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# Boom and Bust Cycles of the World's Financial System and Islamic Modes of Finance as a Sustainable Alternative

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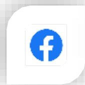

## Abstract

*The conventional financial system is based on credit financing. Banks advance loans to borrowers, charging interest thereupon and passing a portion to depositors/investors. Over the centuries, the world has been experiencing financial up and down cycles after every few decades. Global Financial Crisis of 2008 was the latest among all. The common thing in all these crises was the massive capital infusion of public into irrational speculative investments. On the contrary, Islamic financial system functions wholly on equity-based financing. Instead of offering credit, they offer to invest in assets either together with clients or exclusively. In former, both become partners whereas in the latter, bank becomes buyer by advancing finance and client becomes a seller. In this article an attempt would be made to analyse key actors of the financial crises and their aftermath on the World's financial system and to explore Islamic modes of financing as a sustainable alternative.*

Keywords: World Financial System, Boom & Bust Cycle, Debt, Islamic Finance, Credit, Alternative

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## Abstract

*The conventional financial system is based on credit financing. Banks advance loans to borrowers, charging interest thereupon and passing a portion to depositors/investors. Over the centuries, the world has been experiencing financial up and down cycles after every few decades. Global Financial Crisis of 2008 was the latest among all. The common thing in all these crises was the massive capital infusion of public into irrational speculative investments. On the contrary, Islamic financial system functions wholly on equity-based financing. Instead of offering credit, they offer to invest in assets either together with clients or exclusively. In former, both become partners whereas in the latter, bank becomes buyer by advancing finance and client becomes a seller. In this article an attempt would be made to analyse key actors of the financial crises and their aftermath on the World's financial system and to explore Islamic modes of financing as a sustainable alternative.*

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- Factors Leading to Financial Crisis
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## Introduction

The world has witnessed during the last century multiple financial crises. This phenomenon has attracted much criticism in the West as well as in the East on the viability and credibility of the system, particularly after the severe 'Global Financial Crisis of 2008'.

The question arises as to what have been the factors that led to such cycles of financial boom and bust every few decades, causing the losses of trillions of dollars, which happens to be public money, deposited in thousands of banks.

This article will analyze the circumstances to find out why the boom and bust cycle has been surfacing often and causing a financial crunch while compelling the governments for successive rescue operations through billions of dollars in bailout programs from the public tax money.

Some of the severe crises of the last century including recent ones, the Great Depression of 1929, the Latin

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American Debt Crisis in the 1980s, the Black Monday of 1987, the Japanese Asset Bubble Collapse in the 1990s, the ASEAN Financial Crisis of 1997, the Russian Rouble Crisis of 1998, the DOT-COM Bubble of 2000 and the Global Financial Crisis of 2008.

## Factors Leading to Financial Crisis

We will analyze the main features of some of these financial crises to find out the factors that led to the catastrophes repeatedly without an attempt to recourse for a permanent solution:

