Islamic Banking vs the Conventional Banking

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ABSTRACT

This paper argues that if reconcilability between Islam and the West exists in the field of finance and if the two systems can co-evolve in a mutually productive way then we can be optimistic about the ability of the two systems to co-exist. Clearly they involve different attitudes, but this paper argues, on the basis of significant compatibility issues, these are resolvable under the tradition of tolerance that has existed in Western and Islamic societies.

The context chosen for analysis is finance, which is central to global capitalism and an area in which key differences of principle and practice exist between Islam and the West. If we can show compatibilities in that particular area which is fundamental to both systems then we might confidently point to a significant degree of compatibility between the two systems.

I. Introduction

Tensions between Western and Islamic traditions are very much in evidence currently. Many see the two systems as irreconcilable and conflict between the two as inevitable (Huntingdon & Berger, 2002). To see Islamic and Western traditions as polar opposites is to ignore their co-evolutionary past. The influence of Islam on the West, founded on trade was, in fact, strengthened by the crusades. The two societies were influenced by co-migration. European notions of Chivalry, Courtly Love and Romanticism emanated from Islam in the twelfth century. Islamic states have been influenced by Western economics and politics, through imperialism, and the discovery of oil and other natural resources in the Middle East. Europe has sizeable indigenous Muslim populations. Muslim students, poets, writers and scholars have been deeply influenced by Western education. Middle Eastern wealth is deposited in Western industrial companies and financial institutions. The legal traditions of Islam and the West emanate from different sources: Sharia and Roman law. However, when we compare the three religions of the book, Judaism, Christianity and Islam it is impossible to deny that their respective messages coincide substantially. It is hardly surprising then that common traditions and values should exist; more surprising is that they have been overlooked.

Islamic and western banking procedures co-exist sometimes in the same institution (Islamic window), but centrally in the same system, the global economy. The key question addressed in this thesis is the extent to which banking and finance based upon Islamic principles can survive in a global capitalist economy. In other words, can Islamic banking co-evolve with conventional banking without losing its identity? A more general issue concerns the compatibility between the two systems.

Khan (1986) noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948) and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable. There are many such examples; the German hyperinflation of the 1920s, oil shock inflations in Europe in the 1970s, banking crises in Japan and East Asia, Russian and Argentinean default, Enron's bankruptcy. Zarqa (1983), Khan (1986), Chapra (2000), El-Gamel (2001) and Gafoor (1997) state that a significant outcome of an Islamic based profit and loss sharing system may be to introduce greater stability into western style financial transactions. The Islamic system is more stable precisely because of risk sharing.

The Islamic view also has its critics: and not only among mainstream economists. Perhaps the strongest condemnation in the literature of profit/loss sharing which is fundamental to an Islamic approach is Ahmad (1992:14):

> "*The sad reality is that though everyone concedes that Islam prohibits interest, there is not a single Muslim country which is running its financial institutions without resorting to interest.*

Even though the Islamic banks have attracted a great deal of enthusiasm and support, they have also been subject to a number of other criticisms. These are related either to their inability to come up to standard performance expectations, to the fallibility certificates of their Islamic credentials, or their inability to get away from the trappings of conventional banks. The lending activities of Islamic banks are confined primarily to the secondary modes: financing short-term trade and lease operations of large and well-established firms and corporations.

The fundamental difference between the Islamic and Western banking is that in Western banking, the religious and the secular are separated whereas in Islam, the social, economic and religious aspects are very much linked together. The Capitalist system, the predominant economic system, is based on the principle of *laissez faire*, which indicates, at least theoretically, that man, within the rules of the law, is free to pursue profit, with minimal state intervention. Capitalism was boosted by, if not developed as a result of, different factors which preceded its appearance such as: the rise of Calvinism, the Puritan Movement, the Industrial Revolution, the Reformation, the Repeal of Usury… etc. It is also called the private enterprise economy or the free market economy, which is built upon the private ownership and control of the means of production, free choice of occupation and consumer sovereignty.

a) Research Aims

The fundamental aims of the research relate to the following issues:

1. The compatibility of Islamic principles and practice of banking and the Western, modern capitalist financial environment?
2. Whether Islamic and Western banking can co-evolve without Islamic banking losing its identity?

b) Research Development

This research is divided into four parts; part one is a background to the subject; it introduces the reader to the study and provides a general perception of what this research is about, and why it is important. The aims and objectives of the study are set out; the author presents the features of the Islamic banking system as compared to the features of the capitalist systems. Part two sets out the research methodology and explores the research framework. The methodology followed here is theoretically descriptive and analytical. Part three is the data analysis. Part four is the author's conclusions to this research.

