International Journal of Strategic Management and Economic Studies (IJSMES)
ISSN: 2791-299X

Financial Stability in Dual Banking Systems: A Theoretical Comparison between Conventional and Islamic Banks

JOUDAR Fadoua[1,2]

Professor and Researcher

[1] Laboratory of Management Economic and Social Sciences (LAMSES), Private University of Marrakech, Marrakech 40000, Morocco

[2] Research Laboratory in Economics, Management and Business Management (LAREGMA), Faculty of Economics and Management, Hassan 1er University, Settat 26000, Morocco.

EL GHMARI Imad

Associate Professor

Research Laboratory in Economics and Management of Organizations (LAREMO)

National School of Commerce and Management – Béni Mellal

Sultan Moulay Slimane University, Beni Mellal, Morocco

Abstract: The coexistence of conventional and Islamic banking systems is a defining feature of many economies today, particularly in countries with dual financial systems. This duality raises major questions about its implications for overall financial stability. This article provides a theoretical comparative analysis of the two banking models, highlighting their conceptual foundations, intermediation mechanisms, risk management approaches, and their potential effects on financial stability. Through a structured comparison based on several key analytical dimensions, the study demonstrates that while Islamic finance possesses intrinsic stabilizing mechanisms, the coexistence of the two systems can also generate specific risks related to their interaction. The article thus contributes to the literature on financial stability in a dual banking context.

Keywords: Financial stability ; Islamic banks ; conventional banks ; dual banking system ; theoretical comparative analysis

Digital Object Identifier (DOI): https://doi.org/10.5281/zenodo.18506014

Published in: Volume 5 Issue 1

1. Introduction

The subprime mortgage crisis impacted the entire banking and financial system and remains, in fact, a profound crisis that has fundamentally transformed the global financial landscape. It raised various questions concerning the financial stability of the different components of the financial system, as well as the main sources of instability. It is within this context that the significance of reflecting on Islamic finance comes to the fore.

Furthermore, in the wake of the subprime crisis, the Vatican urged policymakers to pay particular attention to the principles governing Islamic finance as a way to overcome these times of crisis. According to its statement, all financial services should move closer to the ethical foundations of Islamic finance in order to restore confidence in the financial systems.

Concurrently, Islamic finance has experienced rapid growth in recent decades. Some experts have argued that Islamic banks could be immune to the effects of such a crisis. This claim is strictly linked to the fact that Islamic finance operates within an environment highly regulated by Sharia principles, which prohibit investments in any type of instrument except those deemed compliant with Islamic law.

This growth has been particularly evident in the MENA region, where conventional and Islamic financial systems now coexist, creating a dual environment whose overall stability remains to be fully conceptualized. Indeed, while Islamic finance exhibits potentially stabilizing features, it also introduces specific risks and operates alongside a conventional system whose vulnerabilities were dramatically exposed in 2008.

Therefore, a fundamental theoretical question arises: How can we conceptualize financial stability in a dual system where two distinct financial logics – one based on interest and risk transfer, the other on risk-sharing and real asset backing – interact, complement, or contradict one another? This issue goes beyond merely comparing the individual performances of the two systems to interrogate the stability dynamics that emerge from their coexistence.

This article aims to contribute to answering this question by adopting a theoretical comparative approach. It will first analyze the foundations, mechanisms, and vulnerabilities of conventional and Islamic systems separately, and then develop a conceptual framework to understand their interaction in a dual environment. This reflection is particularly crucial for countries in the MENA region, as well as for economies like Morocco, which have recently introduced Islamic finance alongside a well-established conventional system.

2. Conceptual Framework

2.1 Definitions of Financial Stability

Financial stability cannot be reduced to a mere capacity to return to equilibrium after a shock, in the manner of a Newtonian mechanical system. According to Schinasi (2004), it rather represents a state in which the mechanisms for evaluating, allocating, and managing financial risks function in such a way as to support overall economic performance. From this perspective, a financial system is considered stable not only when it can absorb or contain existing imbalances without harming real economic activity, but also when it is capable of addressing these imbalances to prevent the emergence of future shocks.

Padoa-Schioppa (2002), for his part, emphasizes the robustness of the financial system. For him, financial stability is characterized by resilience to shocks—that is, the ability "not to give way to cumulative processes that impede the allocation of savings to investment opportunities and the processing of payments in the economy."

This view highlights the inherent trade-off between pursuing stability and accepting a certain level of risk, while acknowledging that financial stability also depends on imbalances outside the financial sector, such as household and corporate debt.