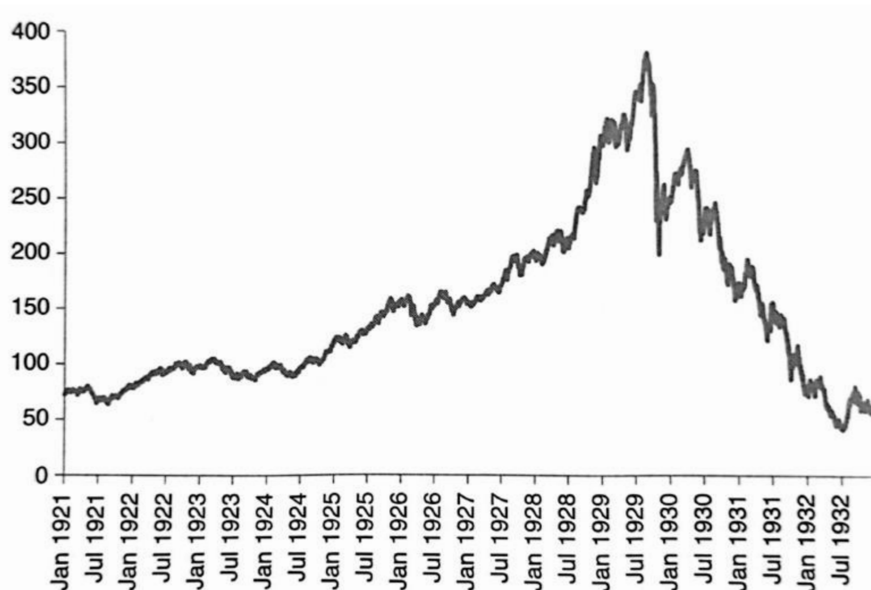
## The Great Depression of 1929

The phenomenon of over-debt financing by American banks started in the early 1920s and continued until 1929 when the share market had reached its boom by touching 500 percent, as recorded by the Dow Jones Industrial Average (DJIA) just before the market crash.

The American banks had begun offering loans to the public to buy shares in the stock market. The loans were advanced to the clients to buy up to 90 percent of the shares' value.

However, on October 28, 1929, the market boom began to reverse as the demand for shares in the market fell down leading to a sharp drop in the shares price. Due to the falling price of the shares, the shareholders started selling their shares in the stock market to save them from further loss, on the other hand, the buyers stopped buying the shares for continuous price-decline of the shares. DJIA dropped by 13 percent on the same day followed by another 12 percent drop by the next day, creating panic in the market among the stockholders, as shown in the Figure below.

Figure 1




Dow Jones Industrial Average from 1921 to 1932
Adapted from: Bloomberg

The borrowers who had bought the shares extensively on loans from the banks have now lost their share value in the stock markets and become unable to repay the loans to the banks. On the other hand, the money depositors who rushed in panic to the banks to withdraw their money were turned empty-handed as the banks had run out of funds to give them their money back. As the banks ran out of funds and could not finance the export industry anymore, US exports also dropped by 60 percent from 1930 to 1933.

It was estimated that by 1933, $140 billion of the depositors' money lost and 9,000 banks had failed during the 1930s in the USA. The main cause was over-debt financing by financial institutions up to ninety percent of the value of the shares to the borrowers who had no potential to repay the loans, yet they continued financing because the market was booming in the 1920s and shareholders were making money in the short term to avail newly sophisticated technologies.

This was not equity-backed financing, instead, it was debt-based financing, which is one of the main differences between the two systems as will be discussed in detail under Islamic financing modes.

An interesting thing to note here is that the US government bailed out the Wall Street firms with billions of dollars while the Main Street firms were not. In other words, the government privatized the profit by saving Wall Street firms and socialized the losses by side-lining the Main Street firms.

## Latin American Debt Crisis of the 1980s

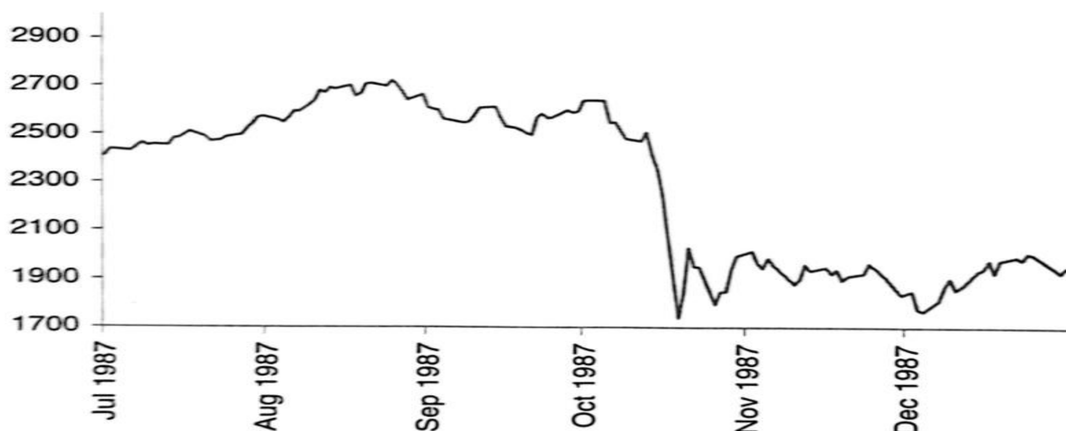
In this crisis also, the same approach of the banks can be seen again in over-debt financing. The American banks began lending multi-billions of dollars to the Latin American countries for their ambitious development programs. It can be seen that within a decade debt volume increased from $29 billion in 1970 to $327 billion in 1982. The volume of debt repayment increased from $12 billion in 1975 to $66 billion in 1982.

