Financial Engineering and Financial Stability: The Role of Islamic Financial System

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Abstract

Financial engineering is one of the most potent techniques of managing risk in the conventional banking system; however, it has also been adduced as one of the major causes for the recent global financial crisis. It has further confirmed the financial instability hypothesis and demonstrates that the present financial order is inherently unstable and fragile. This paper attempts to analyse the risk- hedging strategies in Islamic finance and compare them with the conventional risk management techniques. The paper suggests that Islamic financial system can be a more stable system that can attenuate the financial crisis and enhance economic development.

Keywords: *Financial Crisis, Financial Engineering, Financial Stability, Islamic Banking Law, Islamic Financial Law, Risk Management.*

JEL Classifications: *G00*

Introduction

Financial instability has been a recurrent event that plagued economies in the distant and recent pasts and no economy has been immune from its effects, suggesting that advanced countries are also vulnerable. The present crisis erupts due to the financial greed, speculation, interest-based system and other related interdependent factors (Chapra, 2009). Speculation is often fuelled by fictitious credit, swindle and fraud. Speculative burst has been a cause of many financial crisis in the world, this started in 1720 with the south sea company shares, great depression of 1929, Kuwait Crisis 1980, and now the housing crisis in US and Europe in 2008. It has manifested itself through a burst in the housing bubble, collapse of credit derivatives and securitization (fictitious credit), meltdown of sub-prime market loans, and massive bailout of financial institutions in US and Europe.

The economic and social consequences of financial instability could be disastrous. The last-resort lending by central banks could trigger unbearable inflation, destabilize public finance, erode real savings, and undermine long-term economic growth.

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1.0 The Background to the Recent Global Meltdown

The recent financial crisis in August 2007 was considered as the worst crisis for the past 60 years, in its effects, scale, duration and international dimension (World Bank 2008; Noureddine and Mirakohr, 2008). No economy is insulated from the crisis, due to the global connectivity among countries through the wave of globalisation. However, countries only differ in their responses to these exogenous shocks, while some respond so speedily and consider the shock as real and permanent; others perceive the shock as transient or transitory and respond so passively suggesting the economy could always restore itself back to equilibrium. The crisis is made up of many interdependent and reinforcing forces.

This shock has clearly shown that the present global financial system is vulnerable, fragile, frail and weak, such that the so called advanced economies or financial systems are not immune from this shock. Thus, to avert a huge systemic financial crisis in these economies massive government bail out had to be resorted to.

A number of reasons have been adduced as the causes of the crisis. These include loose monetary policy, financial deregulation and poor supervision of banks, market indiscipline, too big to fail syndrome and incessant financial engineering techniques. Financial engineering is a generic name used for modern financial techniques for hedging financial risks. These techniques include short selling, SWAPs, derivatives, Adjustable Rate Mortgages (ARMs) Securitization, Debt sales etc. Sometimes these are done at the expense of ignorant customers or intentionally to exploit the ignorance of the poor households. During 2004-2006, ARMs totalled US $4.3 trillion, almost half of all new mortgages; this led to high default risk, as large proportion of these mortgages could not be repaid.

A major trend is extraction of financial profit by commercial banks out of personal incomes of household. (This is justification for the huge bail-out packages to cushion the welfare cost). Since individual households depend on finances for their housing, education or health. This financial expropriation (the systematic extraction of financial profits out of wages and salaries) is one of the root causes of the current crisis (Lapavitsas, 2009). This was facilitated through the financial deregulation that started in late 1960s and 70s in developed and developing countries respectively. Deregulation led to loss of primary deposits of banks, this was further worsened by low patronage from large corporations that led to direct borrowing in the open market, thus, commercial banks turned to households or customers to sustain their profit moves. Hence, the high lending to individuals. Lending to individuals could be predatory, this explained the rise in the mortgage lending which rose to $1.75 trillion between 2004-2006.

