Equity-Based, Asset-Based and Asset-Backed Transactional Structures in Shari’a-Compliant Financing: Reflections on the Current Financial Crisis*

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This paper presents interest-free equity-based, asset-based and asset-backed transactional structures endorsed by Shari’a-compliant finance. These structures could explain the potential and relative insulation, yet not immunity, of Islamic financial institutions from the financial crisis. Although Shari’a-compliant financing cannot solve the current financial crisis, the recovering market could consider incorporating some of the insulating principles underlying Shari’a-compliant financing and securitization products, as exemplified in the sample of Shari’a-compliant products in this paper, so as to offer better consumer protection.

Keywords: GFC, home financing, Islamic finance, Islamic products, Shari’a-compliant finance.

1. Introduction
The recent financial crisis has had a strong impact on the global financial sector. To date, most established and emerging markets are affected, and so is the performance of Islamic financial institutions (IFIs). The principles of Islamic finance are believed to have offered – and to continue to offer – a certain insulation from the crisis and the Islamic financial system seems to be affected by what could be termed an aftershock of the global financial crisis (Singh, 2009). It is not directly affected by the subprime crisis but by a reduction in the performance of the global economy. Starting with the crisis in the United States, the financial crisis indicates the existence of extensive flaws under the pressures of substantial global imbalances (Pisani-Ferry and Indhira, 2009). While revealing weaknesses in the global financial system, the crisis is generating a re-evaluation of the fundamentals of the conventional financial system. It is in this context that IFIs have received increased attention due to core principles that have contributed to insulating them.\(^3\) Although

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\(^3\)The acronym IFI in this paper refers to Islamic Financial Institutions. It is an acronym that is often used in writings in Islamic finance and is not to be confused with the acronym for International financial institutions.

*The views expressed in this paper are solely those of the two authors and do not necessarily reflect the views of Amanie Business Solutions, its shareholders or its affiliates.

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inadequate regulations have been blamed for some dimensions of the financial crisis, the focus of this paper is on the underlying financial products that have set off the crisis. Whereas the regulations, global imbalances and the conventional financial products that contributed to the financial crisis are certainly related, they are disentangled for the purpose of this paper. In other words, the focus of this paper is to exemplify key differences between Islamic financial products and their conventional counterparts. These can be considered as the “straw that broke the camel’s back” or the types of financial products and toxic assets that contributed to the crisis, rather than the macroeconomic context or regulatory failures that led to their creation.

2. The Underlying Structural Causes of the Financial Crisis
Excluding the impact that substantial global imbalances and the lack of regulation in areas of the conventional financial system have had on the creation of problematic conventional financial products, this section of the paper focuses on the underlying structural causes of the crisis. It does so, briefly, in order to set a context for the presentation of Shari’a-compliant products which follows. Over the last decade there has been a wealth of social trends and lifestyles, especially in more developed countries, depicting an exponential increase in consumption. The trend in home ownership has quadrupled since the beginning of the last decade and the purchasing power of consumers has been facilitated by a series of financial products in both the primary and secondary conventional financial markets. Such financial products were designed to facilitate mechanisms for consumers to readily obtain home mortgage financing. Additionally, these were facilitated by enabling financial institutions to liquidate debt into a securitization arrangement for debt to be traded in the secondary conventional financial market. Changes in lifestyle, cultural pressures and status perception as well as readily available financing products have placed pressure on the average consumer to purchase more real estate than could potentially be afforded. These structures have enabled banks and financing corporations to provide new loans to lower income groups. As loans were made readily accessible to subprime consumers, the system was exposed to high credit risk.

The financial crisis started with the subprime crisis that included a major decline in real estate prices and real losses in subprime mortgages and the devaluation of structured assets. This led to the failure of players directly involved in the crisis. The subsequent contamination of the other classes of financing products in the credit market and the freezing of non-government credit markets such as commercial papers, interbank and bonds resulted in the dissipating of liquidity. The spike in capital costs led to a credit crisis and to the failure of institutions with weak liquidity and capital. It can be understood that flaws in the current financial system have directly contributed to the crisis. The flaws in this system can be recognized as factors encompassing the demand side in the economic framework (which represents the consumers) and the supply side (which represent the institutions in all sectors mainly from private, quasi-government and government organisations). Facilitated by the reliance of the current conventional financial system on certain financial products possessing structural flaws, it remains to this day complicated to design swift solutions to the crisis. These factors have been brewing in the conventional system for a substantial number of years and have now proved to be directly related to the current financial crisis.