Since the USA was undergoing inflation, the government raised interest rates to combat its inflation. However, the rise in interest rates caused inflation in Latin America as well and the indebted countries found it difficult to continue debt service being inflated. As a result, Mexico officially announced in August 1982, that it is no more able to repay its loan of $80 billion to foreign creditors. Similarly, in October 1982, other 27 Latin American states defaulted by $239 billion and resorted to revising their debt schedules. Citibank including other largest banks ran out of funds and collapsed due to the reason that many Latin American countries failed to repay loans to these financial institutions. Here again, the same policy and practice of over-debt financing in pursuit of interest-based profit maximization led to the crisis. All the loans were backed by debt and not by equity or joint venture which ensures a common sustainable interest.

## Black Monday Market Crash, 1987

It is the day when the stock markets crashed around the world slashing 22 percent of the Dow's value in one afternoon. It was the largest ever daily loss of 508 points as shown in a Figure below.

Figure 2




Black Monday—Dow Jones Industrial Average from July to December 1987
Adapted from: Bloomberg

The reason, to some, is the computerized trading, a newly adopted system, but a closer look reveals that it was in fact insider trading and fraud in securities by some very popular firms on Wall Street.

Insider trading implies buying or selling securities based on secret information about the security. Since this unethical and unfair practice continued long, people came to realize this dishonest trading on the basis of secret information and lost their confidence in the market. Hence, the investors began to withdraw their capital from the market which caused shares devaluation and market crash. On the other hand, companies had also played a significant role by issuing junk bonds which reached a total worth of $200 billion in 1986 more than double the amount issued last year. Junk bonds contain a high risk of default by issuing companies on repayment of the principal amount or the interest or both to the investors.

All these fraudulent practices and weak securities such as junk bonds reflected again the marker players' behavior to pursue short-term money-making tricks.

For example, the investors who invested in the junk bonds and the companies who issued these bonds were playing on a high risk yet continued the game until the companies defaulted on repayments of the bonds.

Similarly, the insiders who bought and sold securities on the basis of secret information were also eager to become a millionaire in the short term. All these factors cumulatively contributed to the bust of the stock market boom as the public confidence shattered in the stock by insider dealings and fraudulent practices.

## The Japanese Asset Bubble collapse 1990s

After World War II, Japan regained its economic power and technological advancement within two decades due to mainly government's strong support for high technology and rapid growth of exports. The large volume of exports generated a huge inflow of cash, which now needed to be invested somewhere. Therefore, a large investment was made in the US markets yet some money was injected into the local stock market, banks, and real estate.

In 1991, industrial and residential land prices rose to 162.0 percent and 180.5 percent respectively if compared to 1985. Similarly, prices of commercial lands had increased to 302.9 percent if compared with that of 1985.

The stock market bubbled soon from 1984 to 1989 as the Nikkei 225 index 2004, had increased about 400 percent during this period. The boom of the stock market was actually pushed up by another boom which was formed in real estate as the commercial lands in the capital and commercial cities were in high demand by business corporations while the supply was short to meet the demand thus pushing the land prices up.

One of the main factors leading to the real estate bubble was again the common factor as witnessed in the past crises as shown in the Figure below.

Figure 3

Japan's stock market bubble—Nikkei 225 from 1970 to 2014
Adapted from: Bloomberg

Since the banks had begun to give loans on easy credit policies to the buyers to borrow heavily to invest in real estate, this easy credit policy led the land prices to bubble up as the loans were easily available for investment at cheap rates. An ordinary salaryman could borrow easily up to 100 million yen for any purpose, conditional on his house being used as collateral.

Moreover, borrowers could borrow up to 90% of their real estate collateral. In 1989, total Japanese real estate worth estimated at $24 trillion.

