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Islamic Finance and Global Financial Crises: How to Keep Finance on Track?

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Abstract

The third quarter of 2007 witnessed unpleasant surprises delivered to global financial markets originating from the American one, for which greed, financial innovation and laxity of regulation were deemed guilty. The financial crisis of 2007–2008 initially referred to in the media as a "credit crunch" or "credit crisis", began in August 2007, when a loss of confidence by investors in the value of securitized mortgages in the United States resulted in a liquidity crisis which prompted a substantial injection of capital.

We think that our puzzle solving clue (hypothesis) to which we can attribute the crisis is the deviation from the basic assumption (or philosophy)driving investment as society welfare and growth tool on the long-term, to become a wild pursuit of short-term gains through orienting financial innovations and the laxity of regulations to serve such new target. Thinking out of the money box (Money received tomorrow= money + interest); an approach; to fit conventional financial tools into Islamic finance, instead of disguising it. As we believe the word Islamic as tag for any application cannot avoid its misuse rather than it can be considered as a standard or a base which must be used to judge the performance of the financial product before its introduction to the market, after usage and subsequently pinpoint adjustments or eliminations required. This should be the main role of the financial gate-keepers regardless of their ideology as the base of judgment that should be kept on sight at all times.

Islamic finance recently gained huge popularity no matter the motive is. Is its construction enough to provide solutions? Is it the mitigation to the current crises? Do we need to return to asset standard? Or some more adjustments are needed to overcome the next crises.

1. Introduction

This paper is trying to explore the causes of the recent financial crisis as well as developing an approach to fit conventional financial products to Islamic principles. The aim is to explore the opportunity for an Islamic financial tool that can gain popularity and acceptance. We believe that securitization was one of the complex reasons behind the 2007-2008 financial crises. We may say that the puzzle solving clue (Hypothesis) leading to the crisis was the deviation from the basic assumption or philosophy driving investment as society welfare and growth tool on the long-term, to become a wild pursuit of short-term gains through orienting financial innovations and the laxity of regulations to serve such perverted goal. In part 2of this paper we are going to emphasis this hypothesis as well as the importance of the gate keeper role.

Raising the question of would Islamic finance philosophy have helped in prevention or partially eliminated such a crisis? We concluded that deviation from the original goal of investment and financial tools are the reasons leading to the recent financial crisis and we may dare to say all major previous crises. We can answer the question above which represents part 3 of the paper.

However during our quest for answers within the Islamic finance literature we were not able to overlook the pit falls in the widely accepted Islamic financial application available as an alias of conventional financial tools. Reluctance of Islamic financial practitioners to benefit from ongoing crisis as an opportunity to reintroduce the Islamic finance as a solution to the international financial society, from this perspective part 4 shed light on the Islamic finance and international society. As the question then is would Islamic finance philosophy -rather than Islamic tools and applications- have helped in prevention or partially eliminated such a crisis? And the need was emphasized to recall asset standard and thinking out of box, part 5 introduces' to blue prints of an approach to fit conventional product to Islamic principles through innovation rather than disguise. Part 6 finally offers some concluding remarks.

2. Deviation from the basic assumption or philosophy driving investment

A very complex number of reasons were accused to be behind the recent financial crisis – recovery is not yet concluded – coming on the top of the list was; greed, financial innovation and laxity of regulation especially in the United States market from which the crisis spilled over the rest of the world. However if we can conclude that greed is unavoidable and might be the heart of the motives of investment (regardless of our perception of greed as a word) and financial innovation is a must (it is our main target in this paper) and laxity of regulation may be the core of a liberal economy (which we agree with). So it is deviation from the basic assumption or philosophy of investment, accordingly we here under discuss the signs of deviation and when the warning bells should have ranged.

Deviation refers to any departure from main philosophy behind any application or course, thus breaching its values or alternating the goal. Accordingly, deviation in practice can be detected whenever an outcome does not coincide with goal. So, any deviation from goals should be considered as a sign that calls for scrutiny.

The following are few signs that we consider crystal clear deviations that should have alerted scrutiny.

2.1 Investment banks and commercial banks overlapping due to GLB act 1999.

The Gramm–Leach–Bliley Act (GLB), also known as the Financial Services Modernization Act of 1999 was desired by many of the largest banks, brokerages, and insurance companies at the time. The justification was that individuals usually put more money into investments when the economy is doing well, but they put most of their money into savings accounts when the economy turns bad. With the new Act, they would be able to do both 'savings' and 'investment' at the same financial institution, which would be able to do well in both good and bad economic times.

Critics of the legislation feared that, with the allowance for mergers between investment and commercial banks, GLB allowed the newly-merged banks to take on riskier investments while at the same time removing any requirements to maintain enough equity, exposing the assets of its banking customers. Yet, prior to the passage of GLB in 1999, investment banks were already capable of holding and trading the very financial assets claimed to be the cause of the mortgage crisis, and were also already able to keep their books as they had. Also, greater access to investment capital as many investment banks went public on the market explains the shift in their holdings to trading portfolios. After GLB passed, most investment banks did not merge with depository commercial banks. In fact, the few banks that did merge weathered the crisis better than those that did not (Calabria, 2009).

President Barack Obama believes that the Act directly helped to cause the 2007 subprime mortgage financial crisis. Economists Robert Ekelund and Mark Thornton(2008) have also criticized the Act as contributing to the crisis. They state that "in a world regulated by a gold standard, 100% reserve banking, and no FDIC deposit insurance" the Financial Services Modernization Act would have made "perfect sense" as a legitimate act of deregulation, but under the present fiat monetary system it "amounts to corporate welfare for financial institutions and a moral hazard that will make taxpayers pay dearly (Ekelund and Thornton, 2008).

Nobel Prize-winning economist Paul Krugman has called Senator Phil Gramm "the father of the financial crisis" due to his sponsorship of the Act (Krugman, 2008). Nobel Prize-winning economist Joseph Stiglitz has also argued that the Act helped to create the crisis (Baram, 2008)

Accordingly commercial banks should have not been allowed access to risky investments, subsequently putting their depositors at higher risk than the one they should have been exposed to. Even with proper disclosure, as risky investment is the area of investment banks by nature.

As according to LaRoche "Investment Banks and Commercial Banks are Analogous to Oil and Water: They Just Do Not Mix." (LaRoche, 2009, p.1)

2.2 Housing price inflation.

In order to understand the 2007-2008 crises which originated from the real estate market and mortgage securities were blamed for we have to understand that the following question.

What is Mortgage? A mortgage is a loan secured by a property/house and paid in installments over a set period of time. The mortgage secures your promise that the money borrowed will be repaid.

