Demand for Islamic Finance and an Ethical Approach of Explaining Global Financial Crisis

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Abstract

The aim of this paper is to elucidate the Global Financial Crisis (GFC) from ethical point of view and to explain the motives of continuous growth of the demand for Islamic finance around the world. The paper shows that ethical justice triggered the disintegration of the financial organisations which ultimately sourced the modern extraordinary GFC in 2008. This research paper sheds some lights on ethical Islamic financial systems which can demonstrate the world various basic principles and these ethics are very much linked to common sense which could enhance financial stability. Is this the right time for the world's conventional financial institutions to embrace ethical financial process?

Keywords: Islamic Finance, Ethical Justice, Financial Institutions, Global Financial Crisis, Globalisation.

1. INTRODUCTION

Recent business history has demonstrated beyond any hesitation that splitting up businesses from ethics run huge risks and latest Global Financial Crisis (GFC) is the attestation of such massive jeopardy. The repercussion of unethical lending practices of major institutional providers devastated the United States financial markets and eventually all major world markets during the second half of 2008. Most of the world's leading economies are still filling that pain. So, global financial market collapse is the testimony to both the unethical behaviors of the businesses based on greed, hubris, corruption and poor corporate governance within the financial sectors as well as the intimate inter-relationship between and among nations through globalisation.

Actually, emphasizing on the wealth maximisation of the shareholder deliberately neglects the perception of ethics and its long term shock on the value of the organisation. Moreover, various corporate misdeeds founded on the lack of corporate governance eroded the public trust of business leaders and their organisations, which eventually caused the biggest financial crisis since the great depression. In addition, globalisation which refers to the integration of national economies, especially their financial sectors, greatly increased the intensity of the GFC because of its capability to transmit an impulse arising in one country around the world very rapidly.

According to Al-Suhaibani and Naifar (2014), all the recent financial crises are, in principle, debt crises. As the Islamic finance is offering the provision of avoiding debt-creating flows and the opportunity of adopting such a financing system that are found on 'risk-sharing', rather than 'risk-shifting', the demand for Islamic finance is growing rapidly throughout the whole world. Therefore, Aribi (2015) appropriately mentions that the Islamic financial systems are a fast-growing segment of the global finance industry, and posturing challenges to the ways that current financial institutions are

received and expected around the world. In the last 15 years, Islamic finance around the world has consistently been recording double-digit annual growth rates not only within but also outside of Muslim economies (Fang & Foucart, 2014). Thus, the signs of growing demand for ethical finance across the world are clearly observable and the people are showing curiosity for such sustainable ethical economic development irrespective of their religious or ethnical background.

The purpose of this paper is therefore to explain the Global Financial Crisis from ethical point of view and to clarify the reasons of continuous growth of the demand for Islamic finance around the world. This paper is structured as follows: next section shows an ethical approach of explaining the Global Financial Crisis; followed by the historical basis of ethical finance around the world. After this section we show the business ethics in religion, especially in Islam and the final segment of this research shows the lessons for the world's existing conventional financial systems from Islamic finance.

2. ETHICAL APPROACH OF GLOBAL FINANCIAL CRISIS

One of the major specific responsibilities of every business organization in modern age is to maximize their shareholders' possessions, which lead them to perform unethical practices. Natale and Sora (2010) point out that the beginning of the ethical process is a method that can evoke and train individuals to understand and feel what others are feeling. But the process in this case appears to govern automatic and impaired components that focus on the corporations' enhancement of wealth. Hence, aggressive lenders engaged in loans called "sub-prime mortgages." These mortgages were extremely high risk and most of them violated traditional underwriting standards for the industry (Lewis, Kay, Kelso, & Larson, 2010). So, that was the point where greed conquered ethical practices among mortgage lenders nationwide.