Contrary to a widespread belief, Schinasi (2006) reminds us that financial stability does not equate to the total absence of crises. Similarly, Crockett (1997) and Laker (1999) argue that certain fluctuations or institutional failures are part of the normal functioning of financial systems and do not necessarily indicate systemic instability, especially when they result from isolated microeconomic choices. Crockett (1997) particularly emphasizes the dimension of confidence: for him, financial stability encompasses both the ability of key institutions to meet their commitments without external assistance and the confidence of actors in the relative continuity of market conditions.

Foot (2003) reinforces this idea by defining financial stability as the quality of a financial system to inspire and maintain confidence in its institutions and markets. He also highlights the central role of banking stability: bank failures or malfunctions in long-term savings and credit instruments erode public confidence and hinder economic growth.

Finally, Patat (2000) proposes a multidimensional definition of financial stability, which accounts not only for the proper functioning of each component of the financial system but also for the robustness of interconnections among them. The ultimate goal remains to prevent disruptions—whether originating from financial institutions, markets, or the non-financial sector—from significantly and costly affecting the real economy.

2.2 Principles of Islamic Finance and Their Link to Stability

2.2.1 Principles of Islamic Finance

- Prohibition of Riba

Literally, the word Riba comes from the verb Raba, which means to increase, to grow, or to exceed. Financially, Riba refers to "any unjustified increase in capital, arising from a loan or commercial transaction."

Consequently, from the perspective of establishing social justice in the Muslim community, Islam has condemned any commercial transaction that results in unjust enrichment. Given this verdict, Riba constitutes, among other things, a source of undeserved wealth.

Thus, Riba represents any compensation—regardless of its size—specified in a loan contract or any other transaction where payment is based on an initial capital with a surplus. In other words, the recognition of the illegitimacy of interest in a loan rests on the existence of an addition to the original capital and on the existence of a temporal condition affecting this additional payment, as stipulated in a contractual clause.

As a result, interest derived from loans, as understood today, is a form of Riba referred to by Muslim scholars as Riba Al-Nasia. This refers to a premium charged due to a delay in the exchange of value in transactions based on loans or commercial dealings. It remains the most prevalent form of Riba today. However, the concept of Riba is not limited to banking interest alone; it also applies to exchanges of goods of the same kind but of different quality, which is called Riba Al-Fadl.

This prohibition constitutes the main difference between conventional and Islamic finance. It is explained, on the one hand, by the Islamic view of money, which is not considered a productive element in Islam—indeed, it is incapable of generating returns over time.

Moreover, according to Visser (2009), Riba, and particularly Riba Al-Fadl, recalls the issue of unequal exchange, which is a characteristic of capitalist economies. However, this similarity remains unfounded, as Islam does not endorse the labor theory of value, which forms the basis of Marxist thought.

Nevertheless, Haque (1995) considers that, regardless of terminology, both unequal exchange and Riba Al-Fadl represent features of capitalist economies.

A contract based on interest implies injustice to one of the parties—sometimes to the lender and sometimes to the borrower. Riba is unjust to the borrower in the sense that when they take out a loan for investment, they may realize profits or losses. In the event of a loss, they may lose their labor, and yet they are still obligated to repay the borrowed capital plus interest. The lender, meanwhile, is repaid regardless of the loss incurred by the borrower—hence the injustice of Riba. From the lender's perspective, when the environment is characterized by high inflation, Riba creates injustice, particularly when returns are lower than the inflation rate. Furthermore, injustice to the lender occurs when the net profit generated by the borrower exceeds the return provided to the lender on the capital supplied.

- Prohibition of Gharar and Maysir:

The term "Gharar" in Arabic denotes danger or risk, reflecting a situation of incomplete information that can render a transaction between two parties uncertain. Technically, scholars identify "Gharar" in a commercial transaction when it involves the sale of a good that one does not own, or whose outcomes are undefined and/or highly risky.

According to Iqbal and Molyneux (2005), Gharar constitutes the set of "acts and conditions in exchange contracts whose implications are not clearly known to the parties involved. It is something very similar to asymmetric information."

In other words, a lack of information is not the sole indicator defining the presence of Gharar in a contract; it also arises when the contracting parties do not have absolute control over the subject matter of the contract itself. This is why conventional insurance contracts are prohibited in Islam. In contrast, Islamic finance offers an alternative to these contracts under the name Takaful.

Nevertheless, it remains true that in the world of finance, uncertainty cannot be entirely absent due to the intrinsic relationship between financial return and the degree of risk. Faced with this contrast, many Muslim scholars have distinguished between Gharar Kathir (excessive Gharar) and Gharar Qalil (minimal Gharar), considering that only transactions with minimal uncertainty are permissible.