Accordingly a lot of institutions and financial products were developed to be part of and to control this mortgage market like the Fannie Mae, Ginnie Mae and Freddie Mac and MBS, RMBS and ARM Loans who their main role was to magnify the benefits of mortgage, this magnification target the following;

- Reduce the probability of default and spread risks and increase diversification.
- Reduce the burden of down payment and other servicing fees.

However in few years' real estate inflation rate reached 125 percent enormously outpacing the overall economy inflation (Mazumder and Ahmed, 2010), which is a basic sign that should have triggered a scrutiny that in turn would have revealed more related signs for scrutiny as they show up such as:

- Increase in Subprime loans which was driven by the notion that buying a house is a foolproof investment along with the same with investment in MBS since interest rates were on the rise (Mazumder and Ahmed, 2010), thus creating excess supply of credit to MBS, and normally excess supply will push down the price (interest) which was not seen by the market as interest rates were rising. However the increase in interest rates did not mitigate the equivalent

increase in risk which is a disguised price push down, due to the misuse and excessive marketing of subprime loans.

- Increasing executives' compensation, during 2001-2004 employees in mortgage banking and brokerage were encouraged and paid several hundred thousand dollars for selling mortgage loans. Accordingly (Ip et al,2008) report that income and/or assets of numerous mortgage lenders increased by threefold due to issuance of subprime loans (Mazumder and Ahmed, 2010).

2.3 Security Market:

The capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds. Problems has risen from the perverted goals of milking investors for commissions and fees for those steering the market by over cashing cow for the present investment, rather than creating new ones.

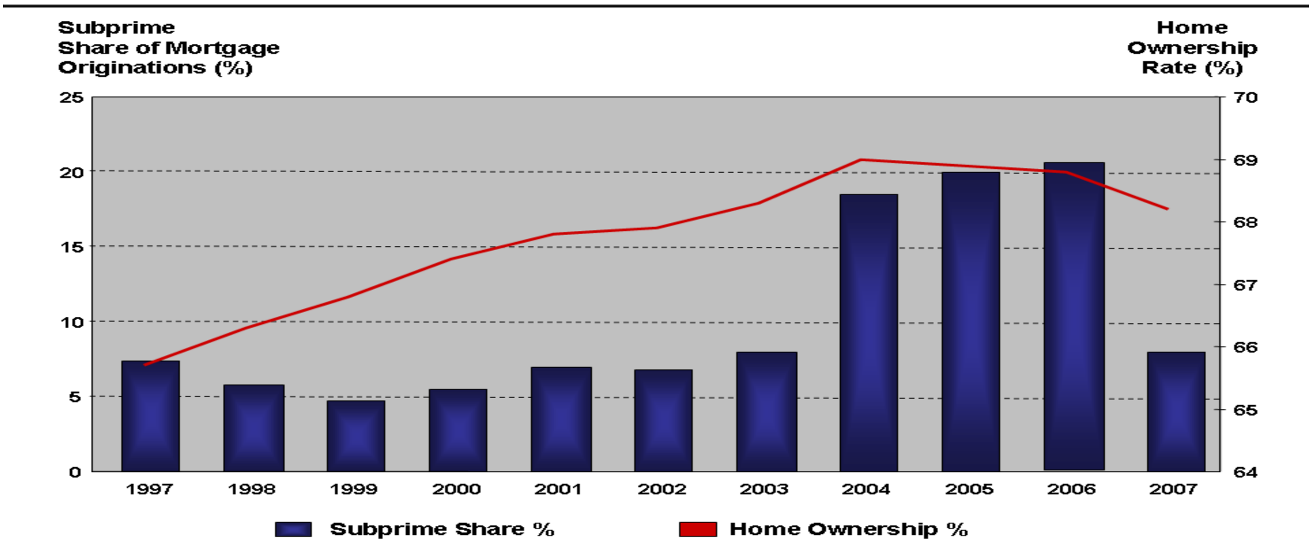
The factor that most changed in the financial sector over the last decade is regulation .Housing bubble certainly is one of the causes of the financial crisis; however, regulatory policies that encouraged speculation and excessive risk taking behavior helped creating the bubble (Mazumder and Ahmed, 2010).

- GLB Act 1999 which replaced the Glass-Steagall Act that existed since the 1933 great depression separating commercial banking from investment banking and insurance companies, which also reduced the Fed's control on investment banks and implicitly allowed investment banks to undertake additional risks.
- The Commodity Futures Modernization Act of 2000 (Replaced the Shad-Johnson jurisdiction accord) allowing single-stock futures contract and deregulated numerous over-the-counter (OTC) derivatives including swaps.
- Cancellation of the uptick rule in the short selling encouraging risk taking behavior from investors and when the market was falling, it even pushed it downward as in absence of the

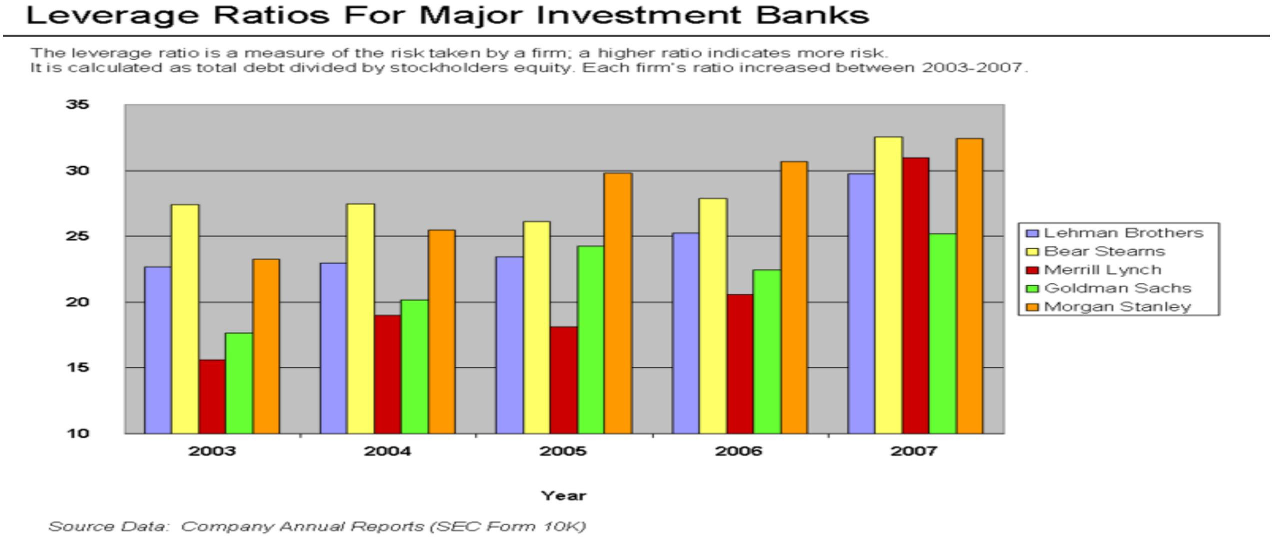
uptick rule during 2007-2008. Short sellers were able to bet heavily especially on financial stocks, and drove their prices down (even by 10-25 percent in a single day especially during the last quarter 2008). This is totally far from the intended goal as short sale was created for liquidity purposes and to enhance the market with different trading strategy, aiming at less volatility and efficient pricing.

