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ISLAMIC FINANCE IN THE MODERN WORLD: EXPANDING THE PERIMETER OF THE PERMISSIBLE AND THE FUTURE OF ETHICAL FINANCE

29 June 2026

This article analyses Islamic finance, its origins and expansion, including the *Shari'ah* foundations and the distinct ethical identity. For its further development to be a source of renewal, Islamic finance must remain anchored in *Shari'ah* juristic reasoning, prudential regulation and supervision, and evidence of real-economy contribution.

Islamic finance may be understood as the progressive expansion of the "perimeter of the permissible": the evolving boundary within which financial innovation is accepted as *Shari 'ah*-compliant while retaining a distinct ethical identity[1]. That perimeter now extends from banking, trade finance and leasing to *sukuk*, *takaful*, sustainability instruments, and AI-assisted governance.

The continuing challenge is to translate formal compliance into deeper ethical performance and to move from fragmented *Shari'ah* approval toward more transparent and technologically assisted governance. This project offers Muslims a means of permissible financial participation while providing the wider financial system with an example of finance shaped by law, ethics, prudence, and social purpose.

Introduction: A continuing achievement

In little more than sixty years, Islamic finance has grown into an industry with assets measured in trillions of dollars.

The Islamic Financial Services Board (IFSB) estimated total global Islamic financial services industry assets at USD 3.88 trillion in 2024, a year-on-year increase of 14.9 percent. Banking remained the dominant segment, accounting for more than seventy percent of industry assets, while *sukuk* represented almost one quarter of the total. Islamic insurance, or *takaful*, remained much smaller (Figure 1).

Growth has been particularly strong in Malaysia, the Gulf Cooperation Council (GCC) countries, Indonesia, Pakistan, Bangladesh, Türkiye, Brunei, and parts of Africa. Islamic finance has also developed in non-Muslim-majority jurisdictions, including the United Kingdom, Luxembourg, Germany, and the United States.

The broader importance of Islamic finance lies in the questions it poses. What makes a financial return legitimate? Should money earn a return simply because time has passed, or only because it is linked to trade, asset ownership, enterprise, or risk? What is the appropriate relationship between private profit, moral restraint, social welfare, and shared prosperity?

Islamic finance is therefore not simply "interest-free banking". The prohibition of *riba* is central, but the wider framework also restricts excessive uncertainty, gambling, deception, unjust enrichment, and prohibited sectors, while seeking asset-backing, trade-linkage, and real-economy purpose.

Three factors are central to the emergence and continuing development of Islamic finance. First, the conversion of classical Islamic commercial-law concepts into enforceable and investable instruments within modern legal systems is the act of "legal translation" that makes Islamic finance operational[2]. Second, the perimeter of the permissible describes the evolving boundary within which Islamic finance may innovate while retaining *Shari'ah* and ethical integrity. Third, embedded governance or ethics refers to the translation of moral principles into contracts, institutions, standards, supervision, disclosure, and accountability.[3]

Re-emergence of Islamic finance: How the perimeter widened

The modern Islamic finance movement emerged from the broader post-colonial revival of Islamic thought. Muslim-majority societies inherited banking systems shaped by European commercial law, central banking, and interest-based public finance. At the same time, Islamic jurisprudence had long prohibited *riba* and had developed sophisticated legal concepts for partnership, agency, leasing, guarantee, debt, charity, and endowment. The modern question was whether finance could be both commercially effective and faithful to *Shari'ah* principles.

The early experiments were modest but important. The Mit Ghamr savings initiative in Egypt in the 1960s is often regarded as an early attempt to mobilise savings without conventional interest. The 1970s marked a decisive institutional moment. The Islamic Development Bank, Dubai Islamic Bank, Kuwait Finance House, Faisal Islamic Bank, and other pioneers gave Islamic finance a multilateral and commercial form.