II. Historical View of Islamic and Western Economies

Khurshid (1994) emphasise that Muslims constitute the bulk of what is now regarded as the Third World. The position of this Third World in the 18th century *vis-à-vis* the West was in no way inferior. They lost the game in the following centuries of industrialization and Western imperialism. But the relative share of the Third World in world manufacturing output at the advent of the 19th century was three times higher than that of Europe and the *per capita* level of industrialization was comparable till 1800. The economies of the Muslim countries were, by and large, supported by a financial system that was not tainted with Riba. Kennedy (1989) gives a snapshot view of the world from 1750 to 1900 that illustrates these points. As is illustrated in table 1 in 1750 the third worlds share in manufacturing output was 73.0 and in the 1900 that had fallen to 11.0

Table 1 Relative Shares (%) of World Manufacturing Output (Kennedy 1989: 375)

Region/Country	Years				
	1750	***1800***	***1830***	***1860***	***1900***
Europe	23.2	28.1	34.2	53.2	62.0
Russia	5.0	5.6	5.6	7.0	8.8
UK	1.9	4.3	9.5	19.9	18.5
USA	0.1	0.8	2.4	7.2	23.6
Third World	73.0	67.7	60.5	36.6	11.0
India/Pakistan	24.5	19.7	17.6	8.6	1.7

Table 2 Per Capita Levels of Industrialization (1750-1900) (Relative to UK in 1900 = 100)

Region/Country	Years				
	1750	***1800***	***1830***	***1860***	***1900***
Europe	8	8	11	16	35
Russia	6	6	7	8	15
UK	10	16	25	64	100
USA	4	9	14	21	69
Third World	7	6	6	4	2
India/Pakistan	7	6	6	3	1

The scenario materially changed in the following two centuries of Western domination. In 1800, Europe occupied or controlled 35 per cent of the land surface of the world. In 1878, its control extended to 67 per cent of the world, and in 1914 it reached the high water mark of 84 per cent. A new economic system was imposed on the world, an offspring of the capitalism and imperialism.

Up to the end of the 18th century Islam did not appear to have lagged behind the west in economic development. The gap however became marked by the end of the 19th century, and this was due to the marriage of capitalism and imperialism. One of the effects of the relative underperformance of Islamic states was the lag in development of a sophisticated financial sector in Islamic states. However in the current period we are seeing a resurgence of Islamic finance, research by The Banker (2008) on the top 500 Islamic Financial Institutions (TIFI), indicates the market potential: the global total of Sharia compliant assets, based on the latest official figures, grew by 29.7% over the past year to reach $500,482m, although this is as yet relatively small compared with the $74,232.2bn in total assets amassed by the top 1000 world banks in the Banker's latest global listing; promising new opportunities.

III. Islamic Banking Features

a) Money in Islam

Khurshid (1994) explains that in an Islamic system money is primarily and exclusively a measure of value, a means of exchange and a standard for deferred payment. As distinct from the ethos of Western economics and conventional banking, money is not regarded as a commodity in itself, to be bought, sold and used to beget money. As a logical consequence of this, in an Islamic framework, money has to operate through some real economic activity or service. It is a facilitator and an intermediary, not an active self-contained agent in itself. In traditional western terms, the role of money in Islamic banking is seen more as a medium of exchange than a store of value or store of wealth. Naturally such an emphasis downplays the importance of interest as a rate of return on money, which is not thought of as capital. Capital is productive, not money, it is a means towards production, through creative entrepreneurial efforts.

Islam prohibits a reward without a share in the risks or a stake in the economic venture. Whatever the category be, any predetermined, fixed increase without sharing the risks of the project or enterprise is *riba* and this is prohibited. It is only the principal amount that is justified in loan transactions. If you want to share the fruits and the rewards, that has to be on the basis of sharing the risk as well as sharing the reward. These precepts shape the nature of Islamic banking.

b) Riba (Usury) and Interest Discussion Forum

The terms Riba and interest are not synonymous, and Muslims should cease confusing one for the other. Some Riba is interest, but not all, e.g. trading one pound of high quality dates for two pounds of lesser quality dates does not implicate the time value of money at all, yet Islam describes it as Riba. Likewise, some interest is Riba, but not all: if a person owes the bank £100 and agrees to defer payment of the debt in exchange for increasing the indebtedness. That is both interest and Riba. However, if a car is bought on credit, interest will be paid, but not Riba.

Gafoor (1995) explores the difference between Riba and interest: the ‘interest’ charged by a modern commercial bank is considered as consisting of six distinct components. This ‘interest’ is called the cost of borrowing, since it is the cost to the borrower or obtaining the loan. It can be put in simple equations:

***Cost of borrowing* =** interest paid to the owner of the funds **+** cost of services **+** cost of overheads **+** a risk premium **+** compensation for inflation **+** remuneration to the bank for providing the service.

Here the depositor is considered to be the real lender, and the bank an intermediary between the lender and the borrower. It is necessary that the reader breaks away from the traditional mind-set created by the historical origins of banks, and considers the modern commercial bank as it functions today: deposit bank and retail bank.