- Introduction of the naked short sale by the SEC on July 6, 2007 since stocks are actually not borrowed, naked short selling artificially creates an excess supply of particular stock and reduces its price. This have led to excessive speculations from investors and went even up till betting on companies positions which literary drove the market from its normal pass in a gambling game.
- Since early 2000 investment in risky projects increased and accordingly the demand for CDS for two main reasons; investors wanted to hedge along with speculation that the risky investment may default.CDS were not only limited to subprime mortgage but they extended to cover auto loans, credit cards, accounts receivable, student loans, etc.

U.S. Subprime Lending Expanded Significantly 2004-2006



Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2008



- Growth of Credit default swaps, by Late 2007 the CDS market was twice the size of the US stock market, ten times higher than the US corporate debt market and three times the size of the US GDP which implies that this is not a sound insurance from credit default rather than a heavy speculation game. The deviation can be detected if we consider CDS as an insurance tool against risky investment that should have adhered to the basic two principles of insurance:

1-Beneficiary should be in direct relation with the risk insured against.

2-No profit is to be made out of the risk occurrence but only remedy.

These 2 conditions were violated as Buyers of CDS do not require holding underlying debts on which CDS are written. Along with the above deviations comes the following remark concerning the CDS which may seem to be out of context unless we consider the questions in the next sub title (2-4):

- CDS are unregulated securities.
- There is no central clearing house for it.
- CDS are privately negotiated between buyers and sellers.
- CDS market is dominated by major global dealers with limited public disclosures.
- CDS were challenged with serious advisers' selection and moral hazard problems as they were brought into the market without adequate regulatory supervision.
- CDS monitoring and transaction costs associated were also high.

- Contractual disputes between buyers and sellers may exist.

Know we can say that the reason behind the crisis is the deviation from the basic assumption or philosophy driving investment as society welfare and growth tool on the long-term, which was our puzzle solving clue (Hypothesis) from the beginning but was it deliberately or not to switch the financial market to become a wild pursuit of short-term gains through orienting the financial innovations and the laxity of regulations, deliberately or not this calls for examining the role of gate-keeper.

2.4 The role of the gate-keepers to prevent or rectify the deviation.

We found ourselves asking the following questions; is the US financial market a true free economy or controlled one? And if the US market is a free one what happened or what changed? Why the excessive cancellation of regulation without considering the collective effect?

Seeking answers for the above questions took us back to the Enron 2001 crisis as we found numerous errors and omissions that existed and led to the problem still existed in the new 2007-2008 financial crisis if not magnified to the Marco level.

During the study of the Enron 2001 crisis especially among law scholars some referred to not as a case of corporate governance failure but as a case of gate-keepers failure. (Coffee, 2002, p.5-6)

> *"Although the term gate keeper is commonly used, here it requires special definition. Inherently, gatekeepers are reputational intermediaries who provide verification and certification services to investors. These services can consist of verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects vis -a-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Attorneys can also be gate-keepers when they lend their professional reputations to a transaction, but, as later discussed, the more typical role of attorneys serving public corporations is that of the transaction engineer, rather than the reputational intermediary. Characteristically, the professional gatekeeper*

essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is necessary because the market recognizes that the gatekeeper has a lesser incentive to lie than does its client and thus regards the gatekeeper's assurance or evaluation as more credible.
To be sure, the gatekeeper as watchdog is typically paid by the party that it is to watch, but its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. "

Accordingly we can view the Enron case if not as a miniature form of the 2007-2008 financial crisis but as an introduction to it, because simply all the exotic tools (Like Derivatives, Futures and last but not least mark-to-market accounting practice) that led to Enron's decay and failure were present in the late crisis with and even adjusted jurisdictions like the Sarbanes–Oxley Act of 2002 tackled mainly the issues of corporate governance totally omitting the role of the financial tools used by Enron and the like who played a major role in there failure in our opinion.

One of the very vague examples of gate keeper failure is the credit rating agencies use "issuer pays" business model where bond issuers pays rating agencies to rate their debt securities. It is alleged that rating agencies were paid by subprime mortgage loans' issuers to favorably rate their securities. Portes (2008) documents an upward bias in rating subprime MBS which is caused by artificially increased house prices. In general, it is apparent that investors were misguided by ratings provided by the rating agencies.

The very deregulation and minimization of government rule as a controller, forced the excessive governmental involvement in 2009 to rescue the market and rectify the failures of the US corporations which took the global financial and economic market down (The American Recovery and Reinvestment Act of 2009).

All of the above led us to confidently believe in the role of the Ethically Unbiased Gatekeeper (whether it is the government or any of its representative establishment or organization) in preventing such crisis or in the worst case reducing its effects or more bluntly to ambulance the

wounded not to count and collect dead bodies, If it cannot act so at least they can act as a whistle blower or as fire alarm at earliest signs of deviation-like those discussed earlier- in order to get suspicious practices under scrutiny.

Also the US financial institutions should consider the implementation of Basel III and not to overlook it as they did with Basel II (Mazumder andAhmed, 2010)

Going through these details we can’t help concluding also and aside from the above, the issue is related to the Agency Theory on Macro level. The control of the republican government and forcing their ideology of free market and minimizing the role of the government in the economy in favor of private sector at an unprecedented scale, wasfinally taking its toll along with the overlooking of the Basel II agreement, rogue credit rating agencies and increasing executives’ compensation. Remarks shown earlier in the last section concerning CDS if not deviation it is an example of looseness. We reached a degree that we disagree with the recommendations on having one single body regulating and observing as we would recommend one body regulating and several observing.

The above leads us to the inevitable question why don’t we have a Financial General or and Accounting General just like we have Surgeon General to watch over people health and District Attorney to defend people wrights as well as the society welfare.