Furthermore, there is a specific case of Gharar known as "Maysir," derived from the word "Yusr" meaning ease, which refers to any transaction that allows wealth to be created purely by chance.

Following this reasoning, Qimar or games of chance are prohibited, as are all other activities that enable gain based on the initial contributions of individuals who risk losing everything or winning at the expense of others.

Thus, any transaction in which essential elements are omitted or neglected is prohibited, according to the consensus of scholars. By extension of this reasoning, speculative practices are also prohibited in Islam, including hedging instruments such as swaps, futures, and options.

- Prohibition of Hoarding:

According to Aristotle, one of the functions of money is as a store of value, meaning that it enables saving and accumulation. This view is opposed to the tenets of Islam. The Qur'an prohibits hoarding, so that money cannot in any way become a source of power for its holder. While the need to save is indeed encouraged in Islam, it is also strictly regulated by Sharia. Specifically, saving is only permissible if a Muslim intends to fulfill their obligations, repay debts, or respond to urgent necessities. This prohibition aligns with economic theory, which holds that individuals are obliged to make productive use of what they own for the common good, rather than for personal enrichment alone. Once again, this restriction is justified by Islam's rejection of unproductive wealth.

- Profit and Loss Sharing:

In Islam, only interest is prohibited, whereas profit is strongly encouraged. As a result of this prohibition, Islam has established profit and loss sharing as the foundation of its commercial operations.
The concept of profit and loss sharing was introduced in the work of Quraishi and later developed by several authors, notably Khan (1984), who defines this system as "the financial mechanism that links financial capital to industry and commerce without the use of interest."
Indeed, while the conventional financial system operates through interest rates, Islamic finance favors alternative participatory instruments, where returns are based on sharing the profits and losses of an investment between the debtor and the creditor according to a formula that reflects their respective levels of participation.

-Asset-backing of financial transactions :

In order to serve the real economy, Sharia permits only operations that are backed by tangible and identifiable assets, such as real estate assets and commodities. The underlying asset must exist in reality, in order to realize the connection between the real economic sphere and the financial sphere.

-Prohibition of Investments in Illicit Activities

Islam not only prohibits risky, usurious, and speculative operations, but also investments in certain so-called "impure" industries whose activities are illicit (such as sectors involving alcohol, pork, gambling, and weapons).
The purpose of this prohibition is to enable the Islamic investor—unlike their conventional counterpart—to align their investment choices between the financial and the ethical dimensions. This objective reflects the growing interest today in ethical and socially responsible investing.

2.3 Islamic Banking Intermediation vs. Conventional Banking Intermediation: Similarities and Differences

Both types of banking intermediation perform the same functions despite their apparent differences. It would be useful to outline below these similarities and divergences:

2.3.1 Similarities

Although they operate within the Sharia-compliant framework, which requires their transactions to adhere to Islamic principles, Islamic banks remain financial institutions that fulfill the same core functions as conventional banks. They act as payment system managers and financial intermediaries.
In this regard, the CIBAFI (2015) handbook titled Fundamentals of Islamic Banking and Finance acknowledges that due to their activities, Islamic and conventional banking institutions share several similarities:
• Both types of institutions are commercial entities licensed by the central bank, with the same mission of channeling funds from surplus agents to those in need.
• Both types of banks offer current accounts, payment facilities, debit cards, and checkbooks.
• In both types of banks, clients agree to deposit their funds for a specified period—such as fixed deposits in conventional banks and investment accounts in Islamic banks—although the return in conventional banks takes the form of fixed interest, while in Islamic banks it is based on a share of profits.
• Both types of banks operate through the interbank market to manage liquidity.

2.3.2 Differences between Islamic and Conventional Banking Intermediation

To delineate the differences between Islamic and conventional banking intermediation, it is important to first identify the characteristics of conventional intermediation, after which we will examine the operational model of Islamic banks.

- **Characteristics of Conventional Banking Intermediation**

To fulfill its role as a financial intermediary, a conventional bank collects funds from its clients' deposits, for which it pays a fixed interest rate. These collected funds are typically short-term deposits, which are then used to grant loans to other clients who become the bank's long-term borrowers. The conventional bank charges borrowers an interest rate higher than the rate paid to depositors. Indeed, it is this spread between the interest charged and the interest paid that constitutes the profit margin of the conventional bank.

The concept of conventional banking intermediation is straightforward: it involves channeling funds from agents with surplus resources to agents in need of funds.