Gafoor (1995:161)

> “*When we travel, with this model in hand, back in time and space from a modern day city to the small town of 1500 years ago, and from the modern commercial bank to the individual lender of that small town called Madinah, we see that all but one of the six components drops out, leaving only the interest paid to the owner of the funds as the cost of borrowing…”*

This model is exploited to provide an interest free commercial banking system that is free of Riba and is yet fully viable and compatible with the conventional system. This system simply avoids all the problems faced by the Islamic banks, because of their current practices. The proposed system requires no changes in either the laws of the country or those of commercial banking. Therefore banks based on this model can be opened and operated in all countries of the world.

c) Profit Loss Sharing

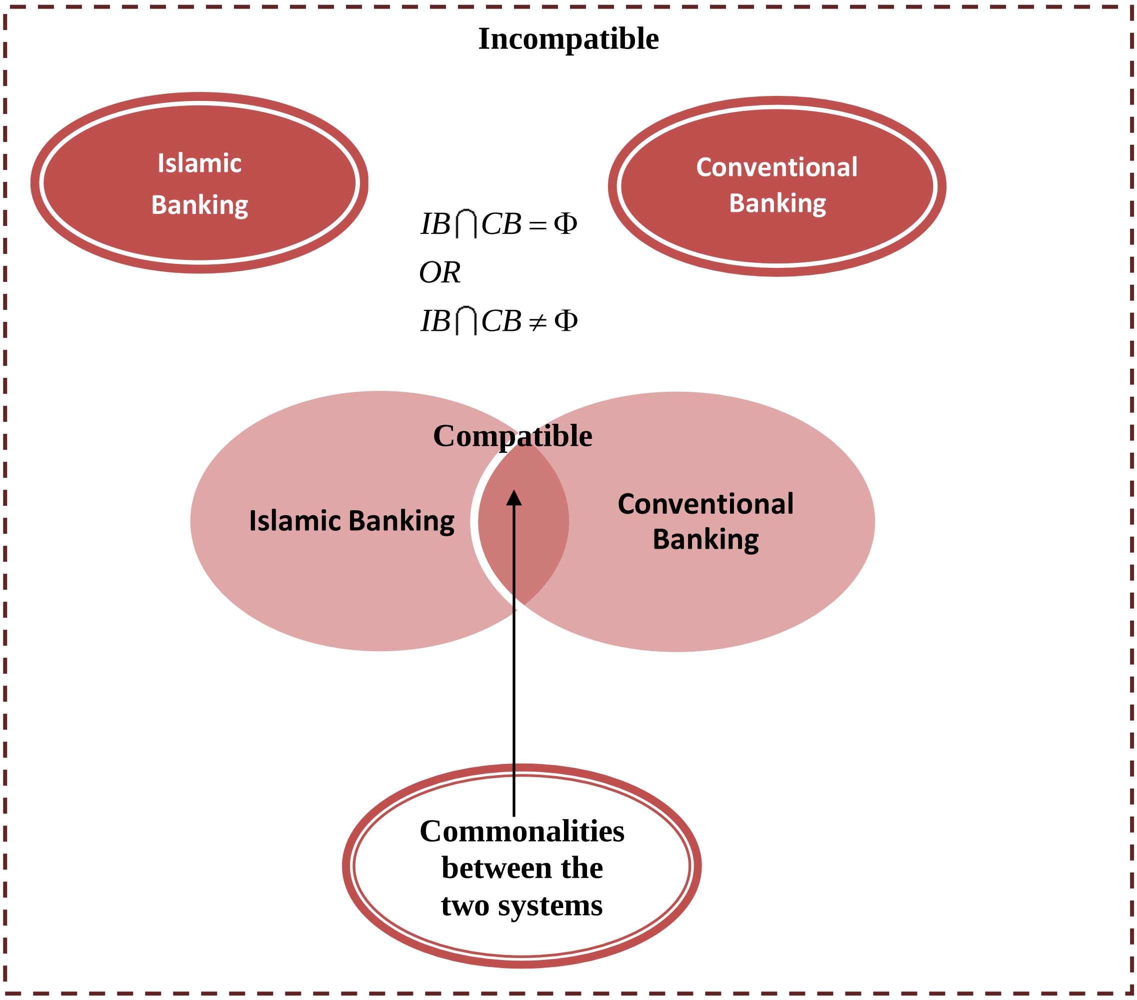
The profit-loss-sharing system has a number of (competitive) advantages over the system of based upon pre-determined interest rates. We can innumerate some standard properties of riba finance according to Islamic writers as follows:

Inefficiency	Interest results in an inefficient allocation of resources, since the investible funds go to the more creditworthy borrowers rather than to more productive projects.
Money verses real market	Money creation in a system of debt finance is based on lending, which makes it prone to oversupply, as there is no direct linkage between additional production and additional money supply.
Public sector	Public sector borrowing, when it is not backed by tangible assets, raises a debt burden for future generations. Islamic asset-backed financing does not constitute a debt burden as assets are available which can be liquidated to repay the debts.
Economic stability	One the propositions of Islamic point view is that debt base finance is inherently unstable.
Price level	Inflation will be minimal, (under an Islamic system) as the money supply will be correlated to economic activities.
Fairness	The Islamic financial system honours the right of ownership by individuals and institutions it favours just rewards for hard work, skill and initiative, and makes the relationship between the individual and the community one of co-operation, integration and duty.
The religious and secular	A close connection between religious and secular life, and between economic and spiritual life is one of the centre principles of Islam.

IV. Research Methodology

The following diagrams illustrate the key question, are Islamic and western banking two disjoint sets? Some schools of thought suggest that at best, Islam and the west are incompatible, and at worst they are a clash of civilizations. This reasrch maintains that looking at global finance and areas where both conventional and Islamic banking coexist, that this coexistence is possible and that is a significant contribution to the debate. This paper says that there is an intersection between the two systems however, is the overlap (diagram 1) sufficient to a) ensure survival of Islamic finance, and b) ensure survival without compromising the inner fundamental ideas?