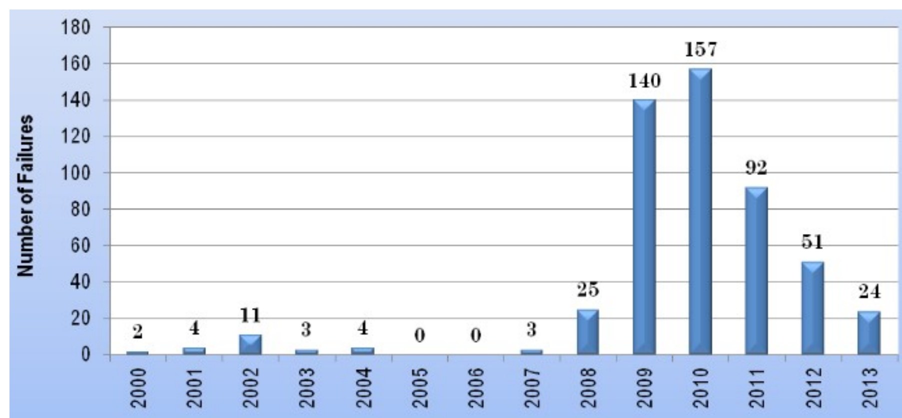

Figure 1: *U.S. Bank Failures, 2000 to 2013. Source: FDIC(2016).*

2.1 Contagion: One of Chief Contributors to GFC

Wall Street financial companies then leveraged these bad loans and sold them to unsuspecting buyers as bundled investments in the secondary markets, which actually exacerbated the problem. Gordon and Valentine (2010) mention that these sub-prime mortgage problems led the government to mediate the banking sectors. When the housing bubble burst, bank were so deep in debt that mass catastrophes appeared about to happen (Patton, 2014).

The collapse of a bank could direct to other banks coming under risk because of their exposures to the original bank through interbank lending / borrowing and other wholesale markets. This type of cumulative bank failure is known as contagion. It would undermine the viability of the payments system which forms the basis of economic transactions. But providing this type of supports generates

moral hazard, which means it can lead bank managements to take excessive risks in the knowledge that the authorities will bail them out if things go wrong and these ideas guided them to commit historical humiliations. Trevino and Nelson (2010), therefore, appropriately mention that no scandal of recent years matches the GFC in 2008 and the crisis was incomparable in its scope. Earle (2009) also reverberates that the 2008 GFC has been compared to a "once – in – a – century credit tsunami", a tragedy in which the failure of trust and confidence played key precipitating roles and the revival from which will necessitate the restoration of these significant factors. Thus, the moral vulnerability and unprincipled practices of the businesses caused the fall down of major banks, grounded a worldwide crumple of stock values, and led to collapse the financial companies, insurers, and eventually sourced the Global Financial Crisis.

2.2 Unethical Corporate Governance Acts as another Contributor to GFC

Inadequate governance and regulations can also lead organisations to commit various corporate misdeeds and eventually people can lose their trust on them. Clarke (2010) states that the prolonged systemic crisis in international financial markets commencing in 2007 / 2008 was also a crisis in corporate governance and regulation. The sternest financial catastrophe since the Great Depression of the 1930s exposed the dangers of unregulated financial markets and nominal corporate governance. Transparency and sound corporate governance are matters of moral turpitude (Hawtrey & Johnson, 2010). Generally speaking, the process of avoidance of ethical responsibility in the credit crisis was not outright criminal evasion and there had been no courtroom prosecutions arising directly from the GFC. But, Hawtrey et al. (2010) point out that unethical choices hiding behind the veil of legality are nonetheless unethical and equally capable of leading to problems such as those witnessed in the GFC. So, during that time, de-regulation of Wall Street unleashed highly incentivised investment banks to flood world markets unethically with toxic financial products. As a result a stunning series of banks and investment companies collapsed in the USA and then in Europe. A fresh world chaos of aggressively unstable markets and deep financial insecurity became fully apparent. People started to lose their expectation from businesses and the process became more intense while the US public were becoming increasingly concerned how they might survive a severe recession, the executives of major banks seemed focused primarily on maintaining their bonuses (Clarke, 2010). Therefore, regulatory restructuring was a must do fixation. But, the lesson to be learned is that regulatory reform without ethical reform will never be enough (Weitzner & Darroch, 2009). Sanchez (2010) also states that one of the pillars of the stability of the financial organisation is an efficient regulatory and supervisory framework of the organisations. Thus, the situation exemplifies how markets and ethics interact in the presence of inadequate governance as well as corporate regulations.