This channeling mechanism is not without risk. When depositors request the withdrawal of their funds, banks are obligated to return them. However, they cannot demand early repayment of the loans they have granted. Consequently, this mismatch in funds leads to a high level of liquidity risk. Moreover, as financial intermediaries, conventional banks also face credit risk when borrowers are unable to meet their repayment obligations. Thus, conventional banking intermediation considers its profit to be nothing other than compensation for bearing these risks.

- **The Operating Mechanism of Islamic Banks**

The range of Islamic financial instruments is capable of designing a formal model of banking intermediation unique to the Islamic system, suitable for fulfilling the typical functions of resource allocation.

According to Askari, Iqbal, and Mirakhor (2015), Islamic banking intermediation relies on three different models. The first is based on Mudarabah and is commonly referred to as the two-tier Mudarabah model, while the second model is known as the two-window model.

The third and less commonly used model is known as the Wakalah model, which is based on the principal-agent framework but with defined restrictions.

A) Two-Tier Mudarabah Model:

This model is named as such because the Mudarabah contract is applied on both sides of the bank’s balance sheet. It enables banks to offer intermediation that closely resembles that of conventional banks. The principle of the two-tier Mudarabah model is that the bank acts simultaneously as an investor and an entrepreneur.

Specifically, the first tier is located on the liabilities side of the bank’s balance sheet. Depositors enter into a Mudarabah contract with the bank as Rab al-Mal (capital provider), since they supply the funds, while the bank in this case acts as the Mudarib (manager) handling the entrusted funds. Depositors share in the profits generated by the bank according to a predetermined ratio. In the event of financial losses, it is the depositors as capital providers who bear them, while the bank only loses its effort.

The second tier is located on the assets side of the bank’s balance sheet. In this Mudarabah arrangement, the bank acts as the capital provider (Rab al-Mal), and the entrepreneurs are the Mudarib. Here, profits are shared according to an agreed-upon ratio. Any financial loss is borne by the bank, while the Mudarib only loses their effort.

Thanks to the two-tier model, the bank's assets and liabilities are fully integrated, reducing the need for active asset-liability management. This makes the model stable and capable of withstanding economic shocks. This model does not impose specific reserve requirements on either side of the balance sheet.

B) The Two-Windows Model:

This model is nearly identical to the previous one, with the only difference being that it includes a requirement for reserve obligations. The model divides the liabilities side of the balance sheet into two windows: one for demand deposits and the other for investment deposits. The choice of window is left to the depositors. However, a 100% reserve requirement applies only to demand deposits, as these are placed with the bank as Amanah (trust) for safekeeping and must be fully backed by reserves since they remain the property of the depositors.

When funds are deposited into investment accounts, they are invested in risky projects, and no guarantee is therefore justified. Consequently, no reserve is required in this case, as these funds are allocated to investment financing and bear the risk of loss.

C) The Wakalah Model:

A third, less widely known model of Islamic intermediation is based on the Wakalah contract. In this model, the Islamic bank acts solely as an agent or Wakil, tasked with managing depositors' funds to generate profit on behalf of the investors and charging them a fixed fee. The other terms of the Wakalah contract are agreed upon between the bank and the depositors.

2.4 Comparative Risks and Vulnerabilities

Like conventional banking institutions, Islamic banks face various situational uncertainties. They are exposed not only to risks similar to those of their conventional counterparts but also to risks specific to their own nature.

2.4.1 Risks Common to Conventional and Islamic Banks

Conventional banks and Islamic banks are exposed to common risks due to their role as financial intermediaries. We will outline them below:

- **Credit Risk:**

This is an inherent risk in banking activity in general. It represents the probability that a counterparty (individual, company, or country) may be unable to repay a loan by the contractual due date. Frequently encountered by banks, repayments may be delayed or not honored at all, which can lead to liquidity difficulties for the bank. Credit risk requires particular attention in risk management, as it is a primary cause of bank failures.

In the Islamic banking context, credit risk manifests in the following financial operations:

- In Murabahah transactions: Credit risk arises when the Islamic bank delivers the asset but is not repaid on time.
- In Salam transactions: The Islamic bank is exposed to the risk of the asset not being delivered on time or not meeting the quality specified in the contractual terms. This may result in delayed or defaulted payments, leading to significant financial losses for the Islamic bank.