To find were did role fit we found that the job of gatekeeper existed in the Islamic governance since the late seventh century as a public servant called (Muhtasib) was a supervisor of bazaars and trade in the medieval Islamic countries. His duty was to ensure that public business was conducted in accordance with the law of sharia. In the late 10^{th} century the duties of the Muhtasib of Cairo included "the regulation of weights, money, prices, public morals, and the cleanliness of public places, as well as the supervision of schools, instruction, teachers, and students, and attention to public baths, general public safety, and the circulation of traffic." In

addition, craftsmen and builders were usually responsible to the Muhtasib for the standards of their craft (Hill, Donald 1984). The *Muhtasib* also inspected public eating houses. He could order pots and pans to be re-tinned or replaced; all vessels and their contents had to be kept covered against flies and insects. The *Muhtasib* was also expected to keep a close check on all doctors, surgeons and apothecaries (Stone, 1977)

A Muhtasib often relied on manuals called hisba, which were written specifically for instruction and guidance in his duties; they contained practical advice on management of the marketplace, as well as other things a Muhtasib needed to know -- for example, manufacturing and construction standards (Ibn al-Ukhuwwa, 1938).

3. Traditionnel Finance versus Islamic Finance:

The last decade of the 20th century and the few years towards the beginning of the 21st century showed explosion in the area of financial innovations. Fundamental economic forces have led to increase competition in financial markets. Greater competition in turn has diminished the cost advantage banks have had in acquiring funds and has undercut their position in loan markets. As a result, traditional banking has lost profitability, and banks have begun to diversify into new activities that bring higher returns. The ability to securitize assets has made nonbank financial institutions even more formidable competitors for banks. Advances in information and data processing technology have enabled nonbank competitors to originate loans, transform these into marketable securities, and sell them to obtain more funding with which to make more loans.

Computer technology has eroded the competitive advantage of banks by lowering transactions costs and enabling nonbank financial institutions to evaluate credit risk efficiently through the use of statistical methods. When credit risk can be evaluated using statistical techniques, as in the case of consumer and mortgage lending, banks no longer have an advantage in making loans. An effort is being made in the United States to develop a market for securitized small business loans as well.

Before 1980, two U.S. banks, Citicorp and Bank America Corporation, were the largest banks in the world. In the 1990s, neither of these banks ranks among the top twenty. The problem is not limited to United States only but it is a worldwide epidemic as stated by (Edward and Mishkin, 1995, p.35)

> *"French and British banks suffered from the worldwide collapse of real estate prices and from major failures of risky real estate projects funded by banks. Olympia and York's collapse is a prominent example. The loan-loss provisions of British and French banks, like those of U.S. banks, have risen in the l990s. One result has been the massive bailout of Credit Lyonnais by the French government in March 1995. Even in countries with healthy banking systems, such as Switzerland and Germany, some banks have run into trouble. Regional banks in Switzerland failed, and Germany's BfG*

> *Bank suffered huge losses (DM 1.1 billion) in l992 and needed a capital infusion from its parent company, Credit Lyonnais. Thus, fundamental forces not limited to the United States have caused a decline in the profitability of traditional banking throughout the world and have created an incentive for banks to expand into new activities and take additional risks."*

Much of the controversy surrounding banks' efforts to diversify into off-balance-sheet activities has centered on the increasing role of banks in derivatives markets. Large banks, in particular, have moved aggressively to become worldwide dealers in off-exchange or OTC derivatives, such as swaps. Their motivation, clearly, has been to replace some of their lost banking revenue with the attractive returns that can be earned in derivatives markets.

Banks have increased their participation in derivatives markets dramatically in the last few years. In l994, U.S. banks held derivatives contracts totaling more than $16 trillion in notional value. Of these contracts, 63 percent were interest rate derivatives, 35 percent were foreign exchange derivatives, and the remainder was equity and commodity derivatives (Edwards and Mishkin, 1995).

Islamic finance is any finance that operates with the principle of Islamic law (Sharia). It is one of the fastest growing segments of today's banking industry. Ahmed (2010, p.1) argued that the world financial system suffered for too long under conventional (Riba) based banking system. The world in searching for an alternative is "hungry to hear the message loud and clear". Islamic finance is an asset based system. Money in itself has no intrinsic value. The prohibition of paying and receiving fixed, predetermined rate of interest is crucial in Islamic finance. The sale of debt and speculation are not allowed. In the conventional financial system risk is transferred and sold while in Islamic finance it is shared like collective insurance scheme. Ethics and social responsibility are pillars to Islamic finance (Alexakis and Tsikouras, 2009). Alchaar (2010) pointed that we are facing today a dilemma of compounded greed of individuals, institutions and nation states. Many individuals were trying to buy better houses than they can stand for,

institutions who are gambling on the benefit of each other through the creation of credit default swaps and nation states with the laxity of regulation. He states (p.1)

> *"These macroeconomic imbalances prevailed in the last decade or so resulted in a downward impairment of the term structure of interest rates. This in turn stimulated demand for credit based instruments that achieved the desired yield uplift. It was called "financial innovations". We all believed in the fallacy that these sophisticated tools and instruments would create value. Apparently, the value they created was mostly illusory … It was a textbook-style manifestation of regulatory sabotage".*

The operations of Islamic finance are based on profit-loss sharing principle and risk division in losses and profits between lender and borrower. Two fundamental financial tools are based on profits and losses principle which are (mudarabah) and (musharakah) contracts. The former is used as investment fund where the financier provides the essential capital and the entrepreneur provides the management. They share profits but the financial losses are beard by the provider of funds alone while the entrepreneur losses his efforts. The latter musharakah is a form of partnership through an equity participation contract. The profits and losses are shared according to partner's share in financing. In addition to profits and losses contracts there are other non-profits and losses modes of finance such as cost plus financing (murabah) which is used in trade and asset finance. The Equivalent to leasing in conventional finance is Islamic finance which relay on (Ijara) and is used in home purchasing. The investor or the lessor which is probably the bank purchases and leases the underlying asset to the borrower or the lessee for a specified rent and term (Mouawad, 2009).

The international financial society after experiencing the severity of the late financial crisis may be ready to accept the Islamic financial applications (no matter the motive is). As we consider the core value to Islamic finance in trying to judge issues we strongly believe that the conventional financial tools are not all total evil that should be discarded in favor of the Islamic developed ones as the problem is in the usage of the tool not the tool itself.

(As for example Joint ventures and business partnership identically implies the same rule of Musharaka which is the most widely accepted and undisputed Islamic financial applications).

- We also found that numerous existing Islamic financial applications are just translation of conventional financial tools without proper innovation in the techniques using mysterious phraseology and debated jurisprudence issues (such as the importance of transferring the title deeds and ownership even if it is done fictitiously) to be able to attract new customers to the financial institutions.