2.3 Globalisation Inflates Unethical Behaviors of Business to Contribute to GFC

Economic globalisation is another aspect which exaggerated the latest financial crisis through rapidly transmitting the impulse happening in one country because of the volatile behaviours of their organisations in the whole world. Therefore, Wade (2008) mentions that these U.S. - centered causes were complemented by more international ones and the house – price bubbles in the USA, the UK, Ireland, Spain, Australia, and New Zealand are just fraction of a more global property bubble over the past decade.

But a number of years ago, mortgages were held by local banks where the mortgagee was most probably known to the bank manager. The mortgage was maintained on the books of the various lending institutions so the bankers had a genuine concern that the mortgage was given under appropriate conditions and that the loan was "good" (Natale & Sora, 2010).

However, because of this economic globalisation, investors can provide their funds in the countries which are perceived to propose the highest return and overall disparity in saving and borrowing allows

high borrowing in one country to be financed by high saving in others. Thus, the process expands the opportunity of borrowing and Gordon et al. (2010) states that these expansions as well as the decline of credit standards created "toxic" (subprime) debt. Thus, the procedure triggered the disintegration of the financial organisations which ultimately sourced the modern extraordinary GFC.

3. HISTORICAL BASIS OF ETHICAL FINANCE

The critiques of 2008 Global Financial Crisis pointed to the absence of true risk sharing in lending as one of the main reasons of that global disaster. In one sense, this is just an extension of an age-old story, where the primary antagonist is the desirous and immoral moneylender taking benefit of helpless people in need of capital (Looft, 2014).

The prohibition of unethical financing is not a new phenomenon. Early European philosophers such as Plato (350 BC) and Aristotle (350 BC) condemned the exercise of directing immoral financing by taking interests. Aristotle (350BC) mentions in *Politics*, Book 1, Part X:

> *"There are two sorts of wealth-getting, as I have said; one is a part of household management, the other is retail trade: the former necessary and honorable, while that which consists in exchange is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of a modes of getting wealth this is the most unnatural".*

Prohibition in practicing unethical financing is actually an old religious concern also, not only in Islam but also in Judaism, Christianity, Hinduism and Buddhism. Ancient records from *Vedic* texts in India (2,000-1,400 BC) and later in the *Sutra* texts (700-100 BC) and in Buddhist *Jatakas* (600-400 BC) display a contempt for taking interest on debt (Kunhibava & Rachagan, 2011).

But according to Looft (2014), the most enduring arguments in contradiction of lending at interest have come from the Abrahamic faith ethnicities of Judaism, Christianity and Islam. This preparation of earning money from money with tiny or no investor accountability was specifically condemned in early Judaism for it exposed to destabilize the community and eventually tear family and tribe apart. Interestingly in Judaism, in the Old Testament (Torah) it is stated, 'if you lend money to any of my people with you who are poor, you shall not be to his as a creditor; neither shall you require usury from him' (Ex. 22:25). This declaration, though, was interpreted to mean that loaning through usury was not permitted between Jews, but tolerable to a non-Jew (Kunhibava & Rachagan, 2011).

About five hundred years back, the Christian church continued to squabble internally over whether or not the prohibitions in the Hebrew scriptures applied to its members or not (Looft, 2014). The prohibition against unethical loaning, usurious transactions, changed. Kunhibava et al (2011) mentions that the reformist group, led by Luther (1483-1546) and Zwingli (1484-1531), approved to the introducing of interest. In the year 1545 the Act of 'In restraint of usury' of Henry VIII in England legalized the obligation of interest. This Act fixed a lawful maximum interest and any amount in additional of the maximum was termed as usury. The exercise of setting a legal maximum o interest rates was later followed by most states of the United States and most of other Western nations. Hence interest was legalized and usury was not legal. Usury today is referred to as a very high rate of interest and thus, Christianity espoused the immoral financing system in their economic life.