Diagram 1 Compatibility Diagram Disjoint sets



The following diagrams 1 - 4 amplify the general issue set out in diagram A1.1 In addition to meeting the conditions and regulations affecting western banks, Islamic banks must also be Sharia compliant and express the underlying principles of Islam, the Qur'anic Spirit (diagram 2). Both Islamic and conventional banks must survive in a hyper-competitive global financial environment (diagram3). Sharia compliance and the Qur'anic Spirit are concepts that are subject to constant scrutiny by Islamic scholars, professionals and customers.

Diagram 2 Institutional Diagram

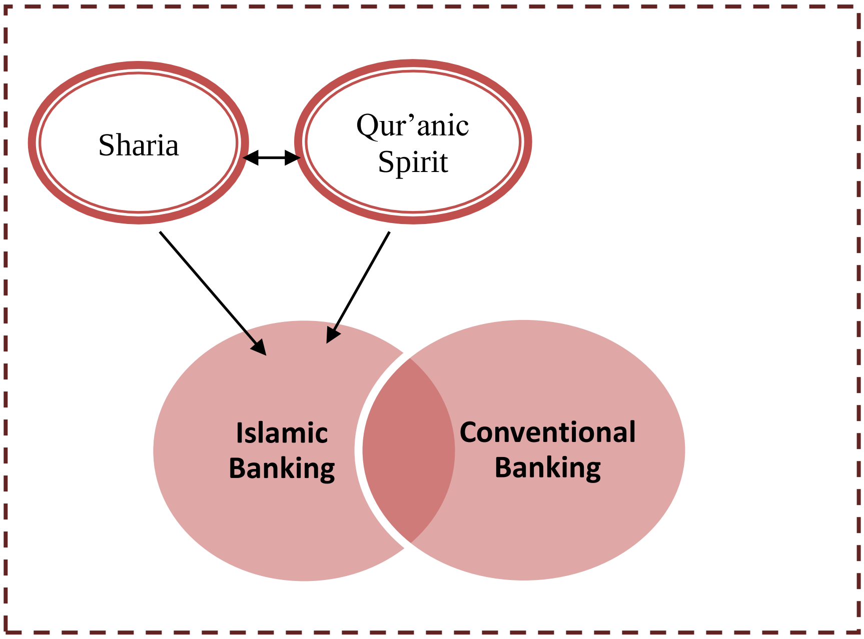


Diagram 3 Outer Foundation

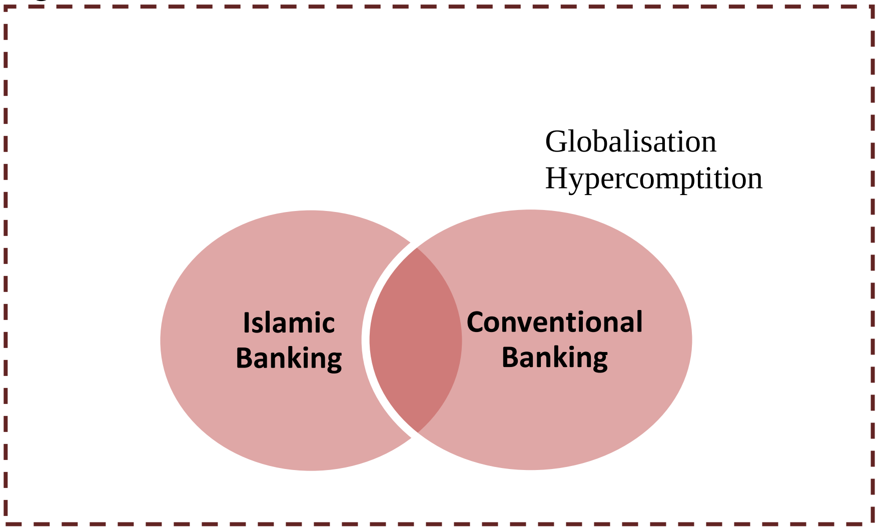
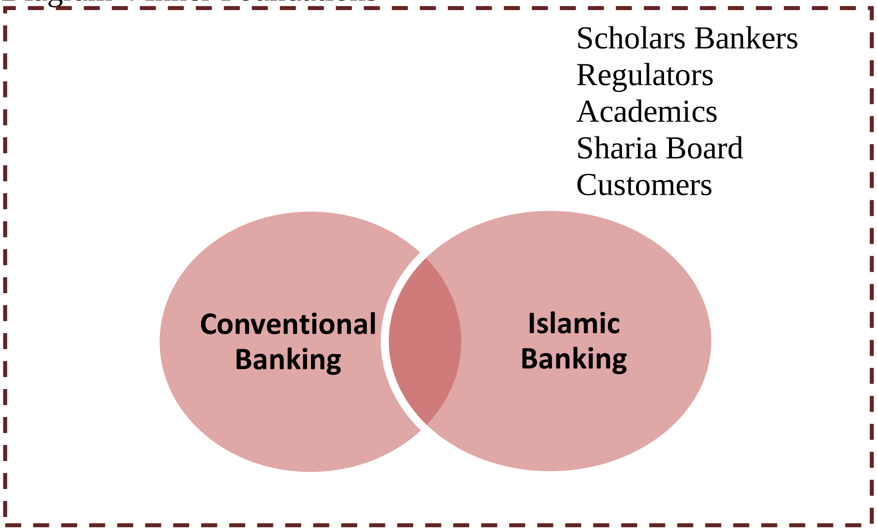


