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Islamic Debt Principles: A Conceptual Framework for Ethical and Asset-Backed Financing

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Abstract: This paper constructs a novel three-pillar conceptual framework for Islamic finance, built upon a rigorous methodological foundation that synthesizes two distinct intellectual disciplines. From Islamic jurisprudence, specifically *Usul al-Fiqh* and *Maqasid al-Shariah*, the framework derives its ethical and legal boundaries for permissible contracts. From financial economics, drawing on risk agency theory, it obtains its economic principles for asset ownership and equitable risk distribution. The framework's development is critically informed by a gap analysis of existing literature, particularly the works of El-Gamal and Chapra, which exposes a persistent and troubling disconnect between Islamic finance's proclaimed ethical ideals of risk-sharing and its actual practice of risk-transfer through debt-mimicking instruments. Using deductive reasoning from first principles of Islamic ethics, the paper derives the framework's core components and then stress-tests them against modern banking products. The proposed framework advances three interdependent pillars: first, strict adherence to ethical rules grounded in Islamic law; second, tangible real asset ownership that links financial transactions to the productive, real economy and third, genuine risk-sharing between financiers and borrowers. The paper argues that these pillars must function interdependently, because legal compliance alone is insufficient. This insufficiency is powerfully illustrated by *tawarruq* (commodity *Murabaha*) products, which check procedural boxes yet lack both real asset ownership and true risk-sharing, rendering them economically indistinguishable from interest-based debt. To transcend the conventional *halal-haram* dichotomy, the framework proposes a "spectrum of *Islamicness*"—a sophisticated evaluative matrix that reveals how most current Islamic banking products score well on legal formality but poorly on economic substance.

Keywords: *Ethical finance, Islamic jurisprudence, Maqasid al-Shariah, tawarruq and commodity Murabaha.*

1. Introduction

Background of Study

The global financial system faces persistent structural challenges. Recurring economic crises from the 2008 subprime meltdown to the sovereign debt turbulence in Europe, have exposed fundamental weaknesses in conventional banking. Excessive risk-taking, speculative bubbles, systemic contagion, and widening inequality (Stiglitz, 2010; Reinhart & Rogoff, 2009). These failures have resulted in a global rethinking of financial ethics, and new movements such as sustainable finance, ESG (Environmental, Social and Governance) investing and impact investing have emerged, aiming to direct capital allocation to wider social benefits (Schoenmaker, 2017; Eccles et al., 2014). Islamic finance has emerged as a leading alternative in this broader reformation, promising an ethical, asset-backed and risk-sharing model of intermediation.

Conventional finance has some key elements that are prohibited in Islamic finance which is based on *Shariah* (Islamic law). First, it forbids *ribā* (interest or usury), which is defined as any predetermined, positive return on money lent, irrespective of the outcome of the enterprise. Second, it prohibits *gharar* (excessive uncertainty or ambiguity) in contractual terms, including speculative sales of what one does not own. Third, it prohibits maysir (gambling or pure speculation) and requires that all financial transactions be supported by real, tangible assets and authentic economic activity (El-Gamal, 2006; Chapra, 2008). The two fundamental contracts in Islamic finance are *muḍārabah* (profit-sharing partnership) and *mushārakah* (joint-venture partnership). In *muḍārabah*, one party provides capital and the other provides entrepreneurial effort, with profits shared according to an agreed ratio, while losses are borne solely by the capital provider. In *mushārakah*, all partners contribute capital and share profits and losses proportionally to their investment (Iqbal & Mirakhor, 2011). These contracts represent the normative ideal of risk sharing, aligning incentives of the financier and the entrepreneur, and encouraging productive economic activity.

Problem Statement

But despite these ethical aspirations, a disturbing chasm has opened up between the normative ideals of Islamic finance and its operational reality. The industry has grown rapidly–global Islamic financial assets are estimated to exceed USD 4 trillion and are projected to reach nearly USD 5 trillion by 2026 (IFSB, 2023). But this growth has been overwhelmingly driven by debt-mimicking products, not genuine risk-sharing instruments. Contracts such as *murābaḥah* (cost-plus sale) and *tawarruq* (commodity Murabaha) that are structurally similar to conventional loans with fixed, predetermined returns, now constitute over 70% of Islamic banking assets in many jurisdictions, while *muḍārabah* and *mushārakah* make up less than 10% (Ernst & Young, 2016; Ahmed, 2021).