As for example the Murabaha in practice is a very vague example of conventional loans disguise, sellers of such product have continuously failed to provide acceptable explanation on the basis on which they have calculated the excess over initial value.

- Furthermore from our understanding of the Islamic finance one important rule that should be fundamentally used in assessing and financial tool that is no profit sharing allowed without assuming part of the risk. The impeded importance of this rule is that its application relaxes all prohibitions up to our concern and we urge Sharia'ah scholars to examine such hypothesis
- We have also reached solid belief that the implementation of the Islamic finance without a currency covered by gold is almost impossible as the goal required to be reached is the Zero interest and without link or reference between the current paper money currently widely used and a relatively stable precious metal to measure deviation over long period of time in order to eliminate inflation and deterioration of paper currency value hinder the implementation of Islamic finance which will only remain cosmetics not a real implementation. If not applicable because of deviation from the global trend then assessment based on assets (asset standard) should be in place which is the core of our introduced approach in part five.

4. Would have Islamic finance helped in preventing or partially eliminated such a crisis?

The non-prohibition of speculation has drifted investment out of its intended role as route to welfare and social benefit to become a gambling tool for speculation adrenaline junkies.

Sticking to the major classification of prohibitions in the Islamic finance we can determine the following:

4.1The prohibition of taking or receiving interest.

This item helps investors to think out of the box (money tomorrow=money + interest) and concentrate on assets rather than on the money itself. As money is a mean not the way to growth. So, by prohibition of interest any investor would convert his money into profit yielding assets instead of keeping it in its raw form of liquid money, this coincide with the real function of Stock Exchange; if you can't invest by yourself, share and delegate management.

4.2 Capital must have a social and ethical purpose beyond pure, unfettered return.

This rules forces investors to consider the society welfare and to take into consideration the ethical and moral hazards of any investment made within the society which was overlooked as we have seen in the financial crisis in the following points:

1- Huge redemption by portfolio manager and "dark pool liquidity" (Institutional order flows, usually in block trades but not available to the public) are partially responsible for high stock market volatility (Mazumder andAhmed, 2010).

2- A recent document filed in New York State court report that bankers, brokers, dealers and traders involved in CDS trading used text messaging to share private information about firm's interventions and positions before actual trades (Mazumder and Ahmed 2010).

3- Credit rating agencies use "issuer pays" business model where bond issuers pays rating agencies to rate their debt securities. It is alleged that rating agencies were paid by subprime mortgage loans' issuers to favorably rate their securities. Portes (2008) documents an upward

bias in rating subprime MBS which is caused by artificially increased house prices. In general, it is apparent that investors were misguided by ratings provided by the rating agencies.

Though the Islamic Sharia'ah prohibits the above unethical behavior of individuals and institutions but it cannot prevent it. However, if ethical behavior is promoted and compensated throughout normal market mechanism this will be the mean to real liberalization Islamic style. Also worth mentioned here that almost all this mull practices are legally condemned globally which resembles a coincide of rational and widely accepted ethics with Sharia'ah.

4.3 A prohibition on transactions involving maysir (speculation or gambling).

This was also violated as seen in the financial crisis in the following issues:

1- Many hedge funds, in addition to using CDS to hedge their portfolios (or bet against a company) sold short financial stocks while these actions by the hedge funds helped them to make profit from target company's diminishing financial performance and value, they created a downward pressure on the stock prices of numerous companies and contributed to high volatility.

2- It is also alleged that numerous hedge funds managed to collect private information and data from analysts of different firms and made bets that the stock price of those companies would decline (Strasburg and Bary, 2009).

4.4 A prohibition on gharar, or uncertainty about the subject-matter and terms of contracts - this includes a prohibition on selling something that one does not own.

1- Naked short selling is used to anticipate a price fall, but exposes the seller to the risk of a price rise. Naked short selling has been illegal in the United States since 2008, as well as some other jurisdictions, as a method of driving down share prices. Failing to deliver shares is legal under certain circumstances (Mazumder andAhmed, 2010).

2- CDS were challenged with serious advisers' selection and moral hazard problems as they were brought into the market without adequate regulatory supervision and buyers of CDS do not require holding underlying debts on which CDS are written.

3- Commodity future contracts are also a major example of selling what you do not own and was heavily invested in.

4.5 Investments in businesses dealing with alcohol, gambling, drugs or anything else that the Sharia'ah considers unlawful are deemed undesirable and prohibited.

These items were deemed unlawful by the Islamic Sharia'ah, mostly due to their greater damage to society away from any minimal benefit they can achieve if any.

Remember that even in societies with different ideology that accept the above mentioned practices have a tolerance ceiling like:

1- Driving under the influence of alcohol and/or drugs is criminalized.

2- Smoking is now almost prohibited with the new antismoking laws.

3- Production and sales of alcohol is in special places with strict supervision and regulation.

4- Gambling is allowed only in special places with strict supervision and regulation.

The clear answer to the raised question in this part is; Yes Islamic financial philosophy would have partially eliminated such a crisis, due to its capacity to eliminate factors that deviates from the basic assumption of investment as a mean of production hence prosperity and welfare of the society, such factors would have not been even introduced to the market.

The only factors that Sharia'ah would not have eliminated its effect are those related to mal-practice and behavioral and ethical issues that should be discourage throughout market mechanism or legal condemnation which is the holding nature of it.

5. Blue prints of an approach to fit conventional product to Islamic principles through innovation rather than disguise.

As we have discussed above to think out of the box when trying to innovate and develop new Islamic financial tools and applications in order to be able to legitimize it according to Sharia'ah. We have to let go the major belief in conventional finance which is money and to think in terms of assets instead.

More thinking out of the box -in the same context- is to avoid the classification of borrower vs. lender, that to be replaced by operating partner vs. financing partner, or even more widely by permanent partner vs. temporary partner. As traditionally the question was, who will benefit out of the equation[1] $F_n = P\,(1+r)^n$, an equation that imbeds variables that in most are not controlled by either parties, in short run such an equation may turn to be a win-win relation however it is a matter of time till it favors one of the parties on the long run; so that it is no more a win-win. Back to the sacrificed classification (lender vs. borrower) whomever you favor you can't grant a fair relation.

Though we chose the bond latter as our experimental application in the next part of the paper, we will use it now as an example of the above discussed dilemma; a bond yielding an interest[2]of 12%

of which inflation represents 8% and the 4% are the average required return on the expected growth of the investment we are involved in, so let us examine the deviation in each part of the equation and whom does it favor ; increase in inflation rate everything being constant (economic impossible condition) this favors the borrower and vice versa. Increase in the growth rate of the investment favors the borrower and vice versa and a combination may occur at

[1]**Future Value of $1 (*r* = interest rate; *n* = number of periods until valuation; *P* = $1)**

[2]interest rate(*r*) which is usually calculated as a risk free rate that includes inflation plus the particular investment premium that includes the special level of risk impeded in the investment

different levels, these are the factors that neither keep constant nor can be accurately anticipated.