Diagram 4 Inner Foundations



The inner foundations of the institutional framework, noted in diagram 4, consist of scholars and academics, of which the interviewees were drawn upon in this research. It also includes the Qur'an and quotes from the Qur'an, all of which make up the inner foundations of Islamic banking. The outer foundations as illustrated above mainly refer to globalisation and hyper-competition. They overlap naturally with the institutional background.

a) Defining the Population of Interest

Since the nature of the research falls within Islamic banks in international financial markets, it was decided to concentrate the study in U.K., USA and Middle East, due to the level of development of Islamic banking, the sampling universe was relatively limited. Initially a stakeholder approach identified five categories of respondents that the author proposed as representative of the various interests in Islamic banking.

Table 3 Sampling Group

Stakeholder	Representing
Islamic Window of Conventional Bank	Islamic banks
FSA, Bank of England, IMF, World bank	Regulators
Sharia Board member	Sharia Boards
Retail customers	All customers
Scholars	Scholars/Imam's/Academics

Substantive interviews with these stakeholders allowed for a process similar to a Delphi methodology that is, combining the judgments of knowledgeable individuals.

b) Interview Responses

The author regroups the questions into one theme on the following table:

Table 4 Study Theme

QUESTIONS CONTEXT	THEME
• Similarities between Western and Islamic banks. • Compatibility for Islamic banks practices in competing in global banking environment.	The compatibility between Islamic and Western banking principles and practice

The table below gives a clear picture regarding the symbols used for each respondent as follow:

Table 5 Interviewees' symbols

Respondents	Symbol	Numbers in each category
Practitioners	$P_1, P_2, P_3......P_N$	5
Scholars/Academic	$SA_1, SA_2, SA_3......SA_N$	6
Sharia Board	$SB_1, SB_2, SB_3......SB_N$	3
Customers	$C_1, C_2, C_3......C_N$	3
Regulators	$R_1, R_2, R_3......R_N$	3
Total Interviews		20

A summary of the narrative analysis is provided in table 6. The author then provides a synthesis of the respondents' comments.

Table 6 Summary of the narrative analysis

Theme
The Nature of Islamic Banking
Common Features of the Two Systems
Distinct Characteristics of Islamic banks
Relations between Islamic and Conventional Banks
Ethical Compatibility

V. Analysis of Findings

In some ways the capacity of Islamic banks to compete is limited by their insistence on risk sharing. Key issues arose in connection with Riba, the connection of Riba to usury and the identification of Riba with interest as such. It also emerged that there was a perception that Islamic banking practice may introduce stability into the financial system as a whole. Respondents generally were not specialists in economics and we noted that about the distinctions between real and monetary rates of interest.

Classical writers emphasise the role of the monetary sector in generating instability. Islamic banks are perceived to be more stable because of the profit and loss sharing system. It is not difficult to translate this perception into the classical framework. Risk sharing diffuses risk (between borrowers and lenders) and connects the monetary and the real sector. In a sense an equity-based system resolves the kind of principal agent problems that emerge when lenders, the banks, are separate from borrowers (agents).

1) Classical writers have much more precise and varied concept of the interest rate than we find in most of Islamic writing, for example classical writers distinguish at least three notions of interest; the real, the natural rate and the money rate, Islamic writers tend to ignore such distinction focusing instead on a single notion of interest which at times is confused with usury.

2) Instability brought about by debt financing is a possibility recognised by both set of writers. This in turn is a source of inefficiency, either through provoking booms and recessions or through over or under investment.
3) We note that the issue of fairness does not feature highly in the discussion of Western writers where as it forms a key components of Islamic writing.
4) In Western tradition economic activity is clearly separated out from issues of religion or spirituality.
5) Islamic and Western banking operate in a global context, and although they appear to operate with quite different fundamental attitudes and motivations there appear to be significant compatibilities and the prospects for co-evolution between the two forms are optimistic.

Let us review some of the key aspects of Islamic banking at this point.