Likewise, the global *ṣukūk* (Islamic bond) market has grown to almost USD 1 trillion, but many *ṣukūk* structures are "asset-based" as opposed to genuinely "asset-backed". In an asset-backed *ṣukūk* investors have rights to cash flows from an asset, but do not own the underlying asset. This way, they do not bear the full risks of ownership such as destruction, depreciation, or impairment, and the structure transfers the risk to the obligor that performs the same economic function as a conventional bond (El-Gamal, 2006; MIFC, 2021).

This gap between form and substance threatens the very raison d'être of the industry. The danger is that if Islamic banks continue to market products that are Shariah-compliant only in the sense of legal documentation and economically indistinguishable from conventional debt, the industry risks becoming nothing more than an "interest arbitrage" mechanism, what El-Gamal (2006) famously called "Islamic finance in name only. This credibility gap not only erodes consumer trust but exposes the industry to charges of hypocrisy and ethical irrelevance.

Connecting Islamic Debt Principles with Broader Global Trends

The issues discussed in this paper are not unique to Islamic finance but are rather a manifestation of global trends toward sustainable and ethical finance. The shift in capital markets toward ESG integration, driven by the United Nations' Sustainable Development Goals (SDGs) and the Paris Agreement on climate change (UNEP FI, 2022; World Bank, 2021), has seen investors increasingly demanding that financial intermediaries demonstrate positive social and environmental impact, in addition to financial returns.

The basic principles of Islamic finance are remarkably in tune with these global trends. The prohibition of *riba* discourages speculation based on debt and excessive leverage. Mirakhor & Iqbal (2013) describe the main contributors to systemic risk and financial instability. The prohibition of *gharar* (excessive uncertainty) promotes transparency and contractual clarity, both of which are key pillars of ESG disclosure standards. The ban on *maysir* (gambling) shifts capital from speculative activities (e.g., derivatives trading) to productive, real-economy investment, a goal common to impact investing frameworks (Scharf & Scholtens, 2022). In addition, the *maqāṣid al-Sharīʿah* (higher objectives of Islamic law) which include the protection of wealth, life, intellect, lineage and faith, are compatible with the "social" and "governance" pillars of ESG that focus on human welfare, responsibility for the environment, and distributive justice (El-Halaby & Hussainey, 2015; Jan et al., 2021).

However, this alignment remains largely theoretical. The current *debt-mimicry* model of Islamic banking does not deliver on these ethical promises. Fixed-return, asset-based products do not incentivize financiers to monitor entrepreneurial performance, do not cushion losses during downturns, and do not contribute to financial stability in the way that genuine risk-sharing would (Askari et al., 2012). In fact, the conventionalization of Islamic finance arguably exacerbates the very problems, inequality, instability, and financialization - that sustainable finance movements seek to address. This disconnection represents not only a religious or legal problem but also a missed opportunity for Islamic finance to position itself as a leading contributor to global sustainable development and responsible investing.

This paper is conceptual in nature and does not present primary empirical data. It is about the structure of Islamic finance contracts, not pricing or operational implementation. The paper is organized as follows: Section 2 gives a review of the literature on Islamic debt, risk-sharing and the form versus substance debate. Section 3 presents the three-part conceptual framework. In Section 4, the framework is used to evaluate existing products and discuss implications. Section 5 concludes with directions for future research.

2. Literature Review

Islamic Debt Financing: Conceptual Foundations

Islamic debt financing occupies a unique position within the broader Islamic financial system. Islamic debt instruments are based on sales, leases or partnerships and must follow Shariah prohibitions on *ribā* (interest), *gharar* (excessive uncertainty) and *maysir* (gambling) (El-Gamal, 2006; Usmani, 2002). Unlike conventional debt which is essentially a loan of money for a fixed interest payment. This structural difference is not just a semantic one; it is a deeper philosophical commitment to linking financial returns to productive economic activity and real risk-taking.

The most common Islamic debt contracts are *murābaḥah* (cost-plus sale) in which a financier purchases an asset and sells it to the client at an agreed markup; *ijārah* (leasing) in which the financier leases an asset to the client at a fixed rental payment; and *tawarruq* (commodity murabaha), a structured transaction involving the purchase and sale of commodities to generate liquidity (Iqbal & Mirakhor, 2011). These contracts are Shariah-compliant technically as far as their legal form is concerned. However, they produce economic results that are very similar to conventional interest-based loans. These results are in the form of fixed, predetermined returns and are largely independent of the performance of the underlying asset (Khan, 2025).