The Bank of Japan recognized that the bubbles were no longer sustainable and raised interest rates in late 1989, however, that was too late to contain the bubbles. This step adversely affected the situation and expedited the bursting of the bubbles instead.

As the real estate prices together with the stock prices declined the borrowers who purchased lands and stock on loans made it difficult to repay the loans to the banks thus resulting in defaults and in turn the banks also defaulted on returns of the deposits to the depositors. The Bank of Japan and the Japanese government attempted to sustain the failing banks by

bailouts and by nationalizing these banks. The government's huge capital infusions and heavy bailouts are also considered by some analysts to have caused stagnation in the Japanese economy for a long time, called 'lost decades.'

## The '.Com' Bubble, 2000

The '.com' was a historic boom based on speculations. It was a new phenomenon for a company to be technologically innovative and listed on the stock exchange as the World Wide Web. The Mosaic web browser was launched in 1993. Shortly after its inception, the World Wide Web gained widespread public attraction and access. The speculative bubble started after the public flooded for subscriptions to the worldwide web.

The notion of commercializing the internet fascinated investment in internet-based companies. Dot-com companies fascinated people to buy their shares. As the public demand grew for investment, venture capitalists provided the capital flow. Low interest rates also encouraged investors to seek high returns.

By the time the boom touched its peak, it had become easy for a 'worldwide web' company to make millions of dollars by an initial public offering of its stock, though the company had never made a profit till that time. '.com' as a suffix of the company's name or 'e' as a prefix of the company's name seemed to become a symbol of a successful IPO.

This phenomenon was not limited to the US stock markets but has spread to other regions around the world.

The boom began to bust when the FED started raising the interest rates in 1999 and continued increasing six times till 2000, which caused a slump in the stock value of the dot-com companies. Due to the rising interest rate, investors began to withhold their capital from further investment in these dot-com companies, hence the high-flying start-up companies could no longer raise further capital to keep the burn rate intact.

In 2001, the bubble began to collapse sharply and many securities of the dot-com companies were no longer traded on the exchange once they ran short of cash as shown in the Figure below.

Figure 4

The NASDAQ Composite Index from 1995 to 2004
Adapted from: Bloomberg

Here again, the common factor was operative which was overwhelming financing of the investors in the stocks of the dot-com companies based on speculation for ongoing rising rates of the stocks in the future too due to their technological character.

However, the difference here can also be noted that this time it was not the banks to lend money to the borrowers for investment in these stocks but venture capitalists who heavily invested by equity in these shares of the dot-com companies. So, it was not debt financing but equity financing with the same mind, i.e., greed and race to make millions in a shorter period without deliberation on the potential of the company and its business prospects, instead, relying on the new fascinating feature of dot-com only, they had begun to make large and blind investments causing to create a bubble of the stock value of these '.com' companies in the markets.

The technology-heavy NASDAQ dropped by 78%, its worth between March-October in 2002, slashing $5 trillion of market capital.

## Global Financial Crisis, 2008

It is the latest devastating crunch that hit the world economy after the Great Depression of 1929. Among

the circumstances leading to this crisis, were that in order to contain the aftershocks of the Dot-Com bust, the Fed had raised interest rate to 6.5 percent by June 2000 from 4.75 percent in December 1998. By this attempt, the economy began to slow towards a recession. Again, in order to boost the economy, the Fed began to lower the interest rate to 1.75 percent from December 2001 until it reached the lowest 1 percent in July 2003.

Thus, the economy was now again on growth and the people who were once attracted by tech companies were now driven by home ownership, as also encouraged by the US government.

Massive borrowings began not only from the banks but also from the specialized mortgage companies since these specialized companies were no longer required to hold their own capital in order to give credit because after buying these mortgages, they were sold either to a Wall Street firm or to the government-backed agencies thus offloading the issued mortgages. Mortgage-backed securities (MBSs) have become very fascinating to Wall Street investors.

The formal procedures for lending mortgages were relaxed by the financial institutions such as 'Adjustable Rate Mortgages'(ARMs), 'No doc', or 'Low doc' mortgages, also called 'subprime mortgages'.