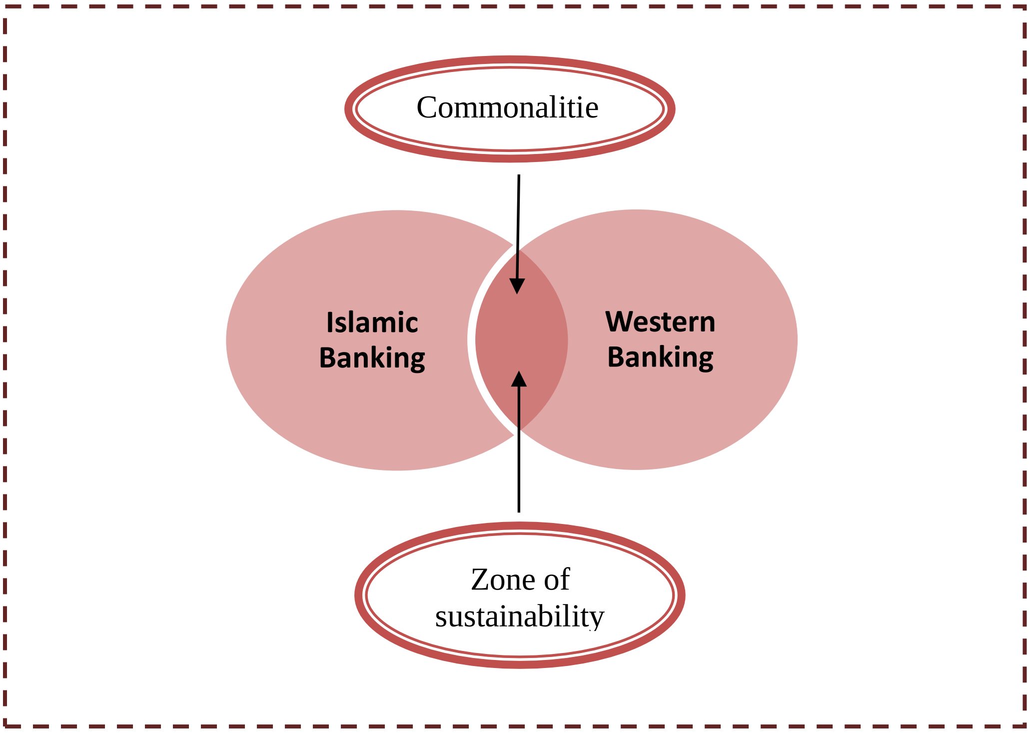
a) The Nature of Islamic Banking

Islamic banks, as an emerging banking system, financial and social institutions, have certain traits prescribed by their specific nature, drawing their principles and rules from Islamic law, which consider that wealth is owned solely by Allah (creature) and is mandated by man acting at his vicegerent. The assumption of this role requires stipulations to be fulfilled. We can summarize the main stipulations governing utilisation of funds can be stated as follows:

a) Prohibition of transactions on a Riba (usury) basis.
b) Man, as acting vicegerent, should endeavour with all his capabilities to invest fund and develop the national resources in such a way that the outcome is, eventually, orientated to serve the community.
c) Wealth should be directed in the ‘halal’ (religiously permitted) channels, which will benefit all individuals. It must not be spent with a motive of exploitation or in religiously prohibited channels, or to the detriment of society or individuals.
d) Consumption should be rationalised and expenditure should be conducted with thrift, avoiding extravagance.
e) Funds are not to be employed to monopolise the resources, utilities or necessities of the society.
f) Money is not to be treated as a commodity in itself but as a unit of account and measure of value that can be used as a means to fulfil the needs of society.
g) A fixed charge on capital is unjust, since the results of borrowed capital is invested are not certain. Risk and reward go together. No risk no return.
h) Making money out of money is contrary to Islamic law; wealth should be acquired through legitimate trade and the creation of real assets.

b) Common Features of the Two Systems

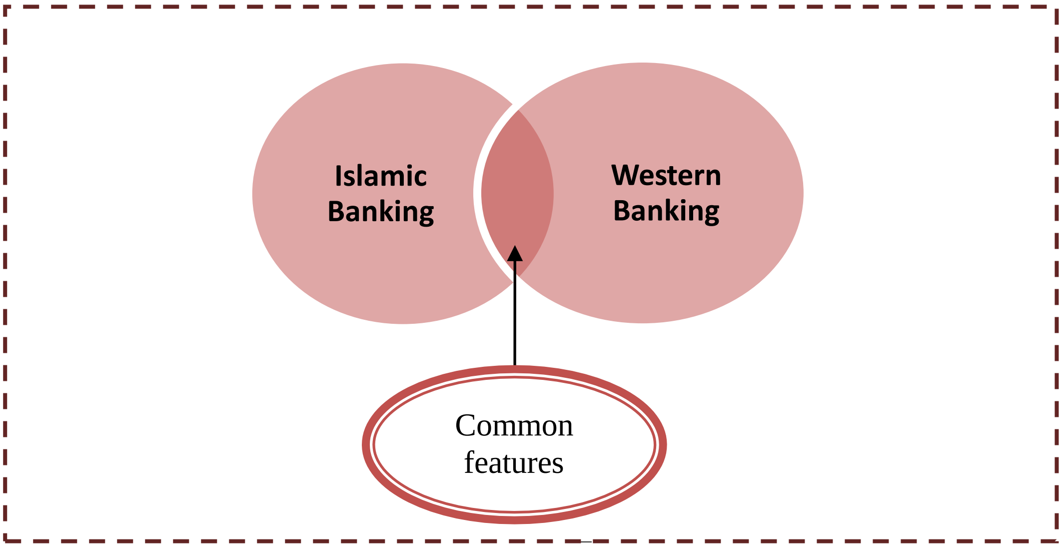
Islamic banks are profit-seeking organisations within the framework of a social and developmental role based upon Islamic law. This is true regardless of the environments in which they operate, whether they are Islamic banks as such, or Western banks with Islamic windows.