- In Istisna'a transactions: Credit risk occurs when, under a parallel Istisna'a contract, the client is unable to honor the deferred installment payment, or when the Islamic bank makes an advance payment to a subcontractor who fails to complete the work. This results in actual losses for the bank.
- In Ijarah transactions: When the client becomes unable to pay the rental installments until maturity due to potentially variable leasing costs, the bank is exposed to credit risk.
- In Musharakah transactions: The capital invested in the Musharakah may not be recovered upon liquidation, as it ranks below debt securities in priority, thereby presenting credit risk.
- In Mudarabah transactions: The Islamic bank is exposed to credit risk on the amounts advanced to the Mudarib. The nature of the contract does not involve the bank in project management, making it difficult to monitor and manage credit risk.

- **Liquidity Risk:**

Liquidity risk refers to a bank's immediate need for financial resources. This risk primarily affects banking soundness. Thus, a financial institution is considered liquid when it has the ability to hold funds efficiently.

Furthermore, liquidity risk stems from two major sources: either difficulty in obtaining funds at a reasonable cost, or the forced sale of assets.

In the case of Islamic banks, liquidity risk is particularly pronounced. Indeed, the restrictions governing asset securitization in Islamic finance, along with the slow development of Islamic financial instruments, explain the difficulties Islamic banks face in obtaining liquidity. In summary, conventional banks benefit from the intervention of a lender of last resort in emergencies, which injects the necessary liquidity. However, these liquidity facilities are interest-based and, as such, Islamic banks cannot utilize them.

Liquidity risk mainly manifests in Murabahah transactions. In fact, liquidity risk is closely linked to credit risk. A client's inability to meet their obligations to the bank creates a significant need for liquidity. The financial institution expects repayment from the client, which serves as a source of cash to cover other financial obligations. However, delayed receipts can cause serious liquidity problems. Not only do delayed payments create liquidity issues, but also deferred receipts, as they generate an unexpected surplus of liquidity at later dates.

- **Market Risk:**

Market risk is defined as the probability that a bank incurs a loss due to fluctuations in market prices. This risk is present in Ijarah contracts. It primarily arises from a decline in the residual value of the leased asset or from the early termination of the contract due to payment default.

- **Operational Risk:**

As defined by the Basel Committee on Banking Supervision, operational risk is "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

" Operational risk may be considered more pronounced in Islamic financial institutions, as they are relatively new and may lack sufficiently trained human capital in Islamic financial transactions.
The same applies to the IT systems used by conventional banks, which may not be suitable for Islamic banks.
In the context of Islamic financial instruments, this risk manifests in the following contracts:

- Murabahah: Operational risk in Murabahah contracts arises when the client fails to fulfill the purchase promise. Any resulting loss exposes the Islamic bank to operational risk.
- Salam: In a Salam transaction, as long as the goods meet the contractual specifications, the bank is obligated to accept them even if they are delivered earlier than expected. In such cases, to store the goods between the delivery date and the date of sale, the bank may incur additional costs such as warehousing expenses.
- Istisna'a: Under an Istisna'a contract, the Islamic bank may face penalties for delay if it fails to deliver the asset to the client on time due to delays by the subcontractor entrusted with the manufacturing. Thus, additional costs are borne by the Islamic bank if the subcontractor is unable to continue the manufacturing process, necessitating an urgent search for a replacement.
- Ijarah: If the Islamic bank becomes aware that the asset under the Ijarah contract is not being used in accordance with Sharia principles, it must repossess the asset and lease it to another client. Additionally, if the asset is damaged without the tenant's fault, the bank is obligated to provide a replacement. Otherwise, the tenant may withhold rent payments for the remainder of the contract and terminate the lease, leading to significant losses for the bank.

- **Foreign Exchange Risk:**

This risk arises from the disparity between the value of assets and liabilities denominated in foreign currencies, or from a mismatch between foreign receivables and payables expressed in the national currency. This risk is speculative in nature, as it can lead to gains or losses depending on the direction of exchange rate movements.
It is particularly relevant for Islamic banks due to their prohibition of hedging instruments against such risks, such as derivatives, swaps, and forward contracts.

2.4.2 Risks Specific to Islamic Banks

The absence of interest rates in Islamic finance means that Islamic banks are not exposed to interest rate risk. However, this does not imply that they face lower levels of risk compared to conventional banks. Like conventional banks, Islamic banks are exposed to liquidity, credit, market, and foreign exchange risks. Additionally, Islamic banks also incur risks specific to their nature, which conventional banks do not face, namely:

- **Mark-up Risk:**

To price their financial instruments, Islamic banks rely on a benchmark rate (typically LIBOR). Thus, the mark-up consists of the benchmark rate plus a fixed risk premium stipulated in the contract. However, while the benchmark rate may fluctuate, the mark-up itself remains unchanged. Islamic banks therefore face mark-up risk because, under Islamic contracts, the mark-up rate is fixed, whereas the benchmark rate is variable. Consequently, an Islamic bank may incur losses if the prevailing mark-up

rate exceeds the contractual rate. This risk is particularly prevalent in profit-sharing contracts such as Mudarabah and Musharakah.