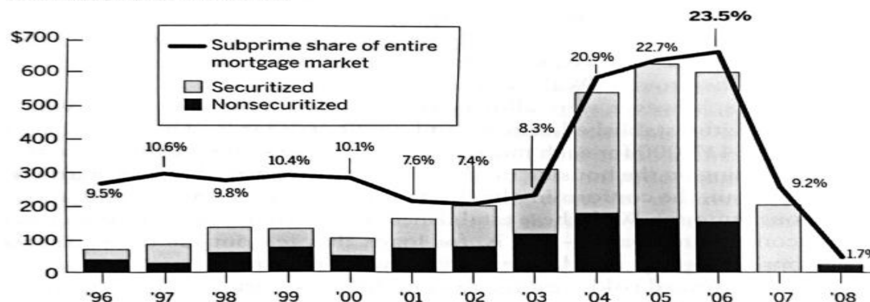
Due to relaxation in documentation and income verification, people, including immigrants having an improper credit history, flooded to borrow heavily to either buy homes or flip the properties (i.e. resell them) as the properties' value was continuously increasing as shown in the Figure below

Figure 5

**Subprime Mortgage Originations**

*In 2006, $600 billion in subprime loans were originated, most of which were securitized. That year, subprime lending accounted for 23.5% of all mortgage originations.*

IN BILLIONS OF DOLLARS




NOTE: Percent securitized is defined as subprime securities issued divided by originations in a given year. In 2007, securities issued exceeded originations.

Subprime mortgage issuance from 1996 to 2008

*Source:* The Financial Crisis Enquiry Report (http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf)

Fraud was also rampant to contribute to the crisis, as in a number of cases, the applicants for house purchase were not qualified to apply for the mortgage so the bank sales-person induced the applicant to put false particulars in the application form whereas in other cases, bank sales-staff used to tie up with a tax worker to redraft applicant's returns of tax in order to put on record requisite income. On the other hand, the appraiser has also communicated the value to be placed on the property. In this series of frauds, the house buyer acquired the home, the salesperson obtained his fixed percentage, the appraiser and tax preparer obtained fees and the banker acquired a mortgage which it would pass on by way of sale to the specialized firms on Wall Street.

Again, the common factor that triggered the past crisis can be seen here as well, as the financial institutions began giving loans overwhelmingly to borrowers without consideration of their potential to repay. Once the borrowers began to default on their mortgage loans, home foreclosures started rising sharply leading to home prices decline. All that resulted, from the devaluation of the property, was that Wall Street crashed by 54 percent of its value in March 2009 as recorded by Dow Jones Industrial Average and the US treasury had to back up 734 financial institutions with over $200 billion. subprime mortgages caused a total loss of around $300 million whereas the derivatives caused a total loss of more than $6 trillion.

The interesting thing to note is that the US government preferred to bail out the Wall Street firms than the Main Street ones.

## Islamic Finance as A Sustainable Alternative

Now we turn to the Islamic financial system and explore its nature of financing which distinguishes it from the former system and how it can become an alternative to the current financial system which has been tested and tried for centuries and resulted in recurrent collapses due to debt financing nature of the system and the government's rescue operations by bailouts of billions of dollars across the major world economies reason being that these giants were considered 'too big to fail'. However, public/tax money was drained into repeated rescue operations without exploring long-lasting future remedies except for more regulatory measures and transparency checks introduced, which still could not withhold the crisis, due to again its financing nature of high levels of debt.

Similarly, the government's successive bailouts of billions of dollars exclusively to 'too big to fail' financial institutions only resulted in insurance for them against future financial crunch and crises as well. Since these institutions were neither made sizable so as to neutralize their impacts on the national economy in the event of their insolvency nor the derivative markets were given due regulatory reforms as aimed by the Dodd-Frank Act, 2010. Rather the multibillion bailouts and Quantitative Easing (QE) programs gave the 'too big to fail' financial institutions a greater confidence to be saved in future crises by the governments at the cost of public/tax money.