During the 1980s and 1990s, the perimeter widened from experiments to systems. Malaysia developed a dual banking structure. Bahrain became a centre of Islamic standard-setting and international Islamic banking. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) emerged to develop accounting, auditing, governance, and *Shari'ah* standards. The IFSB subsequently provided prudential and supervisory standards. The 1990s and 2000s also saw the rise of *sukuk*, which transformed Islamic finance from a mainly banking-based industry into a capital-market industry.

By the 2010s, Islamic finance had become global. Conventional banks opened Islamic windows. Non-Muslim-majority jurisdictions sought Islamic liquidity. The United Kingdom, Luxembourg, Hong Kong, and South Africa issued sovereign *sukuk*. Islamic funds and indices expanded. *Takaful* gained recognition. Islamic fintech, crowdfunding, and digital banking began to emerge.

The most recent phase involves sustainability and digitalisation. Green *sukuk*, social *sukuk*, and trust- or *waqf*-linked instruments connect Islamic finance with environmental and social objectives. Digital banking, tokenisation, smart contracts, big-data credit scoring, and artificial intelligence (AI) now test the next boundary of permissibility.[4] These technologies can deepen Islamic finance's real-economy orientation and help demonstrate that *Shari'ah* compliance is not merely a formal label, but a disciplined way of organising finance to achieve social benefit.

The transformation has been profound. Islamic finance has created institutions, laws, markets, and standards, and has enabled consumers and investors to participate in formal finance without violating religious commitments. It has also used debt-like instruments, commodity *murabaha*, *tawarruq* (used to generate cash liquidity), and *sukuk* structures that sometimes reproduce conventional economics.

This does not mean that the project has failed. It means that the perimeter has widened faster than the industry's tools for measuring ethical performance. The next stage should therefore be assessed not only by expansion, but also by the quality of that expansion.

Shari'ah **foundations: Prohibitions, structures, and objectives**

The *Shari'ah* basis of Islamic finance operates at three levels: prohibitions, principles, and ethical objectives. The prohibitions define what finance must avoid. The principles explain how permissible returns may be generated. The ethical objectives indicate what finance should serve.

The first prohibition is *riba*. Modern Islamic finance treats interest on loans as falling within this prohibition. The moral concern is that money should not generate a guaranteed return solely by virtue of time, without exposure to risk, trade, enterprise, asset ownership. The second prohibition is *gharar*, or excessive uncertainty. Islamic law does not prohibit all risk; commerce necessarily involves risk. It prohibits uncertainty so excessive that it undermines informed consent, fairness, or clarity. The third prohibition is *maysir*, or gambling. Finance should not become a game of chance detached from productive activity or legitimate risk management.

The main structuring principle is asset-backing or trade-linkage. Islamic finance seeks to connect financial return to sale, lease, agency, partnership, usufruct, or ownership. A financier should earn profit by bearing some form of asset, market, performance, or enterprise risk, rather than merely by lending money at interest. Islamic finance also excludes impermissible sectors such as alcohol, gambling, pork-related businesses, and certain forms of conventional financial activity. It is embedded in a wider moral economy that includes charity and benevolence through *zakat*, *waqf*, *qard hasan* (benevolent interest-free loans), and rules against exploitation. The *Maqasid al Shari'ah*, the higher purposes of Islamic law, are often invoked to connect Islamic finance with welfare, social justice, and human flourishing.[5]

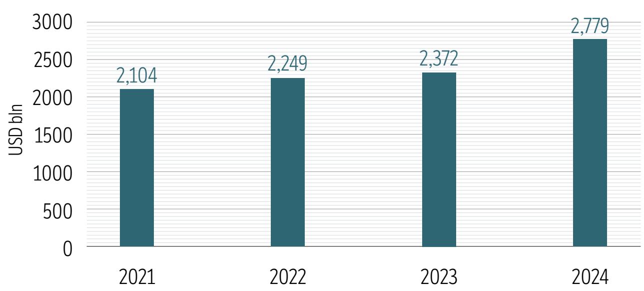
The industry's most visible achievement has been the translation of these principles into products that can operate in modern markets. Its next opportunity is to connect prohibitions more firmly with objectives. Islamic finance has become highly skilled at structuring compliant contracts. It can now build on that expertise by demonstrating more consistently that those contracts support equitable, developmental, and real-economy outcomes. This move from permissibility to performance is the central challenge of the next stage.