A major factor that further worsened the global crisis was the abolition of the Glass-Steagall Act in 1999 (in force since 1933). This formally enabled commercial banks to engage in riskier investment banking practices, created opportunities for banks to trade on their own account.

Another major financial engineering method adopted by many banks was securitization, a method of seeking profits through open financial markets or proprietary trading, which led to the rise of derivatives trading. The housing crisis in USA would not have precipitated a global crisis had the commercial banks not adopt widespread securitization. (Securitization is parcelling of sub-prime mortgages into small amounts, packaging them with large composites of assets and selling them as new securities). Between 2004-2006, almost 80% of all sub-prime mortgages were securitised. Thus, sub-prime mortgage-backed securities ended up in the portfolios of major financial institutions throughout the world. Hence, when sub –prime mortgage holders began to default, this had immediate disastrous global impact, many financial institutions faced liquidity problem, since the mortgage backed securities were no longer saleable.

Thus, securitization was fashionable because it allowed commercial banks to generate more liquidity, remain solvent and make large profits, however, the housing burst in USA made it a bad risk-hedging technique as it became unsaleable over time. Thus, commercial banks were unable to freely borrow from the money market. While illiquidity led to insolvency, the duo led to bankruptcy of many banks and high bank runs on their deposits. Banks then became extremely conservative about further lending and the collapse of securitization led to credit crunch which impacted on aggregate demand leading to falling output, collapse of exports and rising unemployment. The financial crisis then led to global recession.

Banks transformed much of the high-risk mortgage debt (securitizations) into mortgage-backed securities (MBS) and collateralised debt obligations (CDO), and sold these assets on the stock markets to financial firms and insurance companies around the world, transferring to these investors the rights to the mortgage payments and the related credit risk (Pezzuto, 2008).

Truman (2009) observes that new forms of financial engineering were a contributing factor to the global crisis but not the cause. He argues that though innovations have been a feature of domestic and international finance for decades, in many cases, the associated innovations were poorly understood, resulting in a failure of risk recognition, which is a necessary precondition for good risk management. Also, Pezzuto (2008) observes that the level of product innovation has run far in advance of the capacity to utilize these products and the ability to understand the characteristics of risks and long-term consequences.

2.0 Financial Instability Hypothesis

Irving Fisher (1933) reviewed many possible causes that may lead to financial instability. He argued that two dominant factors were responsible for each boom and depression: over-indebtedness in relation to equity, gold, or income which starts a boom, and deflation consisting of a fall in asset prices or a fall in the price level which starts a depression. The depression was triggered by debt liquidation. The contraction of deposits caused a fall in the level of prices. These were followed by a greater fall in the net worth of businesses, precipitating bankruptcies, a fall in profits leading to a reduction in output, trade, and employment, which in turn led to hoarding and showing down of the velocity of circulation.

Minsky (1991) considered financial instability to be endogenous to conventional financial system. This is premised on the fact that the market is characterised by asymmetry information. His core model is known as financial instability hypothesis (FIH), which simply declares that stability in the system is inherently unsustainable. Minsky classified borrowers, according to their balance sheet and ability to make interest and principal payments, in three distinct categories, which are labelled as hedge, speculative, and Ponzi finance. Hedge financing units are those units that can fulfil all of their contractual payment obligations by their cash flows. According to Minsky's definition, the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit. Speculative finance units are units that can meet their commitments on interest payment, even as they cannot repay the principal out of income cash flows. Such units need to roll over liabilities- issue new debt to meet commitments on maturing debt.

For Ponzi units, the cash flows from operations are not sufficient to fill either the repayment of principal or the interest on outstanding debts. Such units can sell assets or borrow. Borrowing or selling assets to pay interest (and even dividends) on common stocks lowers the equity of a unit. The key feature of a Ponzi scheme is its need to attract ever greater sums of money. To survive, Ponzi units must refinance, either by selling assets or by raising more debt. For this to happen, asset prices must continue to rise. Ponzi finance typically emerges during a speculative bubble, when the margin of safety has been undermined.