The main business model in Islamic banking is reliance on debt-like products. Empirical data shows that more than 70% of Islamic banking assets in countries such as Malaysia, the Gulf Cooperation Council (GCC) countries and Indonesia are *murābaḥah, ijarah* and *tawarruq* (Ernst & Young, 2016; Ahmed, 2021; Muneem et al., 2024). In contrast, real profit-and-loss sharing (PLS) contracts *muḍārabah* and *mushārakah* account for less than 10%. This imbalance begs critical questions about whether the industry is living up to its ethical promise or simply repeating conventional finance in Islamic garb.

Theoretical Basis: Theories of Islamic Debt

The theoretical underpinnings of Islamic debt financing are built on three interconnected principles drawn from the *Qur'an, Sunnah*, and centuries of Islamic jurisprudence (*fiqh*). These principles form the normative framework within which all financial contracts must be assessed.

The Prohibition of *Ribā* (Interest): The fundamental prohibition in Islamic finance is of *ribā*, which is usually taken to mean any predetermined and guaranteed return on money lent, regardless of the outcome of the enterprise (Chapra, 2008). The *Qur'an* explicitly condemns *ribā* in several verses (e.g., *Qur'an 2:275-279*), equating it with injustice and exploitation. Crucially, the ban is not on the rate of interest, but on the structure of the transaction: money should not generate money without being intermediated through real economic activity, risk-taking, and value creation (El-Gamal, 2006). This is the principle that sets Islamic finance apart from conventional debt, where interest is just the price of money over time.

Asset-Backing Requirement (*Al-'Aqd 'Alā Al-'Ayn*): The second cornerstone is that all financial transactions must be tied to an underlying tangible asset, service or real economic activity. This is known as asset-backing. In Shariah, a sale of what one does not own, a sale of non-existent goods or a purely monetary sale with no underlying asset is invalid (Usmani, 2002). The requirement is designed to prevent excessive uncertainty (*gharar*) and gambling (*maysir*) and to ensure that finance serves the real economy and does not become a speculative end. This entails, in practice, that Islamic debt contracts must involve the transfer of ownership (or beneficial rights) of a real asset and the financier must bear the risks associated with that ownership, at least for a meaningful period (Iqbal & Mirakhor, 2011).

The Principle of Risk-Sharing (*Al-Ghunm Bil-Ghurm*): The third theoretical pillar is the maxim *al-ghunm bil-ghurm*, which means "profit comes with risk". Based on a well-known *Prophetic* tradition, this principle states the rule that any entitlement to gain is subject to the corresponding risk of loss (Chapra, 2008). In the case of debt financing this means that the return of a financier cannot be fixed or guaranteed but must vary with the actual performance of the asset or enterprise being financed. This is precisely the reason why the PLS contracts (*muḍārabah* and *mushārakah*) are the normative ideal in Islamic finance, they represent a risk-sharing arrangement by balancing the interests of the financier and the entrepreneur. Because financiers bear the downside risk, they have more incentives to monitor and facilitate the ventures they finance, which may lead

to less moral hazard and better economic results (Mirakhor & Iqbal, 2013; Khan, 2019).

Ethical and Asset-Backed Principles of Islamic Debt

Apart from these theoretical principles, Islamic debt financing is also based on a wider ethical foundation that stresses justice *(ʿadl*), fairness (*insāf*) and social welfare (*maṣlaḥah*). Chapra (2008) argues that the objective of Islamic finance is not only to avoid the prohibition of certain acts but also to promote human welfare, reduce inequality and promote economic stability. This ethical dimension is operationalized by the *maqāṣid al-Sharīʿah* (higher objectives of Islamic law) which include the protection of faith, life, intellect, lineage and wealth. Any financial contract that undermines these objectives, e.g. by aggravating debt distress, promoting speculation or widening inequality, fails the ethical test even if it is technically compliant with *Shariah* (El-Halaby & Hussainey, 2015).

This ethical vision is connected to the asset-backed requirement. If the financier owns the asset then they have the risks of the asset (depreciation, destruction or impairment) and are incentivized to ensure it is used productively. This is quite different from pure monetary lending, where the lender has no interest in the success of the borrower's endeavor, and can call in his money regardless of the results. Thus, the asset-backed approach encourages productive finance instead of speculative finance. The approach is in line with broader global movements toward sustainable and responsible investing (Scharf & Scholtens, 2022; Jan et al., 2021).

Yet, as the literature increasingly demonstrates, the practical implementation of these ethical and asset-backed foundations has been patchy, at best. Many Islamic banks do not see asset ownership as a real issue, but a legal formality, such as holding title for a fraction of a second in *tawarruq* transactions or structuring *sukuk* as "asset-based" rather than "asset-backed" (El-Gamal, 2006; Safutra, 2026). The division of legal form from economic substance is a fundamental betrayal of the ethical and asset-backed ideals that Islamic finance claims to stand for.

