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# CHALLENGES OF ADOPTING ISLAMIC FINANCE WITHIN CONVENTIONAL BANKING SYSTEMS

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**Abstract:** The growing interest in ethical and alternative financial models has increased the relevance of Islamic finance within commercial banking systems. This article examines the key issues associated with the implementation of Islamic finance products in commercial banking practice. Using a qualitative analytical approach, the study explores institutional, regulatory, and operational challenges that influence product adoption and performance. The findings indicate that commercial banks tend to prioritize Islamic finance instruments that closely align with conventional banking structures, while risk-sharing products remain limited in practice.

**Key words:** islamic finance, commercial banks, Islamic finance compliance, Islamic banking products, dual banking system.

**Annotatsiya:** Axloqiy va muqobil moliyaviy modellariga bo'lgan qiziqishning ortib borishi tijorat bank tizimlarida islomiy moliyaning dolzarbligini kuchaytirdi. Mazkur maqolada tijorat banklari amaliyotida islomiy moliya mahsulotlarini joriy etish bilan bog'liq asosiy muammolar tahlil qilinadi. Sifat tahliliga asoslangan yondashuv orqali mahsulotlarni joriy etish va ularning samaradorligiga ta'sir ko'rsatuvchi institutsional, me'yoriy-huquqiy hamda operatsion muammolar o'rganiladi. Tadqiqot natijalari shuni ko'rsatadiki, tijorat banklari asosan an'anaviy bank tuzilmalariga yaqin bo'lgan islomiy moliya instrumentlariga ustuvor ahamiyat beradi, tavakkalchilikni bo'lishishga asoslangan mahsulotlar esa amaliyotda cheklangan darajada qo'llanilmoqda.

**Kalit so'zlar:** islomiy moliya, tijorat banklari, islomiy bank mahsulotlari, ikki tizimli bank modeli.

**Аннотация:** Рост интереса к этическим и альтернативным финансовым моделям обусловил повышение актуальности исламских финансов в системе коммерческого банковского обслуживания. В статье рассматриваются ключевые проблемы, связанные с внедрением продуктов исламского финансирования в практику коммерческих банков. На основе качественного аналитического подхода анализируются институциональные, регуляторные и операционные факторы, влияющие на внедрение и эффективность данных продуктов. Результаты исследования показывают, что коммерческие банки в большей степени отдают приоритет инструментам исламского финансирования, близким по структуре к традиционным банковским продуктам, в то время как инструменты, основанные на принципе разделения рисков, остаются ограниченными в практическом применении.

**Ключевые слова:** исламские финансы, коммерческие банки, продукты исламского банкинга, двухуровневая банковская система.

## INTRODUCTION

The increasing diversification of the global financial system has intensified interest in alternative financial models that emphasize ethical conduct, financial stability, and inclusive economic development. Within this context, Islamic finance has emerged as one of the fastest-growing segments of the international financial architecture, attracting attention not only in Muslim-majority economies but also in advanced and emerging financial markets worldwide. The appeal of Islamic finance is rooted in its foundational principles, which promote asset-backed transactions, risk-sharing arrangements, and the close linkage between financial activities and the real economy.

Over the last two decades, the growth of Islamic finance has coincided with recurring episodes of financial instability in conventional banking systems, particularly during and after the global financial crisis. These developments have stimulated renewed academic and policy-oriented debates regarding the resilience of

alternative financial models and their potential contribution to systemic stability. Islamic finance, by prohibiting interest-based lending and speculative transactions, is often regarded as a framework that inherently mitigates excessive leverage and promotes prudent risk management. Consequently, policymakers and financial institutions increasingly view Islamic finance as a complementary mechanism rather than a substitute for conventional banking.

Against this backdrop, commercial banks have begun to explore the integration of Islamic finance products into their operational structures, either through the establishment of Islamic windows, subsidiaries, or full-fledged dual banking models. However, the implementation of Islamic finance products within conventional commercial banks presents a set of complex challenges that extend beyond product design. It requires fundamental adjustments in regulatory compliance, institutional governance, accounting practices, and risk management frameworks. Unlike conventional financial instruments, Islamic finance products must adhere not only to prudential regulations but also to Islamic finance principles, creating a dual layer of compliance that can significantly increase operational complexity.