The first theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. Inspired by Schumpeter's notion of "creative destruction", Minsky described the proliferation of financial innovations as means to attract more borrowers and to bypass existing regulations. The level of product innovation has run far in advance of the capacity to utilize these products and the ability to understand the characteristics of risks and long-term consequences.

Transmission mechanism

When there is excessive and imprudent lending and lenders are not confident of repayment, there is an excessive resort to derivatives like CDSs to seek protection against default. The buyer of the swap (creditor) pays a premium to the seller (a hedge fund) for the compensation he will receive in case the debtor defaults. If this protection had been confined to the actual creditor, there may not have been any problem. What happened, however, was that hedge funds sold the swaps not to just the actual lending bank but also to a large number of others who were willing to bet on the default of the debtor. These swap holders, in turn, resold the swaps to others. The whole process continued several times.

While a genuine insurance contract indemnifies only the actually insured party, in the case of CDSs there were several swap holders who had to be compensated. This accentuated the risk and made it difficult for the hedge funds and banks to honour their commitments. The notional amount of all outstanding derivatives (including CDSs of $54.6 trillion) is currently estimated by the BIS to be over $600 trillion, more than ten times the size of the world economy.

Though Islamic finance goes against these instruments, it however provides an alternative framework for hedging risks.

3.0 The Shariah Concept of Financial Risk

'*No risk, no gain*' is perhaps the most striking feature of the Islamic Financial System, as further encapsulated in the Prophetic tradition –cum- Shariah legal maxim "Revenue follows liability" "**الخراج بالضمان**"[1]. This is clearly mirrored in the prohibition of any return on zero-risk assets or business venture. Under Islamic law, a partnership contract is invalid where a partner agrees to share in profits but not in losses, while a lender is barred from claiming dividend of leveraged assets simply because he bears no risk. Similarly, the lessor who receives rentals in an *ijarah* agreement must equally bear the losses arising out of the damage in the leased asset, not as a result of misuse of same by the lessee. (Arbouna, 2006).

Furthermore, the Islamic concept of risk in financial activities sets a clear dividing line between risk associated with real economic transactions, which result in value adding and wealth-creating activities, and risk linked to zero-sum activities, where no net additional wealth is created but, on the contrary, culminates in 'eating wealth for nothing' (**أكل أموال الناس بالباطل**), denounced in strong terms in many Qur'anic verses. (See *Al-Baqarah*2: 188; *Al-Nisai* 4: 29 & 161; and *Al-Tawbah* 9: 34).

[1]- Narrated on the authority of Aishah *-radiya Allah anha-*, Sunan Abu Dawud vol.ii p.306 ; Sunan Tirmidhi vol. iii p.581; and Sunan Ibn Majah vol. ii p. 754 .

According to the Islamic legal icon, Ibn al-Qayyim Al-jawzi (D. 751 A.H),

> Risks are in two categories: commercial risk, where one would buy a commodity in order to sell it for profit, and rely on Allah for that. The other risk is that of gambling, which implies eating wealth for nothing. This (the latter) is what Allah and His messenger have prohibited [2].

The above assertion shows that Muslim scholars are ignorant of neither the dual forms of risk nor the distinguishing factor between tolerable and intolerable risks in the eyes of the law. Moreover, it is evident from the same statement and many other similar ones made by Muslim jurists those commercial risks or, in economic phraseology, 'residual risks' are inseparable from economic activities.

Islam frowns on any attempt to separate residual/commercial risk from gain, as that amounts to a sharp negation of the Shariah principle "Revenue follows liability". Liability to risk is thus an inalienable prerequisite for one's entitlement to profit; hence the position of Islamic law or commoditizing risk through derivatives and other instruments. Detaching risk from ownership and by extension from real economic activity would amount to gharar (uncertainty) and/or sale of what one does not own, both of which are considered in Islamic law as equivalent to lending with interest. (Arbouna, 2006).