Likewise, there are several activities of the Islamic banks (not involving interest) which are similar, or almost similar, to those of conventional banks, such as handling of current accounts, opening of letters of credit, collections remittances, safe deposits etc., on which the bank earns fees, commission and exchange.

There is still some scepticism among the conventional banks about Islamic banking, which could be substantially removed if Islamic banks, being newcomers in the field, made more efforts to explain their working to the conventional banks. Faysal Islamic Bank of Bahrain has played a significant role in removing the misunderstandings about Islamic banking, Islamic syndicated financings, pioneered by them, in which both Islamic and conventional banks participate, is one such example. The two can further benefit by exchange of information Islamic banks about the Islamic countries and conventional banks about the non-Islamic world. There could also be more training programmes for bank personnel on subjects of mutual interest.

c) Distinct Characteristics of Islamic banks



We are now in a position to clarify some of the issues set out in the diagram in E11.4. The distinct features of the Islamic banks are as follows:

1) The relationship between Islamic banks and their customers is not that of debtors and creditors, or the other way round, but one of participation in risks and rewards.
   a) There is no previously fixed return on the funds invested with the bank. Similarly, there is no previously fixed return on funds provided by the Islamic banks. The return is decided, for both sides, in the light of the profit/loss realised from the transactions in the ratio of capital participation or agreed ratio of profit sharing.
   b) There is no liability on the Islamic bank, who is Mudarib (manager of funds) to owners of deposited funds (Rab al-Maal), except in the case of current accounts, to return their funds in full on demand, if the bank has not been negligent in investing funds, these funds share profit or loss resulting from the transactions they are invested in. This is the motivation force, which impels the Islamic bank to employ its resources with more prudence and efficiency.
2) Unlike conventional banks, which pool together capital fund and investors funds, an Islamic bank keeps the two segregated, in order not to mix up the profit earned on its own funds (capital) plus current account balances, repayment of which is guaranteed, with the profit earned on investor’s funds, which are accepted on a profit and loss sharing basis. This enables the bank to calculate correctly the profit due to investors.
3) Islamic banks do not provide finance by offering cash loans, as is the case with conventional banks, but through participation (Musharaka) or through some other form of Islamic instrument like Murabaha, Ijara…etc. A significant portion of their activities is trading, i.e. they buy goods needed by their customers and sell them at an agreed profit to the customer against ready cash or on deferred payment basis.
4) Islamic banks are multipurpose banks, as they play the role of commercial, investment and development banks. They operate in the short-term like commercial banks, and in the medium and long-term investment development banks like nonbank financial institutions (NBFIs), depending upon the structure of their resources.
5) While the role of the conventional banks is to attract financial resources and to lend them on interest, so as to make a profit, the emphasis of Islamic banks is on their financial resources to develop the society as a whole. Profit is, no doubt kept in sight, but that is not the main objective of their financing. The emphasis is on achieving the socio-economic objectives of the society without transgressing the injunctions of the Sharia.
6) Islamic banking is primarily equity-based.
7) While certified auditors satisfy conventional banks with the traditional review, Islamic banks are subjected to additional reviews by the religious supervisory boards to ensure that funds are being raised and invested in ways that confirm to Islamic principles.

d) Relations between Islamic and Conventional Banks

Islamic banks represent a link in the chain of the banking system; it is inconceivable that Islamic banks will operate in isolation, shunning conventional banks. Experience has shown that the two systems can complement each other, and mutually beneficial relationships can be established in various fields of investment and exchange of know-how. Islamic banks are more familiar with the traditions and conditions of the Muslim countries and are therefore, in a position to assist the conventional banks as informed partners in these countries such as:

a) Correspondence services

Arrangements exist and can be further extended between Islamic banks and conventional banks for acting as correspondents and agents on a reciprocal basis. They can enter into arrangements under which drawings can be made on each other and cheques drawn on one bank by selected clients can be paid by the other bank. Accounts operated under such correspondent relationships will be free of interest.

b) Opening of documentary credits

The operations conducted by Islamic banks require the opening of letters of credit in connection with foreign trade operations. Since the foreign trade of most of the countries where Islamic banks exist is by and large with western countries, the majority of the letters of credit are, and can be, opened on the conventional banks of these countries.

c) Exchange of funds between Islamic and conventional banks

There is room for exchange of funds between these two groups of banks on an Islamic basis. This can take the following shapes:

- Islamic banks can accept fund from conventional banks in the form of an investment account, with return calculated according to the profit made by the investment pool, and vice versa.
- Financial co-operation can also be envisaged between Islamic and conventional banks in the areas of project financing and leasing. The Islamic bank can act as Mudarib for the conventional bank. As a matter of fact, this is already happening but on a small scale,

d) Ethical Compatibility

Islamic banking and ethical investments in the west appeared on the world scene almost simultaneously nearly a decade ago. There are remarkable similarities between the two value-oriented financial movements. However, the surfacing of the two movements at the same time was not an accident but the result of disillusionment with the prevailing economic systems: the communist and the capitalist. The communist economic system, adopted by many countries with high hopes, proved to be a dismal failure. It not only failed to solve people’s problems but aggravated them bringing hardship and misery to millions of people during of its existence. Capitalism, the other dominant economic system, encourages concentration of wealth in a few hands by its excessive emphasis on materialism and attraction to materialism has undermined moral and ethical values leaving many directionless. It tends to make the rich richer and the poor poorer. The system is characterised by relentless and unfettered pursuit of profit.