Two key catalysts of the crisis may be identified. The first catalyst is the large injection of money from the private sector and banks into the mortgage bond market. The second catalyst is the high volume of lending practices by the mortgage brokers, banks and others that have had an impact on credit risk, especially in the loan market where the adjustable rate mortgage (ARM) is the key. One may assume that it is the presence of these two catalysts that strongly contributed to the crisis, as well as poor regulations of these catalysts and substantial global imbalances leading to the context in which such products were created rather than the products or structures themselves. Yet, this paper takes into account an observation that these two catalysts are intrinsically linked to the structure of products and financial arrangements. These contain contributing factors, which are discussed from the paradigm of Shari’a-compliant finance. These include financial interest or riba (in the way it was applied for home-financing in the conventional financial sector) and the
arrangement of trading of debt on debt, in its Arabic formulation, *al kali bil kali*. The current financial crisis originating from the US subprime meltdown could suggest that the principles underlying alternative financing methods, such as those endorsed in *Shari’a*-compliant finance, may offer potential alternatives to the conventional products that contributed to the current crisis.

3. *Shari’a*-Compliant Financing

Essentially, Islamic finance refers to all aspects and activities in the financial system that are not contradictory to the principles of Islamic commercial law. It has a distinct set of contractual structures and product structures for financing operations. Yet, these financing operations share the same objective of achieving equivalent economic benefits as those offered by the conventional financial system. In the words of Sheikh Yusuf Talal Delorenzo, a leading *Shari’a* board member:

> While these products and services may appear similar to conventional financial products and services, particularly from an economic perspective, the contractual and structural underpinnings of these products and services comply with the *Shari’a*. Thus, while a *Shari’a*-compliant home finance contract may resemble a conventional mortgage in many ways, the underlying structure is quite different. Simply stated, while the economics are the same, the mechanics are different (DeLorenzo, 2007).

One of the glaring differences between the Islamic financial system and its conventional counterpart is the relationship between the Islamic bank and its customer. The relationship between the Islamic bank and its customer is backed by the nature of the contract that will facilitate the transaction between the parties. Those using Islamic financial products will need to appreciate the importance of the contracts underlying transactions as these will determine the architecture of financial products offered. In the conventional financial system the relationship between the customer and the bank is mainly in the form of a lender–borrower relationship in the case of deposit and borrower–lender relationship for financing.

As this paper analyses current modes of financing that have contributed to the current global crisis, and the potential insulation mechanisms present in *Shari’a*-compliant transactions, the notion of *riba* for this paper is interpreted as meaning what it currently does to the majority of *Shari’a* board members, that the prohibition against *riba* is equated to mean a prohibition against financial interest (Bakar, 2008). Some argue that certain forms of *Shari’a*-compliant financing contain an implicit interest rate, and as such that not all financial interest rates amount to usury or *riba*. In jurisdictions such as that of the United States, certain regulations require financiers, whether conventional or Islamic, to report implicit interest rates charged in credit sales and leases. Arguably, some Islamic finance contracts have implicit interest rates such as for instance the *murabaha* (mark-up sale) and the *ijara wa iqtina* (hire purchase or lease to purchase) contracts, yet these are *Shari’a*-compliant transactions (El Gamal, 2006). As such the equating of all forms of financial interest to *riba* is an issue, from this perspective, that is still debated. Yet, for this paper, the mainstream view of Islamic finance circles is taken to be that which equates all forms of financial interest to the prohibited *riba*.

In Islamic finance, contracts can be applied across trading, investment, loan or agency. Such contracts enable financial institutions to structure products that exclude the element of financial interest predominant in conventional finance, which is known under the Arabic term of *riba*. Derived from the Arabic term that refers to that which is increasing or doubling, *riba* is one of the key prohibitions in Islamic financial transactions. Other prohibited elements in Islamic finance include transactions involving unnecessary uncertainty, or a deliberate lack of transparency on the part of one of the parties to the transaction, that could result in one of the parties being in a disadvantageous situation due to the transaction. This is known under its Arabic term as the prohibition of the element of *gharar*. Also prohibited for the same reason are involvements in activities that are deemed equivalent to gambling, such as speculation which is referred to as *maysir*. 