This position of Shariah according to Al-Suwailem, (2006) if objectively assessed could only be judged as being natural and conforming to economic reality. Risk by nature is inseparable from economic activities, while artificially severing risk will not make it disappear; rather it will come back in more dangerous forms. Derivatives and other risk commoditizing instruments are what Ibn al-Qayyim described as gambling-like-risks prohibited in Islam on the grounds of being ways of 'eating wealth for nothing'. Interestingly, this is being corroborated today from the secular economic perspective. According to Lawrence Summers (1989), "The freeing of financial markets to pursue their casino instincts heightens the odds of crises… Because, unlike a casino, the financial markets are inextricably linked with the world outside, the real economy pays the price (al-Yousef, 2005, p.83). To sum it all up, Steinherr, 2000, introduces a moral dimension to the issue. He observed that just as toxic waste might frequently end up buried in poor and less developed countries, risk might end up born and suffered by poor and less developed countries. Even with respect to individuals in a particular country, this also applies, where ordinary people and taxpayers end up paying the real costs. (Al-Suwailem, 2006). The recent happenings in Wall Street and other major financial markets are clear vindications of the above observation.

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[2]- Ibn al-Qayyim M., *Zaad al-Maad,* Beirut, al-Risalah Publishers, 1986, vol. v. p.718

4.0 Islamic Law, Risk Management and Financial Stability

The Islamic concept of '*no risk, no gain*' does not mean that a creditor or an investor should attach no importance to managing risk, especially the non-residual or manageable risks. On the contrary, Islamic law requires professional management and handling of wealth, as provided for in many statutory authorities of this law. Furthermore, wealth protection (*hifz al-maal*) constitutes a fundamental objective of Shariah, introduction of acceptable measures and tools to protect businesses therefore, as observed by Arbouna (2006) serves the purpose of Islamic law in protecting wealth.

Islamic financial institutions (IFI) need a very strong mechanism for risk management or they risk being at a disadvantaged position in the highly competitive financial market. Mohamad and Tabatabaei (2008) noticed that investors in IFI are in three classes; Shariah-compliant investors, Shariah-preferred investors and returns/ performance-sensitive investors. While the first two groups could be influenced by religious and ethical beliefs, the driving force for the third group is purely the performance of IFI. Members of this group only see Islamic investment as just an alternative asset class; hence, they would take up Islamic investments if, and only if, their returns are better than other investments. Arguably, it is not an overstatement that considerable clients/customers of IFI today are not faith-based, but returns and performance sensitive.

4.1 Risk Management in the Qur'an and Sunnah

As mentioned earlier, many statutory Shariah authorities state unequivocally the unacceptability of waste or mismanagement of wealth. They further introduce certain measures to identify, analyse, monitor and even mitigate risks in any business environment.

"*Give not unto the foolish your property which Allah has made a means of support for you, but feed and clothe them therewith*" (Surat Nisaa' 4:5) is one of those Quranic authorities on risk management. Here, we are barred from indiscriminate submission of wealth to minors, as the risk of doing so is beyond inherent risk of doing business. Withholding a minor's property even against his/her will concur with the concept of risk management. (Arbouna, 2006).

In another verse (Al-Baqarah 2: 282) Allah strongly warned against excessive latitude in the course of transacting business. Hence, He ordered "*Disdain not to reduce to writing (your contract) for a future period, whether it is small or big: it is more just in the sight of Allah, More suitable as evidence, and more convenient to prevent doubts among yourselves*". Credit risk, or the risk of the counterparty's default is a major risk in financial parlance, and this verse accordingly provides that necessary measures be taken to avert it.

Similarly, requesting collateral for financial deals as a technique for risk management has been advocated in the Qur'an. "*And if you are on a journey and cannot find a scribe, then let there be a pledge taken (mortgaging)*" (Al-Baqarah2: 283). Furthermore, another verse makes a comparison between honest and deceitful operators, with a view to assessing the credit worthiness of both as a risk management strategy. Allah says, "*Among the people of the Scripture is he who, if entrusted with a Cantar (a great amount of wealth) will readily pay it back; and among them there is he who, if entrusted with a single silver coin, will not repay it unless you constantly stand demanding…*" (Al-Imran 3: 75).