Even in industrialised societies, the ‘unacceptable faces’ of the capitalist system have begun to cause concern. An instance of how exploitive and cruel the unfettered capitalist economic system was highlighted by the British Media by citing the case of one David Taylor, a client of a major western bank. David Taylor was a leukaemia patient. He had a bank overdraft that was growing at a frightening rate due to the banks hefty interest rate. Worried that the longer he lived the more of his life assurance money would be taken away by his bank, leaving little or nothing for his family. David did not want to prolong his life. He realised that every additional day that he lived would mean less money for his wife and children.

Throughout history Islamic and western civilisations have had many positive interactions with each other, than is currently represented. The Islamic banking system can add to this co-evolutionary history by a positive contribution to western financial systems, as an alternative to the commonly held believe, of the inequality of capitalism and the failure of communism.

VI. Conclusion

As shown through this study, Islamic banking principles have at the core social and ethical responsibility and are indeed compatible with Western ideas of ethical banking and social capital. Islamic principles are concerned with issues of fairness and justice rather than efficiency narrowly defined. These principles focus on the necessity of sharing risk in a fair and stable society, and upon problems of exploitation in markets where power is asymmetric this is the real riba issue.

Putting aside the penetrating comment by Ahmad (1992), "*It's not clear to whom we are cheating…*" about hypocrisy in the current practice of Islamic banks, let us deal with the realm of the ideal. Consider an ideal situation in which Islamic principles of interest were adhered to by a substantial proportion of the world financial system. What they have in common is a prohibition of usury, or excessive interest rates. Could such an idealized system conceivably survive as a foundation of banking in a hyper-competitive global financial environment? Pure logic would dictate that this is not possible in a profit-maximizing world; that is if *excessive* includes interest rates that reflect high risk situations or situations of capital shortage both of which would require high interest rates that might be considered usurious. The recurrent crises in the financial sector, maladministration, deception and unethical behaviour lie at the root of many of these problems. Enron and WorldCom are just two examples. The Islamic approach emanates from a foundation set of ethical principles. So discussions of Islamic finance in connection with global financial practices introduce an ethical dimension that is welcome. Also as Khan (1986) points out an Islamic system of finance might create a more stable world financial market.

During 1950s – 60s, Metzler (1950) of the University of Chicago proposed an alternative system in which contracts were based on equity rather than debt, and in which there was no guarantee of nominal values of liability since these were tied to the nominal values of assets. Metzler showed that such a system did not have the instability characteristics of the conventional banking system. Khan (1985), showed the affinity of Metzler's model to Islamic finance. Using Metzler's basic model, Khan demonstrated that this system produces a saddle point and is, therefore, more stable than the conventional system.

In the late 1970s early 1980s, it was shown, mostly by Minsky (1982), that conventional banking systems were inherently prone to instability because there would always be maturity mismatch between liabilities (short-term deposits) and assets (investment long-term). Because the nominal values of liabilities were guaranteed, but not the nominal value of assets, when the maturity mismatch became a problem, the banks would go into a liability management mode by offering higher interest rates to attract more deposits. There was always the possibility that this process could not be sustained resulting in erosion in confidence and bank runs. Such a system, therefore, needed a lender of last resort and bankruptcy procedures, restructuring processes, and debt workout procedures to mitigate contagion.

By early 1990s, it was clear that an Islamic financial system was not only theoretically viable, but had desirable characteristics that rendered it superior to a debt-based conventional system. The phenomenal growth of Islamic finance during the decade of 1990s, demonstrated the empirical and practical viability of the system. In these circumstances, Islamic finance can provide a viable financial system on a global scale, but there are challenges that have to be met to make it so.

To conclude we see the real area of division between Islam and the West lies in the issue of the dichotomy of religion and secular society that has grown up in the western tradition. Indeed this dichotomy is not complete. Religious leaders have exercised significant influence upon Western history in the recent past. We can note many examples ranging from the influence of the religious right upon US policy and that of the late Pope on the demise of the Soviet Union. Again it would be naive to maintain that Islam is divorced from the bending of religion to politics and to secular purposes. The essence of the division or the lack of it in the case of Islam lies in the notion that secular activities are inseparable from the religious. Intuitively we are arguing in this research that if reconcilability between Islam and the west exists in the field of finance and if the two systems can co-evolve in a mutually productive way then we can be optimistic about the ability of the two systems to co-exist. Clearly they involve different attitudes; to issues of consumerism, forms of finance, ways of life, for example. But these issues, the research argues, on the basis of significant compatibility, are resolvable, under the tradition of toleration that has existed in many Western and Islamic societies since the birth of Islam and the Islamic injunction (2:255) *"that there is no compulsion in religion"*.

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