As an alternative, the Islamic Financial system has its foundation on asset-based financing in all of its forms and manifestations, meaning thereby that no debt is offered as a mode of financing, hence no interest is charged. Thus, Islamic bank has different modes of engaging the client for financing. For example, a bank and a client can go into mutual ownership of an asset by joint venture. The bank can agree to purchase a commodity from the client by financing advance payment and receiving future delivery. The bank can agree to lease out the property to the client and charge rent thereupon. Banks can sell commodities to clients at higher than the market price in installments. There is another way of Islamic financing wherein the client entrusts money with the bank and the bank invests that money in various portfolios as an entrepreneur/management and shares profit as per the agreed ratio. As evident from these financing modes there is no exchange of loan with interest between the bank and the client, rather both are dealing in asset/ commodity or goods one way or the other.

In other words, the deal is based either on partnership, mutual funds, or sale and purchase but not in money reason being money is not a commodity and hence cannot be traded for gains in Islamic finance.

The second key feature of Islamic Financing is 'sharing profit and loss'. In other words, bearing risk factor is all time associated with any mode of Islamic financing unlike conventional financing where banks never share loss in the event of the client's loss and he has to lose either his mortgaged property or some other security.

But here in Islamic financing both the bank and the client enjoy profit and bear loss together because of security-based financing instead of debt-based financing, which makes both of them equal stakeholders and responsible in the business enterprise. In other words, both the financer and the financed fly together and fall together resulting in a stronger and integrated commercial bonding for sustainable survivors collectively. Among the key principles of Islamic financial jurisprudence are 'No risk no profit', 'No guarantee for profit', 'No loss beyond investment', and 'No sale without ownership and possession of the property'.

Another essential feature of Islamic financing is that certain portfolios are prohibited by divine guidance such as gambling, intoxicants obscene businesses, etc. This shows the moral responsibility of the business world to preserve the sanctity of human society from immorality and inhuman values. Thus, it is also noteworthy that Islamic financing is not only an asset-based but also a value-based financing as observing the moral standards.

Islamic finance also possesses another very significant financing domain which is called Islamic social finance, based exclusively on the welfare of society without making profitable ventures. This feature is divine obligation in terms of Zakat (1/40 (2.5%), Usher (1/10(10%), Khoums (1/5(20%) and waqf etc. These financings are solely and wholly for the social and economic uplift of the underprivileged and are mandatory for Muslims to observe as one of the pillars of Islam. Thus, Islamic social financing runs parallel to Islamic commercial financing in society for commercial gains as well as social well-being.

## Applied Modes of Islamic Finance

These are Modaraba (Trust Financing), Murabaha (Cost-Plus Financing), Musharaka (partnership Financing), Ijara (leasing), Bay Al-Salam (Forward sale) and Istisna' (Construction Financing).

Some of the key elements of the above-mentioned modes are discussed below to explore their nature of

financing and how they are sustainable alternative financing modes:

## Modaraba (Trust Financing)

This is the simplest financing mode where one party (Investor) brings and entrusts his capital to the other party who would be skilled, qualified, or experienced as an entrepreneur/manager to venture out of a business. The ratio or percentage of the profit (not the profit itself) is agreed in advance and shared accordingly in the event of any such gains. However, in case of loss, the investor loses his investment whereas the entrepreneur loses his time and labor only as he had no capital in the venture.

This is similar to what is called 'Mutual funds' or 'Hedge Funds' in conventional financial systems, in which a fund manager manages an investor's money in different portfolios and charges his fee only. If the loss is incurred it is borne by the investor only and not by the fund manager with an addition that in hedge funds the fund manager earns profit also along with his service fee.

## Murabaha (Cost-Plus Financing)

This is deferred-payment financing which entails the time value of money. In this kind of transaction, a bank acts as a wholesaler than a bank. The bank purchases a commodity from the market as per the demand of the client and resells it to him at a higher price (cost-plus) in installments. Here bank takes a risk as a buyer as well as a seller by taking ownership and possession of the commodity from the market and subsequently transferring the ownership and possession to the client/buyer against the installment/deferred payment.

## Musharaka (Partnership Financing)

This is a joint venture of at least two partners who bring their capital in the form of cash or kind and agree on sharing profit and loss according to their shares invested in the venture. It is noteworthy that the partners can earn more profit than their ratio in the investment, however, this is based on the partner's additional skills, experience, labor, or time and must be agreed upon in advance as the partnership deed does not automatically create a greater entitlement to profit for any partner until explicitly agreed in advance. Thus, the bank and client invest together in a joint venture and share profit and loss according to the agreed-upon ratio.