FIGURE 1. GLOBAL ISLAMIC FINANCE ASSETS: SECTOR, GROWTH AND REGION – GCC & EAST ASIA & PACIFIC ARE PRINCIPAL HUBS

Sources: Data from IFSB, Islamic Financial Services Industry Stability Report 2025.

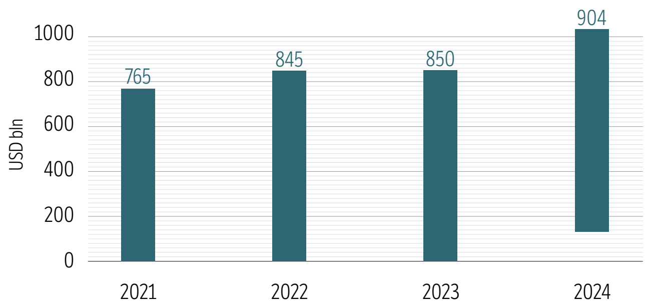
Islamic Banking Growth Trend

Banking is the largest sector; assets reached USD 2.78 tln in 2024; YoY growth 17.05%.



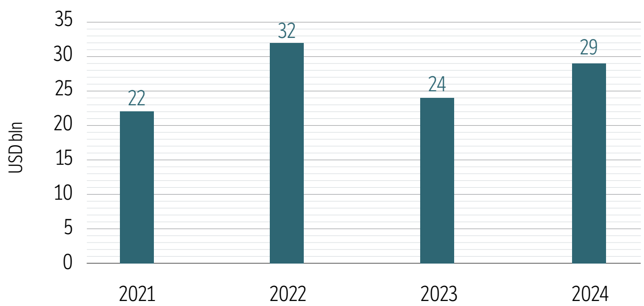
Sukuk Outstanding Trend

Sukuk is a major sector; outstanding sukuk surpassed USD900 bln in 2024; new issuances rose 25.6% to USD 230.4 bln.



Takaful **Contribuition Trend**

Islamic insurance contributions reached USD 28.6 bln by 3Q2024; assets reached USD 54.4 bln.



Global assets of USD 3.88 trillion concentrated in GCC & Southeast Asia.

Region	Total IFSI Assets	Share
GCC	2,060.3	53.10%
EAP	848.6	21.87%
MENA (exc. GCC)	658.0	16.96%
ECA	165.7	4.27%
SA	110.6	2.85%
SSA	22.5	0.58%
Others	14.4	0.37%
Total	3,880.0	100%

Legal translation: From *Fiqh* contracts to modern financial systems

Islamic finance could not operate by invoking classical *fiqh* concepts alone. It had to make those concepts enforceable in courts, recognisable to regulators, intelligible to accountants and investors, and manageable by financial institutions. This is the work of legal translation (Figure 2).

Murabaha illustrates the process. In classical law, *murabaha* is a sale with disclosure of cost and profit. In modern Islamic banking, it often functions as a financing technique. The bank purchases an asset and resells it to the customer at a marked-up deferred price. For *Shari'ah* purposes, the bank must assume ownership and asset risk, even if only briefly. For banking law, the transaction may resemble credit. For tax law, it may involve two sales. For accounting, it creates receivables and profit-recognition questions. Legal translation makes these classifications workable.

Ijara presents similar issues. In Islamic law, *ijara* is a lease of usufruct. In modern finance, it may be used for equipment, aircraft, project, or home finance. Domestic law must decide whether the arrangement is a lease, hire-purchase, mortgage substitute, securitisable asset, or finance lease. *Shari'ah* governance must ensure that ownership, maintenance, and usufruct are allocated consistently with the approved structure.