Sunnah, as the second pristine source of Shariah has equally provided convincing proofs on the permissibility, nay, inevitability of risk management in economic activities. "*Tether your camel and (then) put your trust (in Allah)*"[3] is one famous tradition usually quoted to underpin the importance of prudence, caution and vigilance in doing business. According to Anas bin Malik, a man came to the Prophet (*May Allah's peace and blessing be on him*) asking him whether to leave his camel un-tethered, simply because he had relied on Allah to take care of the camel in his absence. The Messenger of Allah (*May Allah's peace and blessing be on him*) wasted no time in directing the man to take precautionary measures against the risk of loss of his camel (a worthwhile property in those days), as doing so does not suggest in the least lack of trust in Allah (Osmani and Amin, 2010).

In another hadith, we are advised to secure five before five; '*Your youth before your old age; your health before your sickness; and your financially buoyant days before the rainy days …*[4]'. People are thus encouraged to make hay while the sun shines, just as they would, in economic terms, preserve and manage prudently their pension fund to mitigate the risk of poverty during retirement or after losing their jobs.

4.2 Islamic Unique Approach to Risk Management

The Islamic approach to managing risk of any nature is unique in the sense that it seeks to uproot the problem, rather than introducing palliatives; and focuses on preventive measures, instead of devising techniques to deal with offshoots or derivatives of hazardous or risky practices. We shall take one example to illustrate

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[3] Sunan Tirmidhi vol. iv p. 668. The hadith has been adjudged "hasan" according to Albani, N. *Sahih Tirmidhi* vol. vi, p.17

[4] Narrated on the authority of Ibn 'Abbas with a sound chain of transmission, conforming to the standards of both Bukhari and Muslim. Al-Hakim, Abu Abdillah, *Al-Mustadrak* vol. iv p. 341.

this, from the general perspective of the law, before we move to the specific sphere of financial transactions (*mu'amalaat*).

Zina (fornication/adultery) is a capital offence under Islamic law, condemned in very strong terms. The Shariah approach to solving the problem of *zina* in Muslim community is embodied in Allah's saying, "*And come not near to unlawful sexual intercourse. Surely, it is a manifest indecency and an evil way*" (Al-Israa' 17: 32). As observed by Al-sa'di (2000: 457), the prohibition of 'coming near to adultery/fornication' is more forceful than to prohibit the perpetration of the act itself; the former encompasses not only the act, but all avenues leading to, or seducing people into it. The laxity of the Muslim community in enforcing and complying with the above injunction has therefore allowed the manageable risk of *zina* to snowball into a recalcitrant socio-economic dilemma, with far reaching devastating consequences.

Islamic law, through its various rules of business transactions, has put in place effective mechanism to shield both financial institutions and individual business practitioners against any unnecessary risk, by prohibiting *ab initio* dealing in *riba* (interest), which has been identified by many researchers as a major source of financial instability; and emphasizing on risk sharing, rather than risk bearing in financial activities. Furthermore, The law of Islam prohibits dealing in high risky investments, high degree of uncertainty (*al-gharar al-fahish*) and *maysir* (gambling and speculation); while promoting social justice in our business environment through the encouragement of zakah, sadaqah and *takaful* principles. These are the hallmarks of the Islamic outlook of risk management, as a precursor of financial stability.

Elimination of interest in Islam neither suggests nor implies zero-return on capital. What Islam forbids is predetermined fixed return, where one party would be rest assured of return and the whole risk is borne by another. Prohibition of fixed return is not just a Shariah peculiarity, rather it is a sound economic disposition. According to Garis (2007), the economic rationale behind the prohibition of fixed return is the fact that the valuation of the underlying economic activity is not constant; hence, returns must be allowed to fully reflect that reality. Analyzing the conventional interest-based regime as a main source of credit risk, Mills and Presley (1999) observed that the interest-based financial system leads to 'the disruption of the payments mechanisms and reduction in depositor's real wealth'. It also 'entails the destruction of valuable information –capital acquired through bank-borrower relationships'.