Sukuk: The Ideal and the Reality

Sukuk (often termed Islamic bonds) are one of the most important innovations in modern Islamic finance. Unlike traditional bonds, which are a debt obligation of the issuer, *ṣukūk* are structured to reflect shared ownership of an underlying asset, project or business venture. *Ṣukūk* holders have a right to a share of the returns generated by the asset and are exposed to the risks of ownership (Usmani, 2002; AAOIFI, 2025).

The global *ṣukūk* market has grown substantially, with outstanding *ṣukūk* expected to exceed USD 1 trillion by 2025, driven by sovereign issuers in Malaysia, Saudi Arabia, Indonesia, and the GCC, as well as increasing interest from non-Muslim jurisdictions such as the United Kingdom and Luxembourg (Noorali, 2025; Fitch Ratings, 2024). This growth has been celebrated as evidence of the global appeal of Islamic finance and its ability to raise long-term capital for infrastructure and development projects.

However, a growing body of critical scholarship has revealed a significant disconnect between the *ṣukūk* ideal and its market reality. The main critique, most eloquently expressed by El-Gamal (2006), is that most of the *ṣukūk* are "asset-based" and not really "asset-backed." In an asset-backed *ṣukūk*, the issuer does not transfer full legal ownership of the underlying assets to the *ṣukūk* holders. The issuer does not transfer ownership but gives the holders beneficial rights to cash flows from the assets. The structure then creates a contractual obligation on the issuer to pay returns, which in many cases are fixed and predetermined, and which, essentially, reproduces the economic function of a traditional bond (MIFC, 2021).

Indeed, this critique is empirically well founded. Debt-based *sukuk* structures (mostly *ijarah* and *murabaha*) still represent about 70-80% of the global *sukuk* market, while equity-based structures (*mudharabah* and *musharakah*) remain a small minority (Safutra, 2026; Ibrahim & Alenezi, 2024). The prevalence of debt-like *ṣukūk* means that investors do not really share in the risks of the underlying assets – they get fixed returns regardless of the performance of the assets, while the obligor bears the economic burden. As provocatively stated by El-Gamal (2006, p. 124), this is "Islamic finance in name only".

The Divide between Theory and Practice

The theory-practice gap in Islamic finance is a well-documented phenomenon in the extant literature. The

theory-practice gap is a gap between the normative ideals expressed in Shariah texts and the operational realities of the industry. Islamic banking is Shariah-compliant in form and conventional in function. (Khan, 2025) "Banks use the legal forms of Shariah-approved contracts (sales, leases, partnerships), but they engineer them to produce the same economic effects as conventional interest-based loans: fixed, predetermined returns, limited risk exposure, and little monitoring of entrepreneurial performance.

Several factors explain this gap. First, risk aversion on the part of banks, PLS contracts (*muḍārabah* and *mushārakah*) expose financiers to genuine downside risk, including the possibility of total loss of capital. Banks like the predictability of fixed income products because of capital adequacy rules and the shareholders' desire for consistent earnings (Muneem et al., 2024). Second, information asymmetry, PLS contracts require banks to closely monitor and evaluate entrepreneurial projects, which is costly and difficult, especially for small and medium enterprises (SMEs) (Khan, 2019). Third, the Basel capital standards-based regulations consider PLS assets as riskier and require higher capital charges, which further discourages their use (Askari et al., 2012).

Empirical evidence from Malaysia – one of the most developed Islamic finance jurisdictions – suggests that banks view customers as debtors with fixed instalments rather than business partners (Muneem et al., 2024). Such a creditor-debtor relation is fundamentally in contradiction to the spirit of partnership that Islamic finance claims to promote. Similarly, Ibrahim and Alenezi (2024) state that Islamic finance has significant potential for sustainable development (particularly in financing green infrastructure and social enterprises), but this potential is often unrealized because institutions are unwilling to participate in the real risk sharing needed by early-stage ventures.

Regulatory Initiatives to Bridge the Gap

Regulatory and standard-setting bodies have responded to the growing gap between form and substance by taking steps to reform Islamic financial practice. In 2025, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the entity that issues globally accepted standards for the Islamic finance industry, issued its Standard No. 62 on *Ṣukūk* (AAOIFI, 2025). This standard is a major regulatory intervention designed to bring *ṣukūk* structures closer to true asset ownership and risk-sharing.

The main provisions of AAOIFI Standard 62 are:

- Prohibition of fixed or guaranteed returns in equity-based sukuk structures.
- Clear legal title transfer to ṣukūk holders, who must bear the risks of ownership.
- Tougher disclosure rules on asset valuations, cash flow projections, and risk factors.