- **Price Risk:**

Asset or commodity price risk arises from the long-term nature of the assets held by the bank. This risk stems from fluctuations in the prices of goods or assets, or from rising inflation rates. It manifests in the following contracts:

- Murabahah: Under a Murabahah contract, the Islamic bank is responsible for any damage, defects, or deterioration of the asset until it is actually delivered to the buyer. During this period, the Islamic bank is exposed to price fluctuation risk.
- Salam: Under this contract, the Islamic bank is exposed to price risk due to fluctuations in market prices between the time of delivery and the eventual sale at prevailing market prices.
- Istisna'a: Even if the client decides to terminate a parallel Istisna'a contract, the Islamic bank continues to finance the manufacturing of the goods until completion in order to sell them to a third party, potentially at a price lower than the contractual price. Such termination exposes the Islamic bank to asset value loss.
- Ijarah: In an Ijarah contract, price risk arises if the client fails to honor the lease promise. In such cases, the Islamic bank must re-lease or sell the asset, potentially at a price lower than the original lease or sale price.

- **Rate of Return Risk:**

This risk arises from the uncertainty of returns generated by Islamic banks on their assets. Unexpected fluctuations in market rates of return can lead to reductions in a company's profits. In conventional financing, returns are fixed, meaning both the bank and the company know their expected returns in advance. However, in the case of Islamic banks, returns are not predetermined, as investors share profits and losses with the bank.

- **Displaced Commercial Risk:**

This risk is defined by AAOIFI as the risk faced by an Islamic bank when it is compelled to pay its investors a rate of return higher than the actual contractual rate. This situation typically arises when the bank fails to achieve expected results over a given period and is unable to generate sufficient profits to distribute to account holders.

- **Withdrawal Risk:**

Withdrawal risk is a commercial risk involving the withdrawal of funds by depositors if the applied rate of return is lower than that offered by other Islamic banks or conventional banks with Islamic windows.

- **Legal Risk:**

Given their specific nature, Islamic banks are exposed to legal risk for several reasons. First, the regulatory framework in most countries is based on civil law, meaning their legal systems often lack specific laws governing Islamic products. Second, the absence of standardization in Islamic contracts makes the negotiation process for financial transactions delicate and costly, unlike standardized contracts, which are easier to manage and monitor even after signing, as they fall within the scope of existing legal frameworks.

- **Reputational Risk:**

The reputation of Islamic banks is a critical factor for their continuity, as, beyond their financial aspects, Islamic banks are part of ethical and moral finance. Any damage to their reputation can lead to a loss of client confidence in the banking institution, often resulting in deposit withdrawals. Reputational risk is significant not only because it affects the specific Islamic banking institution but also because it can impact the entire financial industry, which is still relatively new and vulnerable to negative or misleading information.

- **Sharia Non-Compliance Risk:**

According to IFSB, Sharia non-compliance risk occurs when Islamic banking institutions fail to adhere to Sharia principles, as prescribed by the Sharia Board or the relevant regulatory body under which the institutions operate. Compliance with Sharia contract requirements ensures the validity of Islamic financial transactions, and any Islamic financial operation that does not comply with Sharia is considered null, rendering its income illegitimate. This is why Sharia non-compliance risk requires particular attention compared to other risks.

- **Concentration Risk:**

This risk refers to "excessive exposure to a specific sector, a given geographic region, a particular type of activity, or a specific mode of financing." This definition implies that in the event of a crisis in the geographic region, market, or sector, such overexposure can lead to significant losses for the investor. To guard against this risk, Islamic banks diversify their portfolios across multiple sectors, markets, and geographic regions, engaging in various activities.

3. Methodology :

This study adopts a qualitative comparative approach based on a systematic documentary analysis. The methodology relies on an exhaustive review of academic and institutional literature (IMF, World Bank, IFSB, AAOIFI), a structured comparative analysis of the conceptual definitions, founding principles, and operational mechanisms of the two systems, as well as the development of a dual analytical framework aimed at examining their interactions and implications for financial stability.

