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# ISLAMIC FINANCE VS CONVENTIONAL FINANCE: UNDERSTANDING THE KEY DIFFERENCES

## INTRODUCTION

Islamic finance is experiencing remarkable growth not only in Nigeria but across global financial markets. Individuals, businesses, and financial institutions are increasingly engaging with ethical financing structures alongside, conventional financing arrangements. According to the Islamic Financial Services Board (IFSB) in its Islamic Financial Services Industry Stability Report 2025[1], the total global Islamic financial services industry continued to expand in 2024 recording robust growth and reaching $3.88 trillion in total assets.

Understanding the fundamental differences between these two systems is essential for any legal or financial practitioner operating in today's global market.

Although both Islamic and conventional finance seek to provide capital for commercial activities, they are founded on different philosophical and legal principles. This article examines those differences, explores the Shariah-based prohibitions that underpin Islamic finance, analyses commonly used Islamic financing structures, and contrasts them with conventional interest-based lending arrangements.

## THE DIFFERENCE BETWEEN ISLAMIC FINANCE AND CONVENTIONAL FINANCE: ECONOMICS VS ETHICS

A basic principle of conventional finance is the maximisation of shareholder value through a profit-oriented and interest based system. Conventional finance operates on the premise that money is a commodity and allows returns to be generated simply by the passage of time regardless of the underlying economic activity. This is known as the "economics of time value of money" - the principle that a sum of money today is worth more than the same sum in the future. Profit motive drives all transactions, and risk is generally transferred to the borrower through fixed interest obligations regardless of commercial outcome.

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Islamic finance, by contrast, is anchored on the principles of Shariah or Islamic law which governs not only religious practice but commercial and financial conduct. Shariah promotes principles of justice, mutual benefit, and the equitable sharing of

1.https://www.ifsb.org/wp-content/uploads/2025/05/IFSI-Stability-Report-May-2025.pdf

risk and reward. Finance is not viewed purely as a commercial enterprise but as a moral one, embedded within a broader framework of social and economic justice.

> "Shariah promotes principles of justice, mutual benefit, and the equitable sharing of risk and reward"

This divergence gives rise to fundamental prohibitions in Islamic finance:

1. Prohibition of Interest (Riba)

The prohibition of Riba is the most defining feature of Islamic finance with the Holy Quran explicitly prohibiting riba in multiple verses. Islam considers lending with interest payments as an exploitative practice that favours the lender at the expense of the borrower.

By contrast, interest is the cornerstone of the entire conventional lending system. Loans, bonds, overdraft facilities, and trade finance instruments are all structured around the lender's right to receive a predetermined rate of return.

2. Prohibition of Excessive Uncertainty (Gharar)

Gharar refers to excessive ambiguity or uncertainty in a contract. Islamic law requires that the subject matter, price, and delivery terms of any commercial transaction be clearly defined and certain. The premise is that if the terms of a transaction are clearly defined and certain, parties are able to make informed decisions about the transaction. Transactions involving significant uncertainty, such as derivative instruments, short-selling, or contracts where the existence or characteristics of the asset are unclear are prohibited under Islamic finance.

3. Prohibition of Speculation/Gambling (Maysir)

Closely related to Gharar, Maysir prohibits transactions that are essentially speculative or gambling in nature, where one party's gain is necessarily another's loss or where any benefit derived is based purely on chance or luck without any productive economic activity.

4. Prohibition of Investments in prohibited activities/businesses

The principle of Shariah prohibits investment in activities or businesses that are considered haram (forbidden). These typically include, the production, distribution, or promotion of alcohol, pork products, gambling, pornography, and certain forms of entertainment deemed unethical. The prohibition is rooted in the principle that financial gain must be derived from lawful (halal) and socially responsible economic activity. Accordingly, investors are not permitted to earn returns from enterprises whose core business contravenes Islamic ethical standards.

5. Profit/loss sharing

Parties entering into the contracts in Islamic finance share profit/loss and risks associated with the transaction. No one can benefit from the transaction more than the other party. Unlike conventional finance, where a lender earns predetermined interest regardless of the performance of the underlying venture, Islamic finance requires that returns be linked to the actual performance of the financed activity. The principle is that profit must be earned, not guaranteed and financial reward must be accompanied by exposure to risk.

6. Each transaction must be related to a real underlying economic transaction.

Common Islamic Finance Structures

In place of interest-bearing loans, Islamic finance employs a variety of Shariah-compliant structures designed to facilitate financing while ensuring that returns are tied to genuine commercial activity.