The above mentioned illustrations pave the road to asset standard financial tools; where equality is the base, hence all parties will experience the same level of risk as we may dare say that we will eliminate the inflation effect and we will be then left with the growth which will be shared on good or bad base.

5.1 Blue print of asset standard Bond

We chose the bond as experimental application to apply this concept and we would like to go through the development of such an Islamic bond in the same way we have discussed it through a brain storming session of questions and answers. However, keeping in mind that for bonds to be Halal no interest rates or discount rate- what so ever- should be applied to avoid Reba. The following introduction will help determining the questions or problems we faced. Traditionally a Bond life cycle start by its initial price face value which totally depends on the current market interest rate in the case of discounted bond type, this is the first date on which we face the interest rate though it may not be an issue for the yielding bond type at issuance. However it eventually arouse when we try to price any of the two types in the secondary market, and if it is an avoidable issue in pricing for the yielding bond type, it is an issue for yield calculation along its life cycle, bond redemption at maturity may not be a subject as a nominal amount however its real value of money is; it is a multiplier of sorrow for one and only one of the parties, and multiplier of joy for the other party, especially in the long run as discussed before –the borrower is a long run player by nature. Shall we not be able to avoid sorrow, we may assume sharing it. We consider the concept of sharing to be the healthiest attitude for real investment.

To sum in the absence of interest we are facing the questions of; How will we determine the face value? Calculate returns? Determine the secondary market price at any given point of time? Redemption value at the end of its life?

Over and above the listed questions "What is in it for me?" was the hardest question to answer, to overcome the concept of interest that dominated our way of thinking and facilitate the answer for such a kind of questions throughout our professional and scholar career, was the hardest part of the process of developing this blue print so and before going through our answers for these questions, we emphasis that even though we may argue that this particular application may not call for a generic change in the financial culture (economic, accounting, legislations and etc…) which might be a prerequisite for other applications, it do call along with any application that depends on the asset standard for a generic shift in basic concept of what is in it for involved parties?

Base point in this application is relating the bond to a particular asset or portfolio of assets accordingly the investor is not lending the organization as a whole however he/she is a temporary partner in a particular asset which is then the base for all questions related to such concluded temporary partnership contract between investors[3], along with emphasizing the concept of partnership the undisputed form of Islamic financial tools it answers the above mentioned questions as follow:

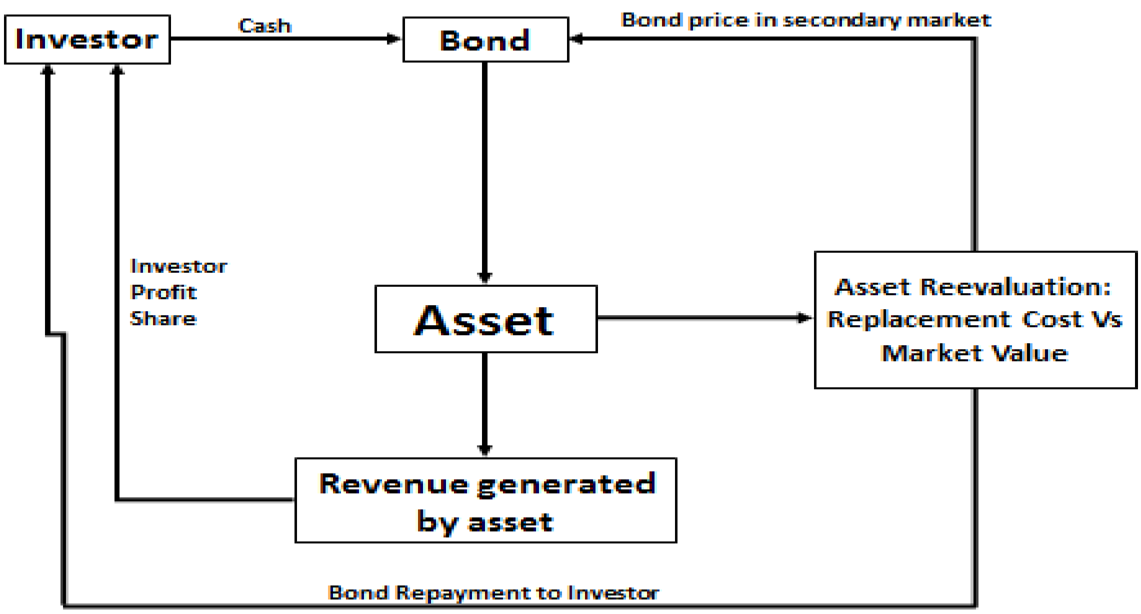
How will the face value of the bond be concluded among partners? Simply as the share of temporary partners, bond holders, in the cost of the asset or required investments divided by the number of issued bonds.

How will returns be calculated? According to its original share of the related asset or portfolio of assets returns; which may take as many as the word return as a concept hold; that is direct profit, cost reduction, shadow price …etc. or even a combination.

[3]Throughout the preceding parts of the paper the word partners and investors will be used interchangeably to refer to the two groups; permanent partners and temporary partners

How will it be evaluated in the secondary market? According to its original share of financing, the related asset or portfolio of assets, as a percentage of current replacement cost or current market value.

How will it be redeemed by end of its life? Same as secondary market evaluation.



At this stage of the application we would like to draw attention to some of the related aspects that was not overlooked rather than it was left for market mechanism to choose among options or create a proper mechanism, such as;

5.1.1 Asset or portfolio of assets vs. the entire entity

The related financial areas such as accounting, taxation….etc. in the introductory phase of the approach, we use the single asset or a portfolio of assets, never the less market may develop the temporary partner into a partner in the entire entity, entitled to a share of the profit regardless of the dividends distribution for instant.

5.1.2 Appropriate partnership ratio and corporate governance

The question at this stage is should the permanent partners have a share in the asset? Or could it be 100% financed through temporary partners, if not what is the appropriate ratio? Should such

ratio or type of relation be discussed in isolation from governance and the ability of the permanent partners to manipulate the outcomes of the asset, or it is indifferent as the permanent partners in spite of their theoretical accessibility as stock holder to management may not be able to exercise the full power, will the theory of stake holder and long run relation with creditors hold against such threats? These questions are example of the questions that we left for the market for two reasons, first it is not the core concept of the application and market mechanism is capable of resolving it, the second reason is – and we repeat- Sharia'ahwould not have eliminated the effect of factors related to mal practice and behavioral and ethical issues that should be discouraged throughout market mechanism or legal condemnation which is the holding nature of it, otherwise a lot of day to day practices in all social aspects can be prohibited for future miss usage probability.