There is also a way out for the bank to offload its share in the asset by selling its portion to the client gradually and periodically thereby increasing the client's ownership until all the portion/share is sold to the client and he becomes the sole owner at the end. This is called 'Diminishing Musharaka'. Private equity and venture capital in conventional financing are similar to Musharaka in Islamic financing.

## Ijara (leasing)

This is to rent out one's property to another party with the right to use that asset against the rental payments. If the lease is with the intention to own the leased property at the end, it is called a financing lease whereas if intended to return after the use, that is called an operative lease.

Lease is beyond a landlord-tenant relationship or car financing tool to a wide array of assets from lands and roads to computers and home financing. As the bank buys a home as per the demand of the client and leases it out to him, the bank may deal as a lesser as well as a seller thus the client becomes a lessee as well as a buyer, and the bank charges rent of the property together with selling the shares to the buyer to make him the owner of the house gradually while decreasing the rental payments.

Similar to home mortgages in conventional financing, house-leasing assets can also be made securities into a pool of leased assets. These securities can be sold to investors, seeking profit-making investments.

However, leasing is entirely different from lending. Hence, a bank is an owner in a leasing transaction while bearing all the risk attached to the property as well as an absolute right to sell the leased property to a third party whereas a mortgage is a money lending transaction by the bank which only has a lien on mortgage asset until the loan is completely paid.

## Bay Al-Salam (Forward Sale)

This dates back to the early Muslim period, when the farmers needed advance to grow their crops and harvest. In the current arrangement bank/financial institution is a buyer and finances the farmer by advancement payment to grow crops and deliver on a deferred period. The financial institution locks the price of the crop, which is usually below the current market rate to gain profit once sold on the market by the institution after delivery from the farmer.

Here various risks are attached such as the quality of the crop, its preservation as well a drop in the market rate at the time of sale in the market after obtaining delivery from the farmer.

Today this mode of financing is used in the farming field as well as in the manufacturing industry where banks buy finished product from the manufacturer before it is manufactured against advance payment below the current market price and sells off on the

market price after obtaining delivery from the manufacturer. This is how finance is provided to the farmer and manufacturer as evident above by the sale and purchase transaction of the commodity and not by loan or debts. In other words, this is what is called trading of commodities and not of currency, unlike the conventional financing system.

## Istisna' (Construction Financing)

This is the most significant mode of financing in real estate development. Islamic financial institution offers the construction of property to its client who promises to buy it on the agreed terms and specifications. The institution then subcontracts with a construction company and pays the total sum to it for construction. After completion of the project, the institution becomes its owner and sells it to the client/buyer at a higher price through installments. This mode of financing is widely applied in the development of infrastructure, such as the construction of roads, power generation projects, and other capital-intensive ventures.

As we analyse the foregoing major financial crises of the last century including the recent ones we find some common factors effective in all the past financial plights. Among those common factors, the major factor is overwhelmingly debt financing to borrowers indiscriminately particularly once the boom touched its peaks such as sub mortgages (low doc, no doc) and adjustable rate mortgages, etc. This phenomenon, prevalent in the crisis, was naturally bound to bounce back to the financial institutions as a large number of the borrowers were unable to repay the loans and thus bound to default ultimately.

Moreover, fraud has been another common factor that has further aggravated the situation such as insider dealings of securities in stock markets, false particulars in loan applications, false appraisals, and false tax returns of the clients to obtain loans by hook or crook.

However, the main problem lies not with the system but with the principle upon which the entire foundation of the conventional financial system rests and that is debt financing which has been in vogue for the last four centuries when people started entrusting gold with the goldsmith instead of the king's royal mint in England who had declared their gold deposits in the royal mint as loans to the monarch and to be repaid over time. This dates back to 1640 during the reign of King Charles I of England.