Mudaraba and *musharaka* remain especially important because they express the risk-sharing ideal most directly. They also create genuine regulatory questions. *Mudaraba* involves one party providing capital and another providing management, with profits shared by agreement and losses borne by capital unless caused by misconduct or negligence. *Musharaka* involves partnership and shared capital contribution. Modern banking regulation, however, is designed around creditors, borrowers, depositors, and shareholders. Profit-sharing investment accounts do not fit neatly into these categories.

Sukuk illustrate the complexity most clearly. A conventional bond is a debt obligation. *Sukuk* should represent interests in assets, usufruct, services, projects, or investment activity. Many *sukuk* are structured to produce predictable cash flows through leases, agency arrangements, purchase undertakings, or commodity transactions. Securities law must classify the certificates. Trust law or equivalent devices must hold assets for investors. Insolvency law must decide whether investors have asset recourse or only obligor credit exposure. Tax law must avoid penalising multiple transfers. *Shari'ah* boards must decide whether the structure is asset-backed in substance or merely asset-based in form.

The central issue for any jurisdiction is whether it provides enforceability, tax neutrality, prudential recognition, consumer protection, liquidity infrastructure, and credible *Shari'ah* governance.

Governing the perimeter: *Shari'ah* boards, AAOIFI, IFSB, and regulators

The perimeter of the permissible is most credible when it is governed by a layered institutional architecture. Product approval by private *Shari'ah* boards is essential, but it is not sufficient on its own. The industry also needs national *Shari'ah* authorities where appropriate, regulators, auditors, courts, standard-setters, market discipline, and post-approval monitoring.

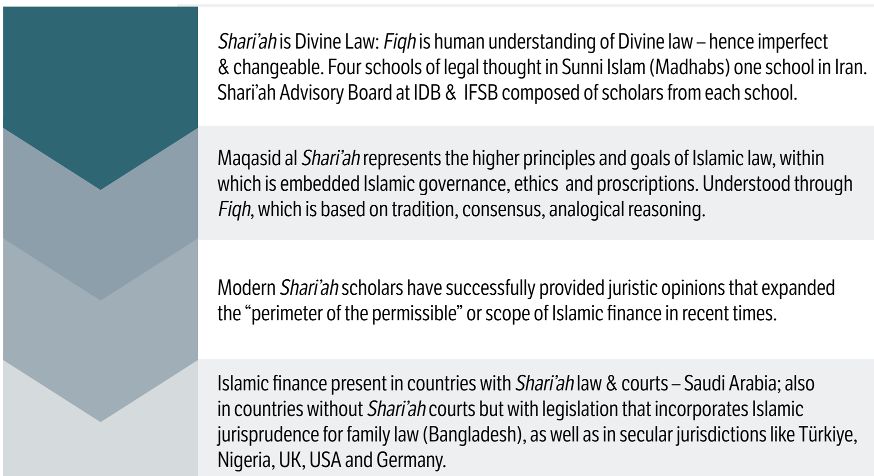
Shari'ah governance is the distinctive issue. Conventional financial institutions are judged principally by legality, prudence, disclosure, solvency, and conduct. Islamic financial institutions must also demonstrate *Shari'ah* compliance. This raises questions of appointment, independence, disclosure, conflicts of interest, and others. What happens if a product is later found non-compliant? Are courts bound by *Shari'ah*-board decisions? How should *Shari'ah* non-compliance risk be treated?

Three broad models exist. A decentralised model leaves each institution to appoint its own *Shari'ah* board, with the state avoiding religious certification. This is common in secular jurisdictions such as the United Kingdom and the United States. A centralised model gives a national *Shari'ah* authority binding or authoritative status, as in Malaysia. A hybrid model allows national *fatwa* bodies, regulators, and institutional boards to interact. Centralisation promotes consistency and can limit *fatwa* shopping, while decentralisation supports flexibility and innovation. The practical challenge is to make the perimeter both expandable and accountable.