5.1.3 Replacement cost vs. Market value;

This question was tackled and debated in several papers in insurance area and we favored the market value as it will always reflect the true value of the assets with its relative competitive advantage.

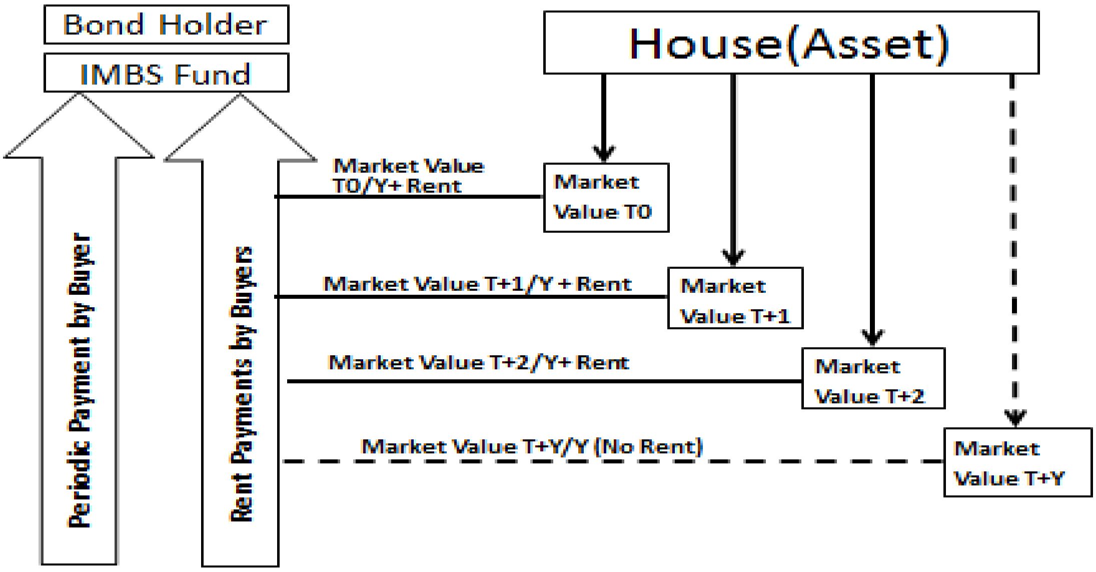
For example, a home purchased in a depressed city neighborhood, may have a market value of $120,000.The exact house, located in a nice suburb, may have a market price of $285,000; however, the cost to rebuild the house after a loss would be the same in either location. The insurance company is looking to insure the home for the full replacement value, not the current market value. Remember, they are going to pay to build you a new home, not buy one for you down the street.

Description	Thriving Suburb	Depressed Neighborhood
Square Footage	2,500	2,500
Year Built	1920	1920
Market Value	$285,000	$120,000
Cost to Replace Home	$275,000	$275,000

5.2Mortgage as an example of asset standard

Examining the capacity of the asset standard to develop a simple application such as bond and we mean by simplicity the presence of a return yielding asset can we examine its capacity in more sophisticated application, on the scale of financial complexity as well as the lack of return generating asset. For this goal the mortgage seems to be challenging and criteria fulfilling application, however and to be frank it won't be as challenging as the bond application as the late represented the concept relaxing. However the merit of this application buried in its capacity to be applied for any type of durable goods thus covering a huge range of house hold needs, accordingly lubricate the market.

Solving clue in this application is the partial selling of an asset, along the loan life Here it will be hard to think out of the box, but assume we are to sell a set of ten cups, one cup at a time, and each time the buyer shows for his/her periodical cup (10% of the asset) we will price it to the market the same can be applied to house sale or as it is called mortgage, however which part of the house buyer wants be able to use as he/she yet didn't pay for it, and if buyer can use it all then, what is in it for the seller? Traditional as in Murabaha a premium was the suitable answer, however subject to debates by jurisprudence bodies, so we figured out that seller can receive a rental value for the unsold portion, this won't only answer the "what is in it?" , but also in case we need to reschedule, what you didn't buy you pay rent for it, that is in a given period of time if the buyer can't buy his/her periodical portion either fully or partially the seller will still be able to receive the rental value of whatever not yet sold part of the asset. Then we may introduce the securitization by a simple question; can we replace the seller by a fund that issues Islamic mortgage backed securities? The answer is: sure, developing the bond application to fit.



Again and at this stage of the application we would like to draw attention to some of the related aspects that was not overlooked rather than it was left for market mechanism to choose among options or creates a proper mechanism. Of this we may mention the following:

5.2.1. Rental value

Should it be fixed or also evaluated year to year? Is any of this application against Sharia'ah if not defiantly it is to be left for market to choose the best, in all parties benefit on a competition base or else.

5.2.2. What will assure keeping the quality of the asset in case of full default?

It seems to be a problem at first glance but overcoming it is a value added for the economy rather than a solution simply we may state.

○ Maintenance contracts source of revenue and assuring the value of asset is maintained against wear out (this is applicable to many assets other than houses that can be subject for rent contracts such as automobile…etc).

○ Takafoul[4] contracts among buyers (for social benefit).

[4] There is more than one alternative for insurance that may be accepted by Islamic philosophy

Remember separating the entities working on these aspects is to be carefully examined to avoid split over experienced in 2007-2008 financial crisis(If we really got the lesson).

Appling asset standard tool in this fashion as it relax the concept of no return without assuming risk, it in turn avoid all the Sharia'ah prohibitions, that is not favoring Islamic finance as an ideology, rather than it favors a sort of guarantee for finance to keep in track as source of human welfare.

6. Conclusion

Sticking to the core philosophy of liberal, rational and widely acceptable ethical investment coincides with the Islamic financial philosophy and we may dare to say Sharia'ah "*the divine rule by the almighty for human prosperity and welfare*"

Judgment of any tool should not be the responsibility of religious clerics only, but should be the work of scholars with deep understanding of the tools subject to scrutiny from economic, financial, accounting and last but not least sharia'ah.

Islamic as tag for any application cannot avoid its misuse rather than it can be considered as a standard or base to be used to judge the performance of the product before its introduction to the market and after usage and subsequently pinpoint adjustments or eliminations required. This should be the main role of the financial gate-keepers regardless of their ideology as the base of judgment should be kept on sight at all times as important as it gets to have a surgeon general (to look after people health and prevent misuse of drugs and food additives), attorney general (to represent the society right against others) there should be an accountant general and investment and stock exchange general to protect investors and business stockholders from being abused by the misuse of financial tools.