From an institutional perspective, the integration of Islamic finance into commercial banking practice raises critical questions regarding organizational readiness and human capital capacity. Conventional banks are typically structured around interest-based financial intermediation, with established performance metrics, incentive systems, and risk assessment models that may not be fully compatible with profit-and-loss sharing arrangements. As a result, the successful implementation of Islamic finance products necessitates a reconfiguration of internal processes, staff training, and corporate culture to ensure both financial viability and Islamic finance compliance.

Furthermore, the issue of regulatory harmonization remains particularly salient in jurisdictions where Islamic finance operates alongside conventional banking under a unified regulatory framework. In such environments, regulatory authorities often face the challenge of balancing financial innovation with systemic stability, while simultaneously ensuring a level playing field between conventional and Islamic financial products.

Despite the growing body of literature on Islamic finance, empirical and conceptual research specifically addressing the implementation challenges faced by commercial banks remains relatively limited, particularly in emerging economies where Islamic finance is still at an early stage of development. Existing studies often focus on the performance comparison between Islamic and conventional banks, while insufficient attention is paid to the institutional transformation process required for effective integration. This research gap underscores the need for a systematic examination of the practical, regulatory, and organizational issues associated with embedding Islamic finance products within commercial banking practice.

## REVIEW OF LITERATURE ON THE SUBJECT

The academic literature on Islamic finance has expanded significantly over the past three decades, reflecting the growing importance of Islamic finance-compliant financial systems within the global economy. Early studies primarily focused on the theoretical foundations of Islamic finance, emphasizing its ethical orientation, prohibition of interest (riba), and reliance on asset-backed and risk-sharing mechanisms [1]. These foundational works established Islamic finance as a distinct paradigm of financial intermediation rooted in moral philosophy, contract law, and real-sector engagement.

Subsequent research shifted toward comparative analyses between Islamic and conventional banking systems. A substantial body of empirical literature suggests that Islamic banks exhibit different risk profiles and balance-sheet structures compared to their conventional counterparts [2]. Scholars argue that profit-and-loss sharing (PLS) arrangements, such as Mudaraba and Musharaka, theoretically enhance financial stability by aligning the interests of banks and clients and reducing excessive leverage [3]. However, empirical findings remain mixed, with several studies noting that Islamic banks, in practice, rely heavily on debt-like instruments such as Murabaha, which resemble conventional lending in economic substance [4].

Another prominent strand of the literature examines the resilience of Islamic banking during periods of financial stress. Studies analyzing the performance of Islamic banks during the global financial crisis of 2008 suggest that Islamic finance-compliant institutions were relatively less exposed to toxic assets and speculative derivatives, thereby demonstrating greater stability in certain contexts [5]. Nevertheless, other researchers caution that the observed resilience may be attributable to structural factors such as market segmentation and regulatory protection rather than inherent superiority of Islamic finance principles [6].

The integration of Islamic finance products into commercial banking practice has received comparatively less scholarly attention, despite its growing relevance. Existing studies on dual banking systems highlight that the coexistence of Islamic and conventional banking within a single institutional framework generates unique regulatory and operational challenges [7]. In particular, commercial banks offering Islamic windows must comply simultaneously with conventional prudential regulations and Islamic finance governance requirements, leading to increased compliance costs and organizational complexity [8].

From a regulatory perspective, the literature underscores the lack of harmonization in Islamic finance regulation across jurisdictions. While international standard-setting bodies have developed guidelines for Islamic finance governance, risk management, and capital adequacy, their adoption at the national level remains uneven [9]. Scholars note that inconsistencies in legal recognition of Islamic contracts, tax treatment, and accounting standards hinder the scalability of Islamic finance products within commercial banks [10].

## RESEARCH METHODOLOGY

This study employs a qualitative research design based on secondary data collection. Academic articles, regulatory documents, policy reports, and international banking standards related to Islamic and conventional finance were systematically reviewed. The collected materials were analyzed using comparative and thematic analysis methods to identify institutional, regulatory, and operational challenges affecting the adoption of Islamic finance within conventional banking systems.

## ANALYSIS AND RESULTS

The introduction of Islamic finance products into commercial banks requires significant institutional adjustments. These adjustments affect governance structures, internal procedures, and product delivery mechanisms. Table 1 summarizes the main institutional components involved in the implementation process and their functional implications (Table 1).