International standard-setting has been central to this effort. AAOIFI and the IFSB do not eliminate national diversity, but they provide a shared technical vocabulary through which Islamic finance can be audited, supervised, and compared. AAOIFI is most closely associated with accounting, auditing, ethics, governance, and *Shari'ah* standards. Its standards provide contract-level guidance on *murabaha*, *ijara*, *mudaraba*, and all related practices. Its governance standards are also important because *Shari'ah* compliance must be monitored through internal review, *Shari'ah* audit, disclosure, and remediation.

The IFSB addresses the prudential and supervisory side. Islamic banks face familiar risks – credit, market, liquidity, operational, concentration, and governance risks – but also distinctive risks arising from Islamic contracts. Profit-sharing investment accounts in banks raise issues of loss absorption and displaced com-

FIGURE 2. ROLE OF LAW: *SHARI'AH* & *FIQH* IN EXPANDING THE "PERIMETER OF PERMISSIBLE INNOVATION"



mercial risk. *Sukuk* raise questions of tradability, recourse, asset-backing, and liquidity treatment. Islamic banks may have limited access to *Shari'ah*-compliant high-quality liquid assets and lender-of-last-resort facilities. *Takaful* operators raise questions about participant funds, shareholder funds, surplus distribution, and others.[6]

The work of AAOIFI and IFSB are complementary. Both are necessary. *Shari'ah* compliance gains credibility when supported by prudential soundness. Prudential soundness gains ethical depth when accompanied by *Shari'ah* integrity. Together with national regulators and *Shari'ah* boards, these institutions allow Islamic finance to innovate without relying entirely on private discretion or commercial pressure.

Jurisdictional models: Malaysia, the UK, Germany, and the United States

Islamic finance can operate in different legal systems, but each jurisdiction must solve the same core problems: enforceability, tax neutrality, *Shari'ah* governance, prudential treatment, liquidity management, consumer protection, and professional capacity.

Malaysia represents the most coherent state-led model. Its success reflects legislation and central-bank leadership that has guided tax reform, capital-market development, human-capital formation, and centralised *Shari'ah* governance. Bank Negara Malaysia's *Shari'ah* Advisory Council functions as the highest *Shari'ah* authority for Islamic finance in Malaysia. Its statutory role gives coherence to product approval, regulatory supervision, and dispute resolution. The strength of the Malaysian model lies in the government's vision and evolving strategy through which legal, regulatory, and *Shari'ah* institutions reinforce one another.

The United Kingdom represents a secular level-playing-field model. The state does not certify *Shari'ah* compliance. Islamic banks are authorised and supervised as banks. *Shari'ah* compliance is left to institutions and their scholars. The UK has nevertheless removed tax obstacles to "alternative finance", supported *sukuk* listing, and developed market infrastructure. English law, London's capital-market depth, and professional services have made the UK a leading international Islamic finance hub. The Bank of England's Alternative Liquidity Facility is significant because it helps Islamic banks hold central-bank-like liquid assets without relying on interest-bearing instruments.

> Ethics in finance cannot rely only on individual virtue. It must be built into institutions, incentives, standards, supervision and disclosure. Islamic finance is exceptionally rich in this respect...

Germany shows that Islamic finance can be accommodated even where the ecosystem remains limited. Islamic banking is possible within ordinary German and European banking law, and KT Bank has operated as a fully-fledged Islamic bank. The United States relies on functional equivalence: regulators ask whether Islamic structures are permissible under secular banking law when treated as mortgages, leases, secured financings, or investment products. US regulators do not certify *Shari'ah* compliance. State law variation, political sensitivity around *Shari'ah* terminology and the absence of a national strategy have limited scale.