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3.1 An Overview of Shari‘a-Compliant Finance from the Perspective of the Conventional Financial Products Discussed

As stated earlier, the cause of the financial crisis is linked to the financial interest-based elements of conventional home-financing products – those targeting particularly the subprime consumers – and also the securitization of these types of loans as investment products to be traded in the secondary market. The approaches taken in the Islamic financial system provide similar home-financing products to the conventional system and achieve the same economic objective as their conventional counterparts. Yet, they do so while excluding the element of riba or financial interest. In Islamic finance, to seek to achieve a stable context, the products applied in the financing models must achieve the needs for both demand and supply equitably and should not contain any elements of uncertainty nor any form of potential manipulation.

3.2 Shari‘a-Compliant Finance Models for Home-Financing

In the Islamic financial system, financing models can be categorised into three areas. Each represents a different set of contracts and demonstrates a unique type of relationship between the parties to a transaction. The first category is asset-based financing. Asset-based financing represents financing activity through the purchase and sale of an asset between the Islamic bank and its customer. This normally is on a deferred payment basis. In this structure the bank acts as the buyer on behalf of the customer, purchasing the asset from a third party and selling it back to the customer on deferred payment over an agreed period of time. The profit that the bank earns is the difference in prices of buying and selling. In this arrangement the relationship between the bank and the customer is that of a seller–buyer and the type of contract usually used is the *murabaha* contract. An example of such an arrangement is the *murabaha* home-financing model.

The second category is equity-based financing. This form of financing refers to a venture entered into by the Islamic bank and the customer where the bank will place a certain amount of money as a capital injection and the customer will work for the venture with some small injection of money or no money at all. The profit and loss in this structure is agreed upon and the exit of this venture is when the bank has realised the targeted profit over a period of time or when the customer redeems the equity of the banks by repurchasing the shares over a period of time. In this arrangement the relationship between the bank and its customer is that of equity partners or an investor–entrepreneur relationship. The types of contracts under this structure are the *musharaka* contract and the *mudaraba* contract. An example of such an arrangement is the *musharaka mutanaqisa* (diminishing *musharaka*) home-financing model.

The third category is the financing of service or work. This financing occurs when the bank purchases an asset on behalf of the customer and leases it back to the customer with an agreed rental payment over an agreed period of time. The asset that is being leased will have the option to be owned by the customer at the end of the leasing period. It is a similar arrangement to the conventional hire-purchase financing. The profit that the bank will earn is from the steady flow of rental payment over the period of time. Exit from this arrangement is when the ownership of the asset is being transferred from the bank to the customer. In this structure the relationship between the bank and the customer is a lessor–lessee relationship and the contracts applied are the *ijara wa iqtina* contract or the *ijara muntahiya bil tamleek* contract. An example of such an arrangement is the *ijara wa iqtina* home-financing model.

The main differences between these financing models and those in the conventional financial system are in the type of relationship between the parties to the transaction, and in the exclusion of the element of financial interest in the transaction. The similarity between these two models is the achievement of similar economic objectives and needs from the demand and supply side. In this case, home-financing needs. Additionally, as will be addressed in the section on Shari‘a-compliant securitization, these Islamic financing products can be securitized into investment products to be traded in the Islamic secondary market.

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3.3 The Securitization Model in Islamic Finance

From an Islamic perspective, the accumulation and development of wealth and the enhancement of liquidity is recommended. The process of managing wealth and achieving the objective of its development must adhere to the requirements of Islamic commercial laws. Under the conventional structure, the securitization process refers to the transformation of illiquid assets including receivables into cash by issuing a debt certificate or bond that can be traded in the secondary market by the bondholders or the investors. The gains derived from this product are from the payment of capital plus the interest from the issuer at a later date as well as any capital gain acquired through the trading of the bond in the secondary market. The securitization model under the Islamic financial system is done through a process similar to that of the conventional financial system. It is classified into two categories which results in two unique products serving a similar purpose yet through a different class of underlying assets (Figure 1).