4. Results :

Table 1. Comparative Analysis of Conventional and Islamic Banking Systems and Their Implications for Financial Stability in a Dual Framework

Analysis Dimension	**Conventional System**	**Islamic System**	**Implication for Dual Stability**
1. Ethical / Philosophical Foundation	Profit maximization, market efficiency.	Compliance with Sharia. Social justice, prohibition of injustice (riba).	Market logic vs. ethical logic. May create regulatory tensions or confidence issues.
2. Principle of Remuneration	Interest rate. Fixed or variable compensation for time and risk.	Profit and Loss Sharing (PLS). Compensation linked to the actual performance of the investment.	Major structural difference. PLS could absorb shocks (loss sharing) but generates uncertainty regarding returns.
3. Relation to the Real Economy	Potential decoupling via derivatives and speculation.	Mandatory backing by a tangible asset. Forced connection to the real sphere.	Potential stabilizer: The Islamic anchor limits the formation of financial bubbles detached from fundamentals.
4. Typical Intermediation Mechanism	Maturity transformation: Deposits (short-term) → Loans (long-term).	Two-tier Mudarabah: Asset/liability integration. No classic maturity transformation.	Mitigated risk: The Islamic model reduces structural liquidity risk but limits credit creation.
5. Key Risk Management	- Credit, liquidity, market risk.	- Common risks (credit, liquidity...).	Complexification: The dual system aggregates the risks of both models and adds additional risks.
	- Hedging with derivatives.	- Specific risks: Mark-up, rate of return, Sharia non-compliance, withdrawal.	
6. Investment Objective	Financial profitability (ROI maximization).	Ethical and financial profitability. Exclusion of illicit sectors.	Diversification effect: Potentially reduces systemic exposure to sector-specific shocks.
7. Role of Trust	Trust in the counterparty's solvency and the deposit insurance system.	Trust in Sharia compliance and the fairness of sharing.	Dual fragility: A crisis of confidence in one system can contaminate the other by association in a dual market.

Source: Prepared by the author.

5. Discussion

The findings of this study are based on the theoretical comparative analysis synthesized in the table above. This comparison highlights profound structural differences between the conventional banking system and the Islamic banking system, which have direct implications for financial stability in a dual banking context.

5.1 Result 1: A Foundational Normative Divergence Influencing Financial Stability

The first major finding concerns the ethical and philosophical foundation of the two systems. The conventional banking system is driven by a logic of profit maximization and market efficiency, while the Islamic banking system is based on compliance with Sharia, social justice, and the prohibition of injustice, particularly through the ban on riba.

This normative divergence creates a structural tension within dual banking systems. Indeed, the coexistence of two different logics—one purely market-oriented, the other ethical—can lead to regulatory asymmetries, misunderstandings among stakeholders, and differing risk perceptions. These factors can undermine financial stability if prudential frameworks fail to account for this duality.

5.2 Result 2: Remuneration Mechanisms with Contrasting Stabilizing Effects

The comparative table shows that the central principle of remuneration constitutes a major structural difference. The conventional system relies on the interest rate, ensuring predetermined returns regardless of the actual performance of the investments. In contrast, the Islamic system adopts the principle of profit and loss sharing (PLS), linking remuneration to the effective performance of the investment.

This result suggests that the Islamic model can act as a shock absorber, insofar as losses are shared between the parties. However, this characteristic also introduces uncertainty regarding returns, which may affect investor confidence and trigger withdrawal behaviors during periods of instability, particularly in a dual banking environment.

5.3 Result 3: A differentiated relationship to the real economy and its stabilizing implications.

The analysis highlights a clear difference in the relationship with the real economy. The conventional system may experience a disconnect between the financial sphere and the real economy, particularly through speculation and the use of derivative products. In contrast, the Islamic system requires that financial operations be backed by tangible assets.

This result confirms that Islamic finance holds stabilizing potential by limiting the formation of financial bubbles detached from economic fundamentals. In a dual banking system, this characteristic can contribute to greater overall resilience, provided that the interactions between the two systems are effectively managed.

5.4 Result 4: Intermediation mechanisms generating distinct risk profiles.

The comparative table reveals that the intermediation mechanisms differ significantly. Maturity transformation in the conventional system constitutes a structural source of liquidity risk. Conversely, the two-tier Mudarabah model in Islamic finance integrates assets and liabilities, thereby reducing structural liquidity risk.

However, this finding also highlights an important trade-off: the limitation of credit creation within the Islamic system. Thus, while the Islamic model mitigates certain risks, it may also constrain the economy's financing capacity, posing a challenge for macroeconomic stability in a dual system.

5.5 Result 5: A complexification of the risk landscape in a dual banking system.

The analysis of risk management methods shows that Islamic banks are exposed to both risks common to conventional banks and specific risks.
This result highlights the increased complexity of risk in a dual banking system. The coexistence of the two models does not merely result in an addition of risks but also generates risks such as regulatory arbitrage and contagion between systems, which can amplify episodes of financial instability.