The description by Mills and Presley (1999: 117) of 'compound interest' as 'compound sin' may be perceived, by some, as being outrageous; however, empirical studies of the economy of many third world countries actually reveal the accuracy of such an assertion. In the words of a former president of such a country, President Olusegun Obasanjo of Nigeria, speaking exclusively of his own country's experience,

> All that we had borrowed up to 1985 was around $5 billion, and we have paid about $16 billion; yet we are still being told that we owe about $28 billion. That $28 billion came about because of the injustice in the foreign creditors' interest rates. **If you ask me what the worst thing in the world is, I will say it is compound interest**![5].

No wonder, ever before a politician like President Obasanjo made such a devastating revelation, many renowned economists had raised the alarm, alas, to non listening ears.

Islamic principle of profit and loss sharing (PLS) is another important instrument of financial stability. Mirakhor (1988) defined an Islamic financial system as one in which there are no risk free assets and where all financial agreements are based on risk and profit and loss sharing. All financial assets are contingent claims and there are no debt instruments with free or floating interest rates. Modeling the financial system as non-speculative equity shares, he showed that the rate of return to financial assets is primarily determined by the return to real sector, and therefore in a growing economy, Islamic banks will always return net positive returns. Under Islamic financial system, banks do not contract interest bearing loans and neither create nor destroy money. They participate directly in production and trade operations on a profit-loss sharing basis.

Islamic finance is interest-free but not risk-free. This principle is applicable to two main factors of production, labour and the capital. In as much as no payment is allowed to labour unless it is applied to work, no reward for capital should also be allowed unless it is exposed to business risk. Hence, financial intermediation, from the Shariah perspective, between a bank and its customer takes the form of a partner-partner rather than a debtor-creditor relationship. (Alam 2003). An Islamic bank identifies investment opportunities, evaluates them to minimize risk and participates directly in the management, monitoring and execution of trade and investment operations.

The economic benefits of Islamic PLS and its roles in risk controlling are discernible in many areas. The status of a Shariah based financial institution as a partner who shares in risks and rewards will prompt it to be more prudent and less reckless in

[5] Daily Trust Newspaper of 11/11/2008. Also available @ http://tradingoil.ruzsitblog.com; *www.globalresearch.ca/index.php?context=va&aid=7319*. Accessed on 3rd May, 2010.

investment drives and decisions. Moreover, such an institution will have more authorities to monitor the business performance, and identify any potential risk in due course. Unlike its conventional counterparts whose main duty is to lend money and can only wait and see the problem occur before it can intervene. (kayed and Mohammed, 2010).

One more instrument of financial stability introduced by Islamic law is the principle of equity-based rather than debt-based financial structure. Islamic financial system introduces greater discipline into the economy by linking credit expansion to the growth of the real economy. Thus, it does not allow creation of debt through short selling and securitization, but instead requires that creation of debt must be through the sale or lease of real, and not fictitious, assets, which the seller actually owns and the delivery of which the buyer equally wishes to take. Unlike the prevailing situation in conventional derivatives market where both the seller and the buyer are only interested in differences in speculated prices. The whole issue thereby translates into gambling and zero-sum game, with practically no value added to the economy. As far back as 1890, a US Congressman expressed his opposition to derivatives in the following way,

> Those who deal in 'options' and 'futures' contract, which is merely gambling, no matter by what less offensive name such transactions be designated, neither add to the supply nor increase the demand for consumption, nor do they accomplish any useful purpose by their calling ; but on the contrary, they speculate in fictitious products. The wheat they buy and sell is known as 'wind wheat' and doubtless for the reason that it is invisible, intangible, and felt or realized only in the terrible force it exerts in destroying the farming industry of the country. (Teweles and Jones 1987: 11 as quoted in Al-suwailem, 2006: 33).