As one of the issue discussed in the financial crisis causes was the financial illiteracy among parties and accordingly the last thing we need is to have a new financial crisis (that would be attributed to Islamic financial tools rather than its misuse), due to the lack of knowledge of the effect of the newly introduced tools on the financial market and economy.

Finally, readers should not consider the financial tools blue-prints illustrated in section 5 of this paper as rigid frames to follow but a flexible model that can be amended, adjusted and rectified if required to suite unique financial requirements of a liberal free market economics based on the free laws of supply and demand.

At last, it is very important to grab the opportunity to develop fully integrated financial solutions in terms of tools, accounting practices and standards and economic studies distinct enough to be the core/seed for an integrated Islamic economy.

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Glossary:

1- **Al Muhtasib** (Arabic: محتسب) was a supervisor of bazaars and trade in the mediævalIslamic countries. His duty was to ensure that public business was conducted in accordance with the law of sharia. In the reign of the SultanBarqûq, for example, the duties of the muḥtasib of Cairo included "the regulation of weights, money, prices, public morals, and the cleanliness of public places, as well as the supervision of schools, instruction, teachers, and students, and attention to public baths, general public safety, and the circulation of traffic." In addition, craftsmen and builders were usually responsible to the Muhtasib for the standards of their craft.

"The Muhtasib also inspected public eating houses. He could order pots and pans to be re-tinned or replaced; all vessels and their contents had to be kept covered against flies and insects... The Muhtasib was also expected to keep a close check on all doctors, surgeons, blood-letters and apothecaries." A Muhtasib often relied on manuals called ḥisba, which were written specifically for instruction and guidance in his duties; they contained practical advice on management of the marketplace, as well as other things a Muhtasib needed to know -- for example, manufacturing and construction standards.

2- **ARM**: Adjustable-rate mortgage.

3- **ARRA The American Recovery and Reinvestment Act of 2009** (Pub.L. 111-5) commonly referred to as the Stimulus or The Recovery Act is an economic stimulus package enacted by the 111th United States Congress in February 2009.The stimulus was intended to create jobs and promote investment and consumer spending during the recession. The rationale for the stimulus comes out of the Keynesian economic tradition that argues that government budget deficits should be used to cover the output gap created by the drop in consumer spending during a recession. The modern consensus (a blend of thinking from New Keynesian and New Neo-classical theory in economics) favors monetary over fiscal policy like the fiscal stimulus.[1] However, the Federal Reserve had already cut interest rates to zero, greatly reducing their policy options. The flow of finances was stagnated because of a liquidity trap, or an over leveraged/broke banking system, also limiting monetary policy effectiveness. While many economists agreed a fiscal stimulus was needed under these conditions, others maintained that fiscal policy would not work because government debt would use up savings that would otherwise go to investments, what economists call crowding out. Proponents countered that the negative effects of crowding out are limited when investment has already stagnated.

4- **CFMA The Commodity Futures Modernization Act of 2000:** is United States federal legislation that clarified most over-the-counter derivatives ("OTC derivatives") transactions between "sophisticated parties" would not be regulated as "futures" under the Commodity Exchange Act (CEA) or as "securities" under the federal securities laws. Instead, the major dealers of those products (banks and securities firms) would continue to have their dealings in OTC derivatives supervised by their federal regulators under general "safety and soundness" standards. "Functional regulation" of derivatives products by the Commodity Futures Trading Commission (CFTC) was rejected for continued "entity-based supervision of OTC derivatives dealers.

5- **Credit Default Swap (CDS)**: is a swap contract and agreement in which the protection buyer of the CDS makes a series of payments (often referred to as the CDS "fee" or "spread") to the protection seller and, in exchange, receives a payoff if a credit instrument (typically a bond or loan) experiences a credit event. It is a form of reverse trading.

6- **Fannie Mae**:The Federal National Mortgage Association (FNMA).

7- **Freddie Mac**: The Federal Home Loan Mortgage Corporation (FHLMC).

8- **Gate Keeper:** As defined are Accountants, analysts, and credit rating agencies functions as gatekeepers to financial markets by providing information on investment products to

investors. Accountants have been accused not only of being aware of accounting irregularities but even of aiding and abetting the violators.

The term "gatekeeper" is not simply an academic concept. In Securities Act Release No. 7870 (June 30, 2000), the SEC recently noted that "the federal laws. Make independent auditors 'gatekeepers' to the public securities markets." 2000 SEC LEXIS 1389

9- **GDP The gross domestic product**: or gross domestic income (GDI) is the amount of goods and services produced in a year, in a country. It is the market value of all final goods and services made within the borders of a country in a year. It is often positively correlated with the standard of living, alternative measures to GDP for that purpose.

10- **Ginnie Mae**: The Government National Mortgage Association (GNMA).

11- **GLB Glass–Steagall Act 1999**: The Gramm–Leach–Bliley Act (GLB), also known as the Financial Services Modernization Act of 1999. The Banking Act of 1933 was a law that established the Federal Deposit Insurance Corporation (FDIC) in the United States and introduced banking reforms, some of which were designed to control speculation.[1] It is most commonly known as the Glass–Steagall Act, after its legislative sponsors, Carter Glass and Henry B. Steagall.

12- MBS: Mortgage-backed security.

13- RMBS: Residential mortgage-backed securities.

14- **Sarbanes–Oxley Act of 2002** (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House) and commonly called Sarbanes–Oxley, Sarbox or SOX, is a United States federal law enacted on July 30, 2002, which set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It is named after sponsors U.S. Senator Paul Sarbanes (D-MD) and U.S. Representative Michael G. Oxley (R-OH).

The bill was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the nation's securities markets.

15- **SEC The U.S. Securities and Exchange Commission**: is a federal agency which holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets in the United States. In addition to the 1934 Act that created it, the SEC enforces the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002 and other statutes. The SEC was created by section 4 of the Securities Exchange Act of 1934 (now codified as 15 U.S.C. § 78d and commonly referred to as the 1934 Act).

16- **Subprime Loans**: Subprime lending (also referred to as near-prime, non-prime, and second-chance lending) means making loans to people who may have difficulty maintaining the repayment schedule.

17- **Sui generis** (pronounced /ˌsuː.aɪ ˈdʒɛnərɪs/;Latin: /ˈsʊ.iː ˈɡɛnɛrɪs/) is a Latin expression, literally meaning of its own kind/genus or unique in its characteristics. The expression is often used in analytic philosophy to indicate an idea, an entity, or a reality which cannot be included in a wider concept.