Table 1. Institutional dimensions of implementing Islamic finance products in commercial banks<sup>1</sup>

Institutional Area	Key Characteristics	Observed Outcomes
Islamic finance Governance	Establishment of Islamic finance boards and internal compliance units	Enhanced ethical oversight but increased decision-making complexity
Organizational Structure	Separation of Islamic windows or specialized units	Improved product focus, yet higher coordination costs
Human Capital	Need for staff trained in both conventional and Islamic finance	Improved compliance quality, limited by skill shortages
Operational Processes	Adaptation of contracts, documentation, and IT systems	Greater transparency, but slower operational execution

The analysis presented in Table 1 indicates that institutional readiness is a decisive factor in the successful implementation of Islamic finance products. Islamic finance governance structures play a central role in ensuring compliance with Islamic principles; however, they also introduce additional layers of approval that may slow operational processes. This creates a trade-off between ethical integrity and operational efficiency.

The establishment of specialized Islamic banking units within commercial banks allows for better product specialization and customer targeting. At the same time, it increases internal coordination requirements, particularly between Islamic and conventional departments. Human capital emerges as a critical constraint, as the limited availability of professionals with dual expertise restricts scalability. Overall, institutional adaptation improves governance quality but requires long-term organizational commitment.

At the product level, Islamic finance instruments differ fundamentally from conventional banking products in terms of risk allocation, asset backing, and contractual structure. Table 2 analyzes key Islamic finance products commonly introduced in commercial banks and evaluates their implementation outcomes (Table 2).

Table 2. Analysis of Islamic finance products in commercial banking practice<sup>2</sup>

Islamic Finance Product	Implementation Features	Practical Results
Murabaha	Cost-plus sale with fixed profit margin	Easy adoption, high demand, limited risk-sharing
Ijara	Asset-based leasing structure	Stable cash flows, higher asset management responsibility
Musharaka	Joint partnership with shared profit and loss	Strong theoretical alignment, limited practical use
Mudaraba	Trustee partnership with asymmetric control	High agency risk, cautious application by banks

<sup>1</sup> Source: Developed by the author

<sup>2</sup> Source: Developed by the author

The results summarized in Table 2 reveal a clear divergence between the theoretical ideals of Islamic finance and their practical application in commercial banking. Murabaha dominates implementation due to its structural similarity to conventional credit products, making it easier for banks to integrate within existing systems. However, its widespread use raises concerns about the limited realization of genuine risk-sharing principles.

Ijara products demonstrate relatively balanced outcomes, offering predictable returns while maintaining asset backing. Nevertheless, they require banks to manage physical assets, which introduces operational and legal risks. In contrast, Musharaka and Mudaraba contracts, despite their strong alignment with Islamic finance philosophy, face limited adoption due to higher uncertainty, agency problems, and monitoring costs. This outcome reflects the risk-averse behavior of commercial banks operating under conventional regulatory expectations.

Based on the analysis of institutional, regulatory, and operational challenges associated with the implementation of Islamic finance products in commercial banking practice, several policy-oriented and managerial recommendations can be proposed.

First, regulatory authorities should develop a clear and consistent legal framework that explicitly recognizes Islamic finance contracts and provides unified guidelines for their accounting, taxation, and supervisory treatment. Such clarity would reduce legal uncertainty and encourage commercial banks to expand Islamic finance-compliant operations beyond limited product offerings.

Second, commercial banks should strengthen internal Islamic finance governance and institutional capacity by investing in specialized human capital and integrated compliance systems. Continuous professional training for bank staff and closer coordination between Islamic finance supervisory boards and risk management units are essential to ensure both financial efficiency and Islamic finance compliance.

Third, greater emphasis should be placed on diversifying Islamic finance products toward genuine risk-sharing instruments. While trade-based products remain important, gradual expansion of partnership-based financing would enhance the developmental role of Islamic finance and align banking practices more closely with its theoretical foundations.

## CONCLUSIONS AND SUGGESTIONS

The integration of Islamic finance products into commercial banking practice represents a complex institutional process rather than a simple extension of conventional product lines. The findings of this study demonstrate that while Islamic finance offers valuable opportunities for ethical banking, financial inclusion, and real-sector engagement, its implementation within commercial banks is constrained by regulatory ambiguity, institutional limitations, and risk management challenges.

Overall, commercial banks tend to adopt Islamic finance products selectively, favoring instruments that closely resemble conventional finance while avoiding contracts that involve higher uncertainty and shared risk.

In conclusion, the sustainable integration of Islamic finance into commercial banking requires a holistic framework that aligns regulatory support, organizational readiness, and Islamic finance governance with long-term development objectives. Only under such conditions can Islamic finance evolve from a supplementary offering into a meaningful component of modern commercial banking systems.

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