Many scholars and practitioners welcome these reforms as a necessary correction toward the ethical roots of Islamic finance, whereas others worry about possible market disruptions. The implementation of Standard 62 requires a basic overhaul of existing structures of *ṣukūk*, which could lead to higher transaction costs, lower issuance volumes and discourage conventional investors used to bond-like returns (Safutra, 2026). But proponents counter that these transitional costs are unavoidable if the industry is to retain its credibility and long-term viability.

Summary of Literature Review

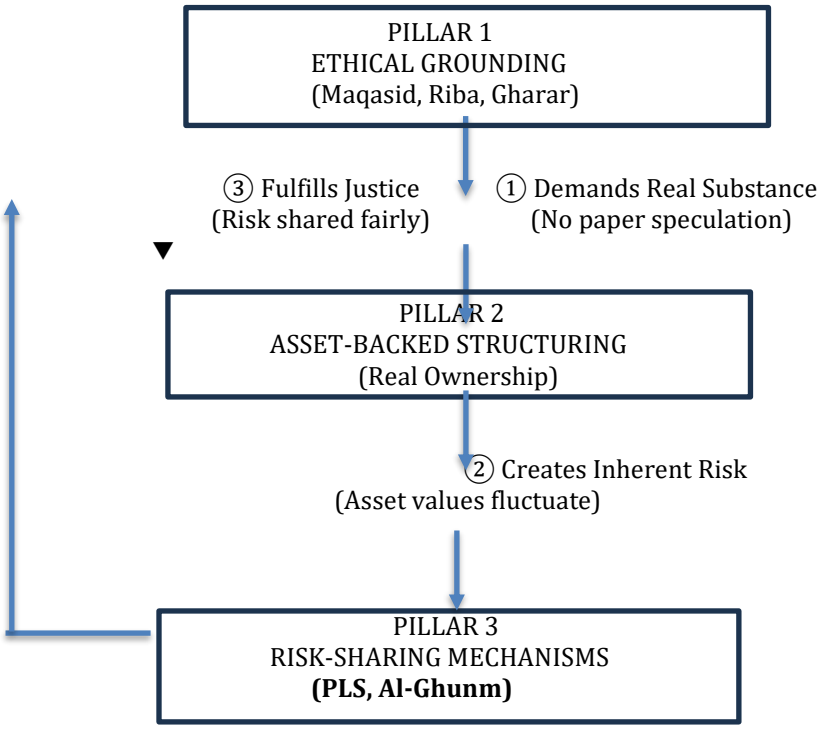
This literature review has identified three basic principles on which Islamic debt financing is theoretically founded, namely the prohibition of ribā, the asset-backing requirement, and the principle of risk-sharing (*al-ghunm bil-ghurm*). However, the practical implementation of these principles has been inconsistent, with the industry dominated by debt-mimicking products (*murābaḥah*, *ijārah*, *tawarruq*, and asset-based *ṣukūk*) that satisfy formal Shariah requirements but replicate the economic functions of conventional debt. Regulatory efforts such as AAOIFI Standard 62 represent a welcome correction, but the literature remains fragmented, descriptive, and yet to fully integrate recent regulatory changes. These gaps motivate the construction of the integrated, tripartite framework presented in the following section.

3. Theoretical Framework

Overview of the Three-Pillar Model

We propose a framework based on three interdependent pillars. We call these Ethical Grounding, Asset-Backed Structuring, and Risk-Sharing Mechanisms. They are connected in a cycle. Each pillar supports and requires the others.

Figure 1: The Three-Pillar Framework for Islamic Debt Principles



Pillar 1: Ethical Foundations

This pillar is the basic rules that have been derived from Shariah. Not only to refrain from the forbidden (*haram*) but to attain the higher purposes of Islamic law (*maqāṣid al-Sharīʿah*) comprising the protection of faith, life, intellect, lineage and wealth. In practice, this pillar involves:

No Riba: The lender cannot charge a fixed guaranteed return. Profit must be uncertain and tied to effort.

No Gharar: Contracts must be clear and without excessive uncertainty. Both parties must know exactly what they are getting.

No Maysir: Transactions cannot be speculative or gambling-like. They must serve genuine economic needs.

Pillar 2: Asset-Backed Structuring

This pillar requires that every transaction is tied to a real, identifiable asset or economic activity. This is what prevents Islamic finance from becoming pure financial engineering. There is a critical distinction here:

Asset-based: The contract mentions an asset, but the financier does not take legal ownership or bear the risks of that asset.