1. Murabahah (Cost-Plus Financing)

Murabahah is a contract of sale in which both the cost price plus the profit margin is known and agreed upon between the buyer (customer) and the seller (bank). The transaction is a sale, not a loan. The bank/financier buys the asset and then sells it to the customer, who pays for it in instalments that include a profit for the bank.

The Murabaha form of financing is typically used in place of loans in diverse sectors. Consumers may use Murabaha when purchasing household appliances, cars, or real estate and businesses may use this type of financing when purchasing machinery, equipment, or raw materials.

2. Ijarah (Ethical Leasing)

Ijarah is an agreement between two parties on a particular subject matter to temporarily transfer the title of that particular subject matter. The validity of the contract of leasing/hiring depends on the fulfilment of the following conditions: i) There must be at least two parties possessing full legal capacity. ii) There must be free consent of the parties. iii) The price or remuneration of the hiring must be determined. iv) The object of the hiring must be ascertained. v) The subject matter should be legal. vi) The period of lease should be ascertained.

3. Musharakah (Partnership)

Musharakah, is a joint enterprise or partnership in which investors share in the profits and losses of an enterprise. According to the principles of Shariah, financiers cannot profit from the interest earned on lending, thus, Musharakah allows the investor to earn a return in the form of a portion of the actual profits, according to a predetermined ratio. However, the investor also faces losses that may occur, again on a pro rata basis.

In a Musharakah transaction, both financiers and entrepreneurs share equal responsibility for the business outcomes, fostering a more balanced risk versus reward relationship unlike traditional lending.

4. Mudarabah

This form of partnership is also known as the partnership of capital and skills. It means that one provides capital to another person for him to trade with using his relevant skills and experience and the resulting profit is divided amongst them according to agreed ratios. The capital provider/owner (rabb al-mal) is the silent partner while the skills provider (mudarib) is the active partner.

5. Sukuk

Sukuk often referred to as the Islamic equivalent of conventional bonds refers to investment certificates which represent the common, undivided

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interest/ownership title to shares and rights in any tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity.

Sukuk allows for direct asset ownership interest and entitles the holders to share in the revenue generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization /sale of the assets. Furthermore, Sukuk unlike bonds, carry returns based on cash flow originating from the assets, based on which they are issued.

### Comparative View of Islamic Finance and Conventional Finance

| Subject | Islamic Finance | Conventional Finance |
|---|---|---|
| **Basis of Return** | Islamic finance generates returns through trade profit, rental income, or profit-sharing tied to real economic activity. | Conventional finance generates returns through predetermined interest. |
| **Risk Allocation** | In Islamic finance, risk is shared between the financier and the client in proportion to their respective contributions and agreed terms. | In conventional lending, risk is largely transferred to the borrower. |

## Nigeria's Islamic Finance Sector

Nigeria's non-interest/Islamic finance sector has grown steadily since the Central Bank of Nigeria (CBN) issued its Framework for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in 2011. According to the 2024 State of Enterprise (SOE) Report[2], Nigeria's Islamic finance industry reached a valuation of ₦2.5 trillion in 2023, with sukuk accounting for the second-largest share at ₦1.09 trillion.

Jaiz Bank, established in 2012, remains the flagship full-fledged non-interest bank in Nigeria, with other Islamic financial institutions being established and commercial banks operating dedicated non-interest banking windows.

The Nigerian federal and state government has also issued sovereign Sukuk, with proceeds channelled into infrastructure development an innovative and growing application of Islamic finance in the public sector showing that the  Islamic Capital Market (ICM), a subsector of the Nigerian capital market is also thriving.

## Conclusion

Islamic and conventional finance are not merely different financial product offerings, they reflect fundamentally different philosophies about the relationship between ownership of assets, money, risk, and commercial activity. Where conventional finance treats money as a commodity deserving of return through interest, Islamic finance insists that profit must be earned through genuine commercial risk and value creation.

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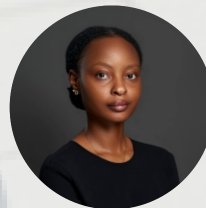
2.https://enterprisengr.com/the-state-of-enterprise-2024-report/

**Daniel Obidiegwu, (MCIArb UK)**
Managing Counsel
d.obidiegwu@greychapellegal.com



**Oyeronke Oyeyemi**
Intermediate Associate
r.oyeyemi@greychapellegal.com

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**CONTACT US:**
Block 2 Plot 17 Adenike Wole Ajibode Street, Lekki Phase 1, Lagos +234 (0) 815 291 4717 info@greychapellegal.com