Subsequently, these gold smiths having huge gold deposits started advancing loans to borrowers and charging interest on the loans while passing their portion to the gold depositors. This is how modern financial institutions came into being. Since these modern institutions don't have any alternative to generate income from the public deposit money except by lending loans, and the more loans advanced the more income generated, hence in pursuit of more money making they ease out credit policy to attract borrowers which create a boom leading finally to a bust due to excessive defaults by the borrowers, and this cycle continues as they are again and again bailed out by the governments as witnessed in the recent financial history.

Whereas, Islamic finance is not an accidental development out of historical constraints and compulsions. Its principles are either derived from the revealed divine texts or divinely approved practices of the time in the society. Hence it is based on the divine wisdom which is decentralization and circulation of wealth and to regulate finance in such an order as not to let the wealth to be accumulated in few hands, as revealed in explicit words of verse no. 7 of chapter no. 59 of Al-Quran. This is the main reason why interest/usury was prohibited again in explicit words of verse no. 275 of chapter no. 2.

In Islamic finance, currency or money is not a commodity to be traded off, it is merely a medium of exchange and does not contain intrinsic value. Trade is allowed in commodities as it possesses utility/intrinsic value. Thus, Islamic financial institutions do not sell money to their clients rather they sell either assets or commodities as we observed in Murabaha (Cost Plus financing), Ijara (financing-lease), Bay Al-Salam (Forward Sale), and Istisna' (Construction Financing).

All these financing modes are sale transactions between the bank and the client either against advance payments by the bank and deferred delivery by the client as in Salam or instant delivery of the commodity by the bank against deferred payments by the client as in Murabaha. Thus, there is trading in commodities and assets not in money or debt. Apart from financing by sale transaction, another financing mode is a joint venture/partnership as both the bank and the client invest jointly and trade in a business sharing profit and loss while bearing joint risk. All these financing modes are called equity-based financing in contrast with debt financing as prevalent in a conventional systems. Hence there is no default as no debt. In the event of default in Musharaka financing, partners will jointly be liable to a third party and not to each other as a debtor and creditor, being the basic principle of partnership law. Similarly, one party is not supposed to return the principal amount to the other party, since both partners own their respective principal amount as per the ratio of capital.

Hence there is no room for a boom and bust cycle in this system and stands as a sustainable alternative to the conventional financial system by eliminating the fundamental issue of debt financing and defaulting recurrence. This phenomenon can also be witnessed from the historical perspective as no Islamic financial boom and bust cycle has ever surfaced since this industry was revived in the 1970s up to date almost half a century lapsed. 'The Black Swan' authored by Nassim Taleb 2009, has also expressed this view as a solution to the fundamental problem of the system which I completely endorse.

## Conclusion

The current conventional financial system direly needs major overhauling. If the system has to be saved from the future financial crises the debt in 2004, has to be converted into equity (shift from debt-based financing to asset-backed financing), which is in line with the Islamic financial system. The significance of this shift can be gauged from the '.com' bubble, 2000, as it did not lead to that severe crisis as witnessed in the global financial crisis, 2008, the reason being that the former was mainly equity-based financing whereas the latter was debt-based financing.

Additional measures would include the abolition of derivatives, an innovation, once made for the protection of investors from the risk of loss has instead turned into casinos for financial institutions for bets, leading the entire system to a more volatile as well as fragile state. Whereas Islamic finance acknowledges risk factors as a part and parcel of every financial transaction, and without risk-bearing, no transaction is validated in Islamic Jurisprudence hence no derivatives are required to make the transaction risk-free.

It is also imperative to break up cumbersome financial institutions into smaller financing facilities and to let them fail instead of bailing them out with billions of dollars from the government treasury in future crises. Apart from these measures, it is also essential to realize that the conventional financial system has been suffering from a trust deficit throughout the current financial history, as criminal, illegal, fraudulent, and unethical practices have been widespread among all the stakeholders in this system increasingly in today's modern era in particular. To be more specific, one measure is that instead of waiting for the default of homeowners of underwater mortgages, banks should rush to change the loans into equity to save the borrowers from default and the banks from failing. Equity by its nature creates a partnership, hence it binds both parties to a common vested interest to succeed. Such equity with homeowners of underwater mortgages would be similar to what is called Diminishing Musharaka in Islamic finance.

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