Asset-backed: The financier actually owns the asset and takes the risks that come with ownership (e.g., damage, depreciation).

Our framework insists on the asset-backed version. True ownership is critical. This is in line with AAOIFI Standard 62, which requires that sukuk holders have full legal title to the underlying assets and that returns are linked to the actual performance of the underlying assets

Pillar 3: Risk-Sharing Mechanisms

This pillar implements the rule "gain accompanies risk." If a financier provides capital, he must accept that he might lose it. He cannot just pass all losses to the entrepreneur and keep a fixed return for himself. The best

way to do this is through *Profit-Loss Sharing* (PLS) contracts such as *Mudarabah* (one provides the capital and the other the labor) and *Musharakah* (both contribute capital and management). Under these contracts, profits are shared according to an agreed ratio and losses are borne strictly in proportion to the capital contribution. Even in contracts based on sales, there may be risk sharing. For instance, in *an ijarah* lease, the lessor bears the risk of damage to the asset during the lease period.

How the Pillars Interact (The Relationship View)

The pillars are not independent. They form a logical sequence and a feedback loop:

Ethical Grounding → Demands → Asset-Backed Structuring: Since ethics prohibit money being created from nothing, financing has to be tied to real assets.

Asset-Backed Structuring → Creates → Risk-Sharing Mechanisms: The financier can't escape the risk of real assets falling in value. This means there must be a sharing arrangement.

Risk-Sharing Mechanisms → Fulfills → Ethical Grounding: Sharing risk fairly is the practical definition of justice (*'adl*), which is the heart of the *maqāṣid.*

The System Collapses if One Pillar Fails:

If a sukuk is asset-based (lacks Pillar 2), it does not create real risk for the investor. The investor receives a fixed return violating Pillar 1 (Riba) and Pillar 3 (No risk sharing). If a product shares risk but does not have real assets (Pillar 2) it is gambling (breaking Pillar 1).

Propositions for Testing

Based on the tripartite framework developed in this paper, we propose the following propositions for future empirical research. Each proposition is derived from the logical relationships among the three pillars and is designed to be testable using quantitative or qualitative methods.

The Core Functional Relationship: At the heart of our framework is the assertion that the three pillars are mutually reinforcing and non-fungible. The "Islamicity" (or substantive Islamic authenticity) of any financial contract is a function of the concurrent existence and strength of all three pillars. It can be written as this relation:

This relationship can be expressed as:

$$\text{Islamicity} = f(E, A, R)$$

Where:

E = Ethical Foundations (Pillar 1) — the extent to which the contract upholds *maqāṣid al-Sharīʿah*, justice, and social welfare beyond mere legal formalism.

A = Asset-Backed Structuring (Pillar 2) — the degree of genuine, constructive ownership of real assets, including full liability for risks such as depreciation, destruction, and impairment.

R = Risk-Sharing (Pillar 3) — the degree to which the financier's return is directly and proportionally linked to the realized performance of the underlying asset, and the financier bears downside risk.

This function is multiplicative rather than additive:

$$\text{Islamicity} \propto E \times A \times R$$

This multiplicative relationship captures the core argument of this paper: if any pillar is absent or weak (approaching zero), the overall Islamicity collapses toward zero, regardless of how strong the other pillars are. In other words, legal compliance (high E) without genuine asset ownership (low A) and risk-sharing (low R) does not produce a substantively Islamic contract. Conversely, risk-sharing (high R) without ethical grounding (low E) is directionless and may lead to unjust outcomes. The three pillars must coexist and reinforce one another.

This relationship also allows for a spectrum of Islamicity—products can be graded along a continuum rather than a binary *halal*/*haram* classification, depending on the relative strength of each pillar.

Testable Propositions

Based on this functional relationship and the analytical framework presented in Sections 3.3–3.5, we propose the following propositions for future empirical investigation:

P1: Legitimacy and Trust Proposition

P1: Islamic banks and sukuk that clearly satisfy all three pillars (ethical, asset-backed, risk-sharing) will have higher levels of customer trust and stakeholder legitimacy.

This proposition is based on stakeholder theory and legitimacy theory (Suchman, 1995; Freeman, 1984). When financial institutions genuinely apply ethical principles (Pillar 1), back their contracts with real assets (Pillar 2) and share risks with their clients (Pillar 3), they are perceived as more trustworthy and authentic. This perception helps to increase brand loyalty, customer retention and overall market positioning. Conversely, institutions that "check the box" on Shariah compliance without actually engaging in conventional business are subject to reputational and consumer skepticism, as documented by El-Gamal (2006) and Khan (2025).