Over time both Christianity and Judaism have drawn dissimilarities between interest and usury, Islamic law does not draw this division. The scholar Reza Aslan (Looft, 2014) reminds that one of the first changes the prophet Muhammad (peace be upon him) made after getting accepted religious authority in Medina was to improve the 'divide between the ridiculously wealthy and the absurdly

poor'. With this intention of building the society on moral rather than utilitarian principles, he banned both interest on loans and taxes on transactions from Islamic economic life. On the other hand, mandatory zakat was introduced, with every member of the community paying according to his or her means. Thus, after collecting 2.5 per cent of total net worth of any Muslims annually, the money was then reallocated to the poorest fellows of the community. Looft (2014) also mentions that as one of the pillars of Islam, and still followed by practicing Muslims, zakat demonstrates an influential passage to assist the poorest of the poor across the world.

On top of redistributing zakat, Islam has also tackled the question of how to integrate risk sharing into investor-driven finance (Looft, 2014), which is the basis of ethical finance in our day to day life. Thus, the intention of establishing the risk sharing financing procedure can ensure an ethical as well as sustainable economic system in our society.

4. ISLAM AND BUSINESS ETHICS

The foremost foundations of Islamic ethics are the Quran, the absolute collection of exposures acknowledged by the prophet Muhammad (peace be upon him), and the Sunnah, which is custom endorsed by tradition, mainly records of the activities of the prophet. The Islamic financial system is founded on total bond to Islamic acknowledged law extracted from these foundations, referred as the Sharia'h (Erragraguy, Merbouh, & Paranque, 2014).

In Islam, all interest-based transactions are firmly banned through both the Quran and the recommendations as well as activities of the prophet (Sunnah) of Muhammad (peace be upon him). The Prophet left no scope for any conflicting or contrary judgement regarding this issue in Islam. This was also decided in the Council of the Islamic Fiqh Academy, during its second session, held in Jeddah 22-28 December 1985, resolution 10/2 (cited in (Kunhibava & Rachagan, 2011):

> *"Any increase or interest on a debt which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay and increase (on interest) on the loan at the inception of its agreement, are both forms of usury which is prohibited under Sharia'h".*

Thus, the Islamic code is the general condemnation for all interest-based transactions which is defined as *Riba* in arabic. According to Erragraguy et al (2014), Islamic ethics underlines that profit in business actions should only come from a real handover of goods and not from an exchange of money. Nonetheless, the exclusion of *Riba* has a much broader meaning than simply denoting to usury or interest. It includes all kinds of unnecessary charges as well as manipulation in business transactions. As such, some trading instruments used in stock markets lend themselves to practices that can be viewed as a form of extreme charges levied on misinformed members.

Erragraguy et al (2014) mentions that in Islamic finance, the major issue is the equitable distribution of risk, while the main threat remains the unfair appropriation of the surplus by a single agent. For that reason, in Islamic finance, the profit-and-loss sharing (PLS) principle is supposed as the most competent way to guarantee equitable distribution of wealth and income among the different contractors. The aim of firm execution of partnership-based contracts in Islam means to introduce more discipline into financial markets by decreasing excessive securitization. Thus, Islamic ethics is designed by the legal architecture resulting from the thorough explanatory efforts directed by Islamic jurists or *fiqh* to preserve equitable conduct in human affairs. It should be remembered that the search for equity in public welfare is fundamental to the justification of financial markets' role and place in society.

