors and society at large.

Practical

To implement an effective integration of Islamic and conventional financial systems, financial institutions should adopt a phased approach that includes regulatory harmonization, digital transformation, and product diversification. Establishing standardized regulatory guidelines that align with both financial models can enhance transparency and compliance (Sakuntala et al., 2025). Additionally, leveraging financial technology (FinTech) can improve access to Shariah-compliant financial products, making them more inclusive and efficient (Masood et al., 2024). Developing innovative hybrid financial products, such as Islamic green bonds (Sukuk), can bridge the gap between ethical investment and economic growth while attracting global investors interested in sustainability (Billah et al., 2024). To achieve these goals, collaboration between policymakers, financial institutions, and technology providers is crucial in ensuring a seamless and effective integration process that benefits all stakeholders.

Academic

Academic research on the integration of Islamic and conventional financial systems has increasingly focused on financial stability, ethical investment, and sustainability. Recent studies emphasize that the principles of Islamic finance, such as risk-sharing and asset-backed transactions, contribute to economic resilience and reduced financial speculation (Shaikh, 2025). Scholars also highlight the role of regulatory frameworks in ensuring a smooth transition between both systems, with comparative analyses demonstrating that supportive

policies can enhance financial inclusivity and stability (Sakuntala et al., 2025). Furthermore, the development of Islamic green finance has gained attention as a viable approach to align economic growth with sustainability goals, fostering responsible investment practices in global markets (Billah et al., 2024). As research in this field expands, interdisciplinary collaboration among economists, legal scholars, and financial practitioners is essential to develop innovative models that integrate the strengths of both financial systems while mitigating their respective limitations.

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