P2: Financial Resilience Proposition

P2: Asset-based sukuk (strong Pillar 2) will exhibit higher resilience in terms of stable returns and lower default rates compared to asset-based sukuk during periods of recessions.

The literature on risk sharing (Askari et al., 2012; Mirakhor & Iqbal, 2013) suggests this proposition. In real asset-backed structures investors take on the risks of the underlying asset, so that in downturns returns decline but the structure does not generate domino effects as losses are borne by investors and not by a single obligor. The risk is transferred to the obligor in asset-based or debt-like structures, however, which results in higher default rates if cash flows fall. This is consistent with the empirical evidence that equity-like risk-sharing instruments are more resilient during a systemic crisis (Akin et al., 2016; Khan, 2019).

P3: Regulatory Impact Proposition

P3: Regulatory changes like AAOIFI Standard 62 which enforces Pillars 2 and 3 will increase structuring costs initially but will result in greater long-term market stability and ethical credibility.

This proposition is grounded in institutional theory and regulatory economics (North, 1990; Williamson, 1985). Tighter regulatory standards impose transition costs on incumbents (e.g., legal restructuring, renegotiation of contracts, and enhanced disclosure requirements). Still, the costs are outweighed by the long-term benefits like reduced systemic risk, less information asymmetry, improved investor protection, and enhanced market integrity (AAOIFI, 2025; Safutra, 2026). This is supported by the experience of other financial regulatory reforms, like Basel III capital requirements, where compliance costs first increased but eventually improved the resilience of the banking system (BCBS, 2017).

P4: Sectoral Applicability Proposition (Supplemental)

This proposition is based on agency theory (Jensen & Meckling, 1976). Where cash flows are inherently uncertain (e.g., in agriculture where climate risk exists, or in SMEs where market volatility exists), fixed-debt financing generates moral hazard, misaligned incentives and financial distress. Risk-sharing models that satisfy all three pillars align the interests of the financier and the entrepreneur, incentivize active monitoring and enable loss absorption during downturns (Khan, 2019; Ibrahim & Alenezi, 2024). This proposition extends the framework to other developmental finance applications besides banking.

Summary of Propositions

Proposition	Focus	Key Relationship Tested
P1	Trust & Legitimacy	Islamicity → Higher stakeholder trust
P2	Financial Resilience	Asset-backed (A) + Risk-sharing (R) → Lower default/volatility
P3	Regulatory Impact	AAOIFI Standard 62 → Short-term costs → Long-term stability
P4	Sectoral Applicability	Three-pillar framework → Better SME/agriculture outcomes

Operationalization for Future Research

To facilitate empirical testing, we recommend that researchers operationalize each pillar as follows:

Pillar 1 (E): Measured using a *Maqāṣid Compliance Index* that evaluates contract documentation against five dimensions: protection of faith, life, intellect, lineage, and wealth. This can be scored by independent Shariah reviewers (cf. El-Halaby & Hussainey, 2015).

Pillar 2 (A): Measured using an Asset Ownership Depth Score that assesses: (i) whether legal title is transferred; (ii) the duration of ownership; (iii) whether the financier bears maintenance, insurance, and depreciation risks; and (iv) the extent of recourse to the obligor in case of asset impairment.
Pillar 3 (R): Measured using a Risk-Sharing Coefficient, defined as:

$$R = 1 - \frac{\text{Guaranteed/ Fixed Return Component}}{\text{Total Expected Return}}$$

Where R = 1 refers to full risk-sharing (fully variable, performance-linked returns) and R = 0 refers to full risk-transfer (fully fixed returns similar to conventional debt).
These operationalizations allow researchers to build an aggregate Islamicity Score (E × A × R) for any given product or portfolio, and thus to statistically test the propositions above.

Conclusion of Propositions
The propositions are the conceptual framework translated into testable hypotheses to be investigated through quantitative and qualitative methodologies. P1: Stakeholder perception and market legitimacy, P2: Financial resilience and stability, P3: Regulatory dynamics and market evolution, P4: Sectoral applicability and developmental impact. Together they offer a complete research agenda to empirically validate (or invalidate) the framework put forward in this paper. Future researchers are hoped to test these propositions across various jurisdictions, asset classes and time periods to build a robust evidence base for the substantive practice of Islamic finance.