5. LESSONS THE WORLD CAN LEARN FROM ISLAMIC FINANCE

After the Global Financial Crisis in 2008, an increasing number of people are questioning the way business is done across the world, bearing in mind the ethical options and speaking more about responsible finance. But the inadequate number of ethical financial systems in modern economy is posing greater threat to social welfare comparing to any other previous time in human history. Therefore, Khan (2015) seems mentioning appropriately that while the global economy remains so systematically based on debt finance and speculation, another crisis is inevitable at some point. After few years of the explosion of the Global Financial Crisis in 2008, several lessons the world's conventional financial institutions can learn from Islamic ethical financing system:

As Islamic finance only allows financing to activities as long as it is linked to the value-creating real transactions, ultimately 'co-investment' growth, which is known as 'credit growth' in conventional financial systems, is very much restricted by growth in productivity and income. Thus, the Islamic financing system creates a natural brake for co-investment growth in 'good' years (De la Torre, 2011). But excessive credit growth in one of the major contributors to modern economic instability. Interest rates are normally used by Central banks to influence this credit growth, which sometimes proved as ineffective. Professor De la Torre (2011) mentions this as the reason of creating '*Hyman Minsky's credit cycles*' that can only worsen economic cycles. Thus, lending too much in good years and too little in bad years like conventional financial institutions is one of the triggers to create financial instability.

Professor De la Torre (2011) also mentions that Islamic financial institutions only allow to invest in physical assets for generating free cash flow and valuation of these physical assets is more transparent. On the other hand, conventional financial institutions can lose most of its investment in a complex to value synthetic product, such as a Collateralized Debt Obligation (CDO), a CDO squared or a Collateralized Loan Obligation (CLO). Thus, Islamic financial institutions can ensure more financial stability compared to that of an investment of conventional financial institutions in a theoretically risk-limited AAA rating CDO squared.

Islamic finance allows risk-taking only if it is integrated with wealth creation, rather than pure zero-sum side betting. But in case of conventional financial institutions, the replacement value of global derivatives with global GDP shows how side-betting can grow to almost reach world production of goods and services mostly through over-the-counter (OTC) transactions which enhance systemic risk. As betting is forbidden under the principle of '*Gharar*' in Islamic faith, this financial system is much less affected by this systemic risk, the OTC derivatives meltdown, that caused the demise of Lehman Brothers (De la Torre, 2011).

The Islamic financial systems ensure long-term ethical sustainable welfare of the human society which is desirable by everyone irrespective of their religious background. Therefore, Khan (2015) righteously mentions that if you remove the Arabic terminology from all of this, Islamic economics makes sense to those in mainstream society who are interested in ethics and value-based economics, rather than the capitalist view of making money as a goal in itself.

6. CONCLUSION

Ethical justice, whether it is encouraged by philosophy or religious faith, can ensure maximum welfare of human society. It can guarantee the desire of accomplishing moral responsibilities for the benefit of all in the society. It seems right that the ethical authoritarian practices of worldwide businesses can ensure maximum welfare achieving efficient procedure. Therefore, the concept of ethical finance catches the utmost importance in every ages of human civilization. Failure to ensure the sustainable ethical financial system in the world would bring disastrous consequences in economic solidity.

Thus, the global corporate humiliations over the past few years came as a shock because of both the enormity of policy failures as well as the discovery of dubious unethical corporate domination, which was far more insidious and widespread than previously envisioned. Prioritising on the maximization of shareholder wealth as the underlying purpose of corporate activity can lead to a situation where the ethical, social and the financial system of the global economy as a whole can be concerned. The power of this apprehension felt throughout the world during the recent Global Financial Crisis. In short, global financial market collapse is the demonstration to both the unethical behaviors of the businesses as well as the intimate inter-relationship between and among nations through globalisation.

In fine, this research paper also sheds some lights on ethical Islamic financial systems which can demonstrate the world various basic principles and these ethics are very much linked to common sense which could enhance financial stability. But the questing is whether the world is ready to bring that 'light' of optimistic economic rebellion in their conventional financial system or not. As Plato stated (cited in Khan, 2015):

> *"We can easily forgive a child who is afraid of the dark. The real tragedy of life is when men are afraid of the light".*

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