In Islamic financial law, there is no credit creation that is not backed by real savings. The amount of deposits in the investment branch of an Islamic bank will be determined by real savings and savings to income ratio (Mirakhor, 1988), and not by credit multiplier as in conventional banking. New cash flows to an Islamic investment originate from new savings; they do not arise from the proceeds of loans transferred from one bank to the other or rediscounting.

The real danger, as spotted by Mohamad and Tabatabaei (2008), lies in the fact that debt-based financial practices are no longer tied to the genuine economic activities, and may distort the demand and supply conditions of the real economy. More pathetically, derivatives and other related speculative activities are even potentially more dangerous than what is being witnessed today of their painful repercussions. Derivatives are simply, in the words of Warren Buffet, "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal". (Buffet, 2002: 15).

High risky investment or high degree of uncertainty *(al-gharar al-fahish*) is also viewed by Islamic law as being inimical to financial stability; hence its outright prohibition. A non-existent or undeliverable commodity cannot constitute an object of sale under Islamic law. A common example of this, as usually stated in *Sharīah literature*, is to sell or buy fish in the sea or birds in the sky. In the same vein, Islamic law has declared as illegal selling of commodity before its proper acquisition on the grounds of likely undeliverability. Hakim bin Hizām narrated, "I asked the Prophet the following question: If a man came to me asking for a commodity I do not have in stock, can I go to purchase same for him from the market? The Prophet (*Salla Allah alayhi wa sallam*) replied, "Do not sell what you have not in your possession"[6]. In other words, a contract that has elements of doubt, speculation and uncertainty is illegal from the *Sharīah* viewpoint. (Alaro, 2009).

Stability of the Islamic financial system is further enhanced through the institution of *zakah* and *sadaqah* (mandatory and voluntary alms), and the integration of same with the very prohibition of interest. In Islam, the injunction of alms and charity and abolition of *riba* (interest) are intertwined. In the Noble Qur'an, the verses that deal with interest have always been preceded or followed by verses that prescribe *zakah* or recommend *sadaqah*; this can never be a mere coincidence. (Cf. Al-Baqarah2: 271-279; Al-Imran 3: 130-134; Al-Nisa'4: 161-162; and Al-Rum30: 37-39) . Thus, when social equity is secured through *zakah/sadaqah*, motives on the side of the lenders to practice interest, and dire need of the poor to accept interest even at prohibitive conditions, will disappear. In such an economy, it will be easy to abolish riba. Islamic finances will be essentially guided towards investment and wealth creation, and much less towards consumption.

Another major contribution of the Islamic financial system is the reinforcement of *takaful* principles among stakeholders. *Takaful* is the Islamic model of insurance and rather than being commercial oriented, is based on cooperation of stakeholders or business associates. *Takaful* has been identified by many researchers as a viable tool for mitigating the unfavourable outcomes of market and credit risks, and can also protect financial institutions from collapse (Kayed and Mohammed, 2010).

[6]- Sunan Tirmidhi vol. iii p.534

Conclusion:

Islamic financial institutions' resilience to the global shock has been linked to their non-investment in in toxic assets through debt trading, short selling and derivatives. This did not happen by accident but as an offshoot of a strong regulatory framework put in place by the Shariah. Under Islamic banking legal framework, there is no room for credit creation out of thin air; liabilities of the financial institutions are covered by tangible real assets owned directly by these institutions. The underlying cause of the recent economic crisis is the greed of those who failed to anticipate the consequence of their unethical practices in turning the financial markets into gambling casinos. If the entire humanity does not want to risk seeing a repeat of this ugly scenario, where greed of some very few people would affect the lives of billions negatively, then greed and individualism (a.k.a. Capitalism) must give way to a cooperative approach of Islamic financial system.

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