The first category is the conversion of the Shari’a-compliant deferred debt that originated from the contract of exchange of a Shari’a-compliant asset, into a tradable paper that can be traded in the secondary market. This process is known as tawriq and is viewed as a similar arrangement to that of the conventional securitization process. The difference though is that the subject matter of Islamic securitization must be based on a Shari’a-compliant arrangement, whereas for the conventional securitization the subject matter includes interest-bearing transactions. The second category is the transformation of Shari’a-compliant illiquid assets into investment certificates that are tradable in the secondary market. This process is known as taskik and the underlying asset for taskik is usually in the form of tangible fixed assets, investment portfolios or transferrable rights. The product of this process is known as the sukuk or the Islamic investment certificate. The sukuk are another result of the Shari’a-compliant securitization process. The sukuk are seen as one of the few Islamic financial products that are stand alone from any similarities to conventional products such as bonds. While the conventional bond structure is a debt certificate representing the “IOU” relationship, the sukuk are an investment certificate that represents the undivided shares in ownership of assets, usufruct, projects and services. The sukuk also demonstrates the partnership relationship between the issuer or originator and the investor.

One of the distinct features in the Islamic financial system is the dynamics of its contracts. One contract can be applied to so many financial activities: from the banking sector, to the insurance sector (takaful) and to the capital market. In the case of sukuk, contracts that are commonly applied

![Figure 1. The Islamic Securitization Model](image)
to other areas of the Islamic financial sector, such as the common contracts applied in the structures are those based, among others, on the contracts of murabaha, mudaraba, musharaka, ijara, salam and istisna. There are about 14 types of sukuk recognised by the Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI), a Bahraini-based standard-setting body represented by Islamic finance scholars internationally and it has been seen as the most influential forms of Shari’a opinion or fatawa outfit in the global Islamic finance market. For the purpose of studying the effect of sukuk in relation to the current financial crisis, this paper presents three forms of sukuk that are based on the mudaraba, musharaka and ijara contracts. Each of these contracts is applied within the respective securitization product structure to suit the needs of the investors and the underlying transaction can be in the forms of asset-based or asset-backed transaction.

3.4 Islamic Asset-Based Securitization Process for Asset-Based Securities
Islamic asset-based securities refer to the Shari’a-compliant capital market securities structured out of the debt originating from the sale of an asset. The debt is pooled together and repackaged by adding value in terms of credibility and liquidity to indebtedness and becomes what is known as the Islamic bond. This bond evidences the indebtedness as the result of executing the underlying contract of exchange in the transaction and provides the rights over the obligations attached to the financial asset. The contract of exchange is also known as uqud muawadat comprising the murabaha, ijara, salam and istisna structures. The income and return to the bondholders or investors are derived from the financial rights to the obligations attached to the debt and also to any capital gains in the secondary market transaction. The other type of Islamic asset-based securities is the result of the securitization of Shari’a-compliant financial lease or ijara arising from the sale and leaseback arrangement of an asset. The product universe of Islamic asset-based securities includes all types of Islamic bonds as well as the sukuk al ijara, sukuk al salam, sukuk al murabaha and sukuk al istisna models.

3.5 The sukuk al ijara
The sukuk al ijara represents an investors’ undivided ownership of a leased asset and the claims to the cash flow arising from it. Due to this feature, the sukuk al ijara is categorized as an asset-based sukuk. It is the top Islamic financial security product that is acceptable by Shari’a boards globally due to Shari’a features that are acceptable across jurisdictions and due to its efficient forms of financial protection of the investors. It was first introduced by the Malaysian government through the issuance of the Malaysian sukuk al ijara in 2002. The sukuk al ijara papers or certificates represent the right over a leased asset and not receivables like the conventional bonds or the Islamic securities originating from bai’ bithaman ajil, murabaha, salam and istisna where these structures represent indebtedness. As such, the sukuk al ijara structure triggers no arguments amongst scholars on the permissibility of its tradability in the secondary market as the bai’ al dayn structure is non-existent in that particular context. In the sukuk al ijara structure, the originator sells the asset to the sukuk holders (the investors) at purchase price on a cash basis. The sukuk holders will then lease back the asset to the originator with a put option or purchase undertaking under the principle of wa’ad or promise (unilateral contract) to buy back the leased asset at the end of the lease period. During the lease period, the investors will benefit from the cash flow income deriving from the rental of the lease asset to the originator. This is the total rental income at the end of the lease period which is equivalent to the capital invested plus profit. Through the introduction of the put option, constant rental income and tradability in the secondary market have made the sukuk al ijara the most popular Islamic fixed income instrument across jurisdictions.