Ethics in finance: From permissibility to performance

Islamic finance offers a distinctive method for making ethical questions operational within financial contracts, institutions, and regulation, while striking its own balance between deontological and consequentialist ethics. Consequences are of critical importance to Islamic finance, but it does not reject the deontological imperative: do the right thing "even if the world burns". Rather, it observes it more broadly. Thus, maximising shareholder wealth cannot be the sole focus of finance when this imposes harm on wider stakeholders.[7]

Thus, Islamic finance maintains that finance is not morally neutral. Financial claims and returns must be assessed not only by legality and profitability, but also by their relation to justice, transparency, productive activity, risk allocation, and social welfare.

The idea of embedded governance is pivotal. Ethics in finance cannot rely only on individual virtue. It must be built into institutions, incentives, standards, supervision and disclosure. Islamic finance is exceptionally rich in this respect because it has developed formal *Shari'ah* governance structures. But those structures must themselves be governed. Scholars must be independent. Conflicts of interest must be managed. *Shari'ah* rulings must be transparent enough to sustain trust. Internal *Shari'ah* review and audit must test actual execution, not merely documentation. Regulators must understand *Shari'ah* non-compliance risk as part of operational, reputational and sometimes prudential risk.

The ethical promise of Islamic finance is therefore larger than the avoidance of interest. Its deeper claim is that finance should be disciplined by a moral architecture. It converges with broader global debates on sustainable finance, responsible investment, stakeholder governance and financial stability, but it also differs from them. ESG finance often begins with external impact. Islamic finance begins with the legitimacy of the financial transaction itself: the source of return, the subject matter of the contract, the allocation of risk, and the permissibility of the underlying activity. Each approach is subject to risk. ESG can become greenwashing; Islamic finance can become *Shari'ah* arbitrage.

Much Islamic finance remains concentrated in debt-like structures. Not enough is devoted to genuine partnership, SME risk capital, social finance, climate resilience and inclusive development. But the ethical framework remains powerful precisely because it creates grounds for internal critique. Islamic finance can be judged by its own principles. The question is not merely whether the industry grows, but whether it grows in a way that narrows the gap between formal permissibility and substantive ethical performance.

This is where the perimeter of the permissible becomes an ethical concept. The perimeter should not be expanded merely to accommodate market demand. It should be expanded where innovation allows Islamic finance to serve legitimate needs in a manner consistent with *Shari'ah* principles and public welfare.

In this sense, the perimeter of the permissible is also the perimeter of ethical credibility.

The development agenda and the AI frontier

Islamic finance has created a global industry, enabled Muslims to save and invest in ways they regard as religiously permissible, mobilised capital for infrastructure, housing, trade, and public finance. It has produced standards, scholarship, regulatory guidance, and market practice.

The next agenda is also clear. Much Islamic finance remains concentrated in debt-like structures. *Murabaha*, *tawarruq*, and commodity-based liquidity tools dominate many balance sheets. Profit-and-loss sharing remains limited because of agency problems, information asymmetry, and regulatory capital constraints. *Sukuk* often provide investors with credit exposure similar to bonds rather than genuine asset risk. *Takaful* remains small, and Islamic social finance remains insufficiently integrated with the commercial sector.

These are not reasons for pessimism. They identify the areas in which institutional creativity is now most needed. Islamic finance can strengthen empirical evidence on inclusion, productive investment, climate transition, and social welfare. It can improve *Shari'ah* governance through better disclosure and post-approval monitoring. It can design *sukuk* and partnership structures that carry clearer real-economy substance.

Artificial intelligence is likely to shape the next phase. In conventional finance, AI is already used for credit scoring, fraud detection, anti-money-laundering monitoring, customer service, portfolio management, compliance, and supervisory technology. Islamic finance can use these tools, but it has an additional layer: *Shari'ah* compliance.

AI can support *Shari'ah* screening by improving data extraction and classification. It can also support contract review because Islamic finance documentation depends on sequence and legal form. *Murabaha* requires purchase, possession, sale, and deferred payment. *Ijara* requires proper allocation of ownership, maintenance, and usufruct. *Sukuk* require alignment among offering documents, trust deeds, purchase undertakings, service-agency agreements, and *Shari'ah* approvals. AI can compare documents with approved templates, detect inconsistencies, and flag clauses that may create *Shari'ah* or legal risk.