5.6 Result 6: Investment objectives favoring the diversification of systemic risk.

The table highlights that investment objectives differ between the two systems. The Islamic system combines financial profitability with ethical considerations, excluding certain illicit sectors. This positioning can lead to greater sectoral diversification of investment portfolios.
This finding suggests that the presence of Islamic finance in a dual banking system can help reduce systemic exposure to certain sector-specific shocks, thereby enhancing overall financial stability.

5.7 Result 7: Trust as a critical factor of fragility or stability.

Finally, the analysis highlights the central role of confidence in both systems. While confidence in the conventional system rests primarily on solvency and deposit insurance, confidence in the Islamic system also relies on compliance with Sharia and the principle of profit and loss sharing.
In a dual banking system, this finding reveals a specific vulnerability: a crisis of confidence affecting one system can spill over to the other through association effects, amplifying the risks of financial contagion.
To synthesize and visualize the seven key findings of our analysis, the conceptual diagram below illustrates the dual architecture of the banking system and the dynamic interactions between its conventional and Islamic components. It highlights both the inherent stabilizing mechanisms of Islamic finance and the emerging vulnerabilities specific to their coexistence.

Figure 1. Comparative Analysis: Dual Banking Systems and Financial Stability

Source: Prepared by the author.

6. Conclusion :

This study allows us to conclude that the coexistence of conventional and Islamic banks can give rise to a distinct financial system, characterized by stability and risk approaches that sometimes oppose and sometimes combine. This duality can only be understood if both financial intermediation models are examined in relation to each other to analyze their interaction on the stability of the financial system as a whole.

Due to its principles, Islamic finance requires a number of foundations that are absent in conventional finance. Its contribution in terms of linkage with the real economic sphere, the principle of profit and loss sharing, and its prohibition of speculation can, in principle, induce a stabilizing effect on the

economy. However, despite this effect, it is important to emphasize that the Islamic model presents risks both common to the conventional model and risks specific to itself.

The major problem, therefore, is to find the environment conducive to stability in the case of coexistence between the two models and to address the risk of contagion and transmission that may occur. Furthermore, dual financial stability requires an alignment of both prudential frameworks, implying the implementation of unified regulation capable of considering the specificities of each model while respecting the channels through which the two models can influence each other. The challenge is to leverage the stabilizing characteristics of Islamic finance while accounting for the risks to which it is exposed in the presence of its conventional counterpart.

Thus, these results imply the need to move beyond mere supervision by central banks and financial authorities toward an integrated design of the prudential framework to apprehend the risks of both systems simultaneously, thereby strengthening confidence in the dual financial system. Moreover, from a research perspective, it is important to empirically test both financial models in terms of resilience, especially during crisis periods, in order to model the transmission channels of shocks in a dual context.

Reference

[1] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). (n.d.). *Shari'ah standards*.

[2] Askari, H., Iqbal, Z., & Mirakhor, A. (2015). *Introduction to Islamic economics: Theory and application*. Wiley.

[3] CIBAFI. (2015). *Fundamentals of Islamic banking and finance*.

[4] Crockett, A. (1997). *The theory and practice of financial stability*. Princeton Essays in International Finance.

[5] Foot, M. (2003). *What is financial stability and how do we get it?* The Roy Bridge Memorial Lecture.

[6] Haque, N. U. (1995). *Riba, interest and profit*. Pakistan Institute of Development Economics.

[7] International Monetary Fund (IMF). (n.d.). *Publications and reports*.

[8] Iqbal, M., & Molyneux, P. (2005). *Thirty years of Islamic banking: History, performance and prospects*. Palgrave Macmillan.

[9] Islamic Financial Services Board (IFSB). (n.d.). *Standards and guidance*.

[10] Khan, M. F. (1984). *Islamic banking and its impact on the economy*. University of Karachi.

[11] Laker, J. F. (1999). *Monitoring financial system stability*. Reserve Bank of Australia.

[12] Padoa-Schioppa, T. (2002). *Central banks and financial stability: Exploring the land in between*. European Central Bank.

[13] Patat, J.-P. (2000). *La stabilité financière*. Presses Universitaires de France.

[14] Schinasi, G. J. (2004). *Defining financial stability* (IMF Working Paper No. 04/187). International Monetary Fund.

[15] Schinasi, G. J. (2006). *Safeguarding financial stability: Theory and practice*. International Monetary Fund.

[16] The World Bank. (n.d.). *Global financial development reports*.

[17] Visser, H. (2009). *Islamic finance: Principles and practice*. Edward Elgar Publishing.