3.6 Islamic Asset-Backed Securitization Process for Asset-Backed Securities
Islamic asset-backed securities are the product of the asset-backed securitization process of converting illiquid assets into cash on a true sale basis in exchange for an investment certificate that can be kept or traded in the secondary market. Under this arrangement, the asset can be either a tangible fixed
asset or a receivable asset like the Islamic hire purchase. However, the latter is only applied in the Malaysian market due to the debatable Shari'a issue on the application of the sale of debt or bay al dayn at discount value in the secondary market. Among the core differences between the structures of asset-based securities and asset-backed securities is the transaction of "true sale". The true sale represents real sale whereby the ownership, rights and obligations of the underlying assets must be legally transferred to the investors that are usually represented by the trustee. Under the normal practice this trustee is known as the special purpose vehicle (SPV), which is a bankruptcy-remote company. In the case of asset-based securities such as sukuk al musharaka and sukuk al mudaraba, there is no transaction of true sale that takes place between the investor and the originator; the sale is only affecting the transfer of financial right of the asset. In terms of income, asset-based securities render income from the financial rights to the obligations attached to the debt. The income for the investors under the asset-backed securities arrangement is derived directly from the cash flow of the asset being securitized.

4. The Benefits of Shari'a-Compliant Finance

Both the conventional and Shari'a-compliant finance systems possess pros and cons to their users. The current financial crisis has affected the conventional financial industry. The Islamic finance industry has also been severely affected. However, the troubles hitting Islamic finance stem from a different source than those that are affecting the conventional one. For Islamic finance, it was due to the lack of liquidity in the whole financial market (inclusive of both the conventional and the Shari'a-compliant markets) which was mainly caused by the credit crunch and low consumption in the economy. Currently, the Islamic finance system works either closely or hand in hand with the conventional system. It is clear that in a situation where two financial systems work together in achieving equivalent economic objectives in a single market, should one be hit severely, the other would be affected in an equivalent manner. In order to look at the benefits of Shari'a-compliant financing structures and their potential to provide insulation from the causes of the current global financial crisis, we first need to identify the key areas of the perceptions, applications and structures of the financial models and to compare them with the conventional ones. These areas are firstly on the differences of perspective on money and how money is being applied in a market; secondly, on the differences of structure in the financing products, as in this case, particularly home-financing; and thirdly on the underlying assets used to back the structure or transaction of financing.

Money is an invention that replaces the exchange of two coincides of wants under the barter trading scenario. Historically, money evolved with the introduction of commodity money like gold and silver where these moneys carry their own intrinsic value as a legal tender for exchange. Then paper money was introduced as a medium of exchange guaranteed by the government and backed by a precious commodity like gold. Today most of the world's currencies are not backed by a gold or any commodity. This is fiat money. Both conventional and Islamic perceive fiat money to function as a medium of exchange, a unit of account and a store of value. However, in the last function which is the store of value, conventional and Islamic systems have differences in perception.

In the conventional financial system, money can be stored and borrowed in the form of savings or financing where under both scenarios money can be retrieved at a higher value or at profit. Under this arrangement money is perceived to some extent as similar to a commodity where it can be priced for future value in order to gain profit on behalf of the lender or borrower. This happens as the theory of money under the conventional system applies the rule of "time value of money". To illustrate the point, under this rule, money in the future has a higher value of money today. Technically when a bank offers financing, it will take the opportunity cost of keeping the money by giving it to the customer who needs the financing. This loss needs to be recouped by placing the interest in the financing structure. The interest that is gained at the end of the whole financing tenor is the profit that the bank has made throughout the whole servicing process.