AI can also strengthen *Shari'ah* audit and compliance monitoring by tracking transaction flows and asset transfers.

Large language models can help scholars, lawyers, and regulators retrieve, compare, and summarise classical *fiqh*, modern *fatwas*, AAOIFI standards, IFSB guidance, national *Shari'ah* rulings, court cases, regulatory circulars, and institutional precedents. Properly used, this may support more disciplined expansion of the perimeter of the permissible.

AI nevertheless requires caution. It may give false confidence by retrieving supportive precedents while ignoring contrary reasoning. It may understate differences among madhhabs, confuse descriptive summary with normative ruling, or accelerate product replication without ethical assessment.

AI cannot issue binding *fatwas* or assume moral responsibility. It cannot replace recognised scholarly authority or determine the perimeter of the permissible. Its proper role is complementary: it can illuminate the perimeter, but it cannot define it.

The future of AI in Islamic finance should therefore be framed not as the automation of Islamic law, but as the construction of AI-assisted *Shari'ah* governance: a system in which technology strengthens, rather than displaces, human juristic responsibility.[8]

Conclusion: From Product Expansion to Ethical Credibility

The emergence of Islamic finance is a post-colonial phenomenon, reflecting the capacity of Muslims to shape participation in modern economic life according to their own aspirations. These aspirations represent sovereign consumer preferences.

This is the central rationale of Islamic finance. It is both a critique of conventional finance and a participant in modern markets. It seeks ethical distinctiveness while often using conventional benchmarks. It aspires to risk-sharing while frequently relying on debt-like contracts. It values juristic diversity while needing standardisation. It invokes social welfare while often measuring success by asset growth. These are not disqualifying contradictions. They are the tensions of an industry seeking to translate a moral and legal tradition into modern financial systems.

The concept of the perimeter of the permissible explains both the achievement and the task ahead. Islamic finance has grown by progressively expanding this perimeter. But the perimeter cannot be expanded by legal engineering alone. It must be expanded through disciplined *Shari'ah* reasoning, prudential soundness, ethical scrutiny, institutional accountability, and evidence of real-economy contribution.

The IFSB and AAOIFI architecture is central to that task. AAOIFI helps define contract-level, accounting, audit, ethics, and *Shari'ah*-governance expectations. The IFSB helps define prudential, supervisory, and financial-stability expectations. Together with national regulators, *Shari'ah* boards, courts, and market discipline, they provide part of the infrastructure through which Islamic finance can be made governable and credible.

Finally, the future of Islamic finance should not be measured primarily by asset growth. It should be measured by whether the industry can govern the expansion of permissibility in ways that are transparent, prudent, ethically credible, and demonstrably connected to the real economy. Its larger promise is to offer Muslims permissible financial products and to show humanity that finance can be lawful, prudentially sound, and morally disciplined. ●

https://doi.org/10.26619/2183-4822.2026.CJ.12

Endnotes

[1] The formulation "the perimeter of permissible innovation" is introduced in J. Ahmed, *Speech by the Secretary-General of the IFSB at IFSB Seminar on Islamic Finance and Global Regulation: Moving Targets and New Horizons*, 4 April 2017. www.ifsb.org.

[2].I use "legal translation" as derived from comparative-law on the movement of legal concepts between systems. See V. Cattelan, The Typewritten Market: Shari 'ah-Compliance and Securitisation in the Law of Islamic Finance, *Arab Law Quarterly* 35, no. 1–2 (2021). Máximo Langer and others have similarly used the terms "legal transplants" & "legal transliteration".

[3].The concept of "embedded governance" in this article develops the seminal formulation in *Islamic finance and global financial stability report*. Report of the Joint Task Force Chaired by Tun Dr. Zeti Akhtar Aziz. IFSB-IRTI, 2010. www.ifsb.org

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