4. Discussion of Implications

Implications for Theory
Our framework offers a more complete and integrated theory of Islamic debt. It moves away from listing rules separately and instead demonstrates the structural and functional links between ethical foundations, asset-backed structuring, and risk-sharing mechanisms. By conceptualizing these three pillars as mutually reinforcing and non-fungible (Islamicist = E × A × R), the framework explains why Islamic finance often fails to meet its normative goals: because it implements the rules in isolation—treating legal compliance as sufficient—rather than as an integrated system where each pillar depends on the others for substantive authenticity.

This framework also positions Islamic finance as a useful model for all ethical finance, not merely for Muslim-majority contexts. The principles that finance should serve the real economy, that risk should be shared rather than transferred, and that contractual relationships should embody justice and transparency are universal values. They offer important lessons for reforming global finance, which is still marked by excess leverage, speculative bubbles and systemic instability (Askari et al., 2012; Stiglitz, 2010). This paper contributes to the wider literature on sustainable finance, ESG investing and stakeholder capitalism by demonstrating how these principles can be operationalized in a coherent framework.

The framework also advances the study of *maqāṣid* by moving beyond abstract moral appeals to measurable, contract-level standards. It translates the higher objectives of Islamic law (*maqāṣid al-Sharīʿah*) into concrete, measurable dimensions of asset ownership depth and risk-sharing coefficients, thus bridging the gap between normative theory and positive analysis.

Implications Product Development Practical Checklist
This framework is a practical step-by-step checklist for the design and evaluation of Islamic financial products for bankers, product developers and Shariah advisors. When practitioners are planning a new product or reviewing an existing one, they need to ask three fundamental questions:
Pillar 1 (Ethics): Does the contract satisfy the higher ethical objectives of Shariah (*maqāṣid*), or does it only meet formal legal requirements? Is it fair and transparent?
Pillar 2 (Asset-Backing): Does the bank truly own the underlying asset and bear its entire liabilities, including maintenance, insurance, depreciation and destruction risk, or is ownership only constructive and ephemeral?
Pillar 3 (Risk Sharing): Is the return of the financier tied to the actual performance of the asset/enterprise or is it a fixed predetermined payment like conventional interest?

If any of these questions receives a negative or qualified answer, the product fails the framework and should be redesigned or discontinued, regardless of its Shariah board approval.

Summary of Implications

In summary, this section has demonstrated the broad implications of the three-pillar framework. Theoretically, it offers an integrated model that moves beyond fragmented analyses and positions Islamic finance as a model for ethical finance globally. Practically, it provides a checklist for product developers, a basis for Shariah board accountability, and a rationale for regulatory reform—while also identifying key real-world disincentives that must be addressed for successful implementation. Empirically, it offers a rich agenda with operationalized variables and testable propositions. Finally, we have acknowledged the framework's limitations, particularly its conceptual nature, legal heterogeneity, interpretive diversity, and scope constraints. These limitations are not fatal but rather point to fruitful avenues for future research and refinement.

5. Conclusion and Recommendations

Summary of Contribution

This paper addresses the critical gap between the normative ideals and operational realities of Islamic finance. We have constructed a simple but powerful conceptual framework that organizes Islamic debt principles into three integrated pillars: Ethical Grounding (Pillar 1), Asset-Backed Structuring (Pillar 2) and Risk-Sharing Mechanisms (Pillar 3). We have demonstrated that these pillars are interdependent and non-fungible; authentic Islamic debt requires all three to be present simultaneously. If any pillar is missing or significantly weakened, the financing becomes structurally conventional, regardless of its Shariah documentation or legal form.

The framework contributes to theory by synthesizing Islamic jurisprudence with financial economics into a unified evaluative lens. It informs policy by providing a clear rationale for regulatory reforms, such as capital carve-outs for genuine PLS assets, that could encourage risk-sharing and enhance systemic stability. Finally, the framework links Islamic finance with wider global trends in ESG investing and sustainable development, thus placing Islamic finance as a legitimate and relevant player in the transition to ethical and responsible capitalism.

Final Word

Islamic finance has enormous potential to contribute to building a fairer, more stable and more sustainable global economy. Its fundamental principles - the prohibition of interest, asset-backing, and risk-sharing - are not merely religious injunctions but universal lessons for reforming a financial system mired in excessive leverage, speculation, and inequality. But this potential will be unlocked only if the industry stays true to its values. The three-pillar framework provides a clear map for that journey: by promoting ethics, real assets and collective risk, Islamic finance can provide a pragmatic and credible alternative to the debt-based, speculative model that dominates the world today. The transition will not be easy and will require a sustained commitment from regulators, practitioners and scholars alike. But the alternative is to continue down the path of form without substance, which risks making the industry irrelevant, a mere "Islamic finance in name only" (El-Gamal, 2006). The choice is clear and it is time to act now.

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