Having this perception in mind, the imposition of interest is deemed to be reasonable as money is perceived to be a self-generating profit item to replace the loss of opportunity to use the money for the next best alternative profit-making activity. In short, money can make more money. In the
Islamic financial system, money can also be stored and borrowed; however, money cannot be retrieved at a higher value to gain profit. Money has to be put into a real economic activity in order to gain profit. In other words, from a Shari’a-compliant finance perspective, money is merely a means of exchange and it alone cannot create more money, it must be used either through investment or trading transactions. Having a clear understanding of the differences in the perception and applications of money between the conventional and Islamic financial system, we can now easily understand the difference between the conventional and Islamic financing structures.

As explained earlier, while conventional banks use money to gain profit, their Islamic counterparts will have to place the money into real economic activity through the contract of exchange as in the case of the buying and selling of a Shari’a-compliant asset and the contract of participation into a venture of a Shari’a-compliant business activity. The Islamic bank needs to use a time-consuming and perhaps a riskier approach to achieve the same objective as the conventional forms. As the conventional bank provides its financing services to the customer, it will enter into a debtor–creditor relationship as evidenced by the financing contract. The time value of money principle does not apply in the Islamic banking activity as money is not being lent or borrowed. Rather, it is used to purchase assets or as an investment into a venture. This is reflected in the relationship between the bank and the customer in the form of buyer and seller relationship.

In the conventional financing structure, a loan structure is embedded with the interest rate and in current practice almost all financial institutions calculate compound interest rather than simple interest. The former can cause more problems to the customer. As the customer receives the money from the loan she/he can repackage this money and lend it to another person at a higher interest rate to gain profit from the differences between the two interest rates from the borrowing and lending activities. This process can continue until the amount of debt and interest increases tremendously. For example, a bank gives out a loan to A for AUD100k at an interest rate of 5 per cent, this person then finds another person, B and lends the money at 7 per cent, in this case A will earn a profit of 2 per cent. B goes out and meets C who is willing to pay the 15 per cent interest. C finally meets D who is in need of cash and has no problem to repay the loan at 25 per cent. The process goes on. Finally, the original AUD100k amount grows to millions of dollars of outstanding value which is being transacted in the market. The real cash circulated is not those millions of dollars but actually the initial amount of debt which is the AUD100k and the other outstanding value is artificial. When one of the debtors defaults the repayment, it will decrease the strength of other creditors which causes the domino effect that can collapse the chain of loans. This is one of the main causes of the recent financial crisis. Billions of dollars suddenly disappeared when the market collapsed where a large amount of the money was artificially created through the imposition of interest.

5. Moving Forward
Excluding the regulatory dimension to the conventional sector and substantial global imbalances that have contributed to the financial crisis, this paper has presented Shari’a-compliant financial products for home-financing that rely on tangible assets and securitization models that rely on asset-based and asset-backed securitization processes. As for the Shari’a-compliant types of home-financing presented in this paper, they do not include the ARM (considered ribawi in Shari’a-compliant finance), they provide clients what could be a safer financing approach, cushioned from the problems that subprime customers are currently facing with the conventional home-financing model. The underlying financial structures in the Islamic financial system are potentially stable compared with their conventional counterparts due to the non-application of riba and the avoidance of the sale of debt on debt (al kali bil kali). These Shari’a-compliant products offer, based on these principles, better consumer protection.

This paper has brought a perspective of the principles that are believed to have contributed to the insulation of IFIs from the broader financial crisis through different sets of contractual relationships between customers and IFIs. In explaining what principles the relative insulation of IFIs stems from, this paper focused on the principles underlying interest-free asset-based, equity-based
and asset-backed transactions. The principles in Islamic finance that have contributed to cushioning Islamic finance from the broader financial turmoil is what conventional finance to a degree could potentially benefit from by replicating in a recovering market. Yet, an actual quantitative analysis of the impact of the global banking and financial crisis on the Islamic financial system would be highly recommended to further analyse the potential of the insulating mechanisms present in the Islamic financial sector. Such an analysis, to this day, seems absent. It is possible that the insulation of the Islamic financial sector from the financial crisis will be apparent in a few years, and this will need to be verified with a quantitative analysis.

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