

## Islamic Financial System and its Ethical Values: A Solution to Financial Dilemmas

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**Abstract:** Over the past recent years, the world has witnessed the downfall of large and prominent financial institutions. Financial distress and economic downturn have negatively affected the society at large. While it is acknowledged that the root of financial crisis is due to the heavily practiced of interest-based financing found in the subprime mortgage market, the present study advocates that the crux reason for such failures is pinned down to the unethical practices of the market players in the financial system. It is due to the inherent system that has driven them to misbehave and develop their greediness. Using Lehman brothers as the background, this study identifies various unethical issues. This study proposes Islamic ethical values and principles which are embedded in the Islamic financial system as a solution to curb and overcome financial crises.

**Key words:** Financial, background, economic, interest-based, Islamic financial, subprime

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### INTRODUCTION

The current practice of conventional financial system has shown its vulnerability which underlies unsettling issues. The 'problematic' system over the centuries has led the global facing experience financial crises and economic meltdown. The system is not at fault entirely but it also boils down to the market players who run the system, whom are the market players. The market players and the system are strongly intertwined. Failure of such system is due to unethical practices.

Generally, a financial system in other words, the services provided are varied, inter alia producing and offering liquidity, screening and monitoring creditworthiness and channeling of funds from the constituents who are in surplus to the other who are in deficit. Be that as it may, the fundamental practice of this system is the debt-credit relationship between the financiers and the customers. This can be asserted by Mirakhor (2009) which he describes that the mechanism of loan is for productive activity in the conventional financial system. Loan mechanism is seen as a platform to generate interest. Ultimately, loan and interest-based are two main components of the said mainstream system.

Consequently, it can be impliedly understood that the main focus of the conventional financial system is the creditworthiness of customers and almost at all times, overlook the soundness of a particular project that investors are willing to invest in. The financial institutions are less care or worse do not care of the funds which they

have ploughed that would seek low profitability. Their main concern is the ability of the customers to repay the principal amount of owed and plus with interest (Shah *et al.*, 2012). This could be said as a reflection of inefficiency of the overall system and more importantly, it can be regarded as unethical practice as social welfare of the public as a whole is being denied. This compounding effect of interest causes hardship which result the customers to pay more than the initial amount was owed.

The notion of financial activities in the modern financial system is an active capital market whereby the structure has the proportion of debt and equity which practically would want to raise funds. The goal embedded in the capital market system is the ideology of profit maximization of shareholder's value. This is the paramount consideration for every financial institution or firms involve in the capital market industry. Thus, apart from the interest-based system, the goal of maximization is treated as the ultimate factor to determine and ensure highly competitive financial businesses. However, the quality of financing is found to be negligible and due to this concept of maximization, the interest of other stakeholders is being undermined.

It is noteworthy that subprime mortgage loans are highly practiced in the capital market which is basically, founded on the interest-based system. The interest loans to home buyers are offered at higher rates as compared to the average portion of credit risk. Nielsen pointed out that the practice of subprime loans underlies the financial institutions to make more money from

short-term commissions and fees for advising whereby the financing being arranged by them in the method of trading new types of large securitized package based on the debt-based financial transactions.

In contemplation of the modern financial system as discussed above has undeniably allowed the market players to behave in an unethical manner. The said system itself underlies ethical issues whereby mostly it is driven with greediness and often disregards the wellbeing of the society. As such the exponentially adverse effect is on the market players whereby they would misbehave through committing fraud and manipulation in financing businesses and eventually, put the public at jeopardy with the occurrence of financial or economic distress.

The emergence of Islamic financial industry for the past forty years is ideally to serve a better alternative financial system and to be able to provide a solution to such economic meltdown. The Islamic financial system offers a different spectrum to the current practice of financial system whereby the unique feature of it must adhere to the Islamic principles. It is also essential to note that in any circumstances Islamic principles are involved, correspondingly it encompasses Islamic ethical virtues. These virtues have been clearly provided in the Quranic and Sunnah teachings.

This study aims to examine the practice of the conventional financial system and identifies the causes that led to financial crisis from the ethical perspective. Accordingly, it seeks to find a solution whereby Islamic financial system and the core of its practice is the Islamic ethical aspect and moralities can curb such financial crisis. Islamic ethical values should be embraced with the advent of Islamic financial system. This is because the movement of Islamic financial system in terms of its philosophies and goals are entirely different from the mainstream capitalism of financial system. Therefore, it is hoped that these values can be inculcated or instilled in the market players to operate the financial system efficiently and able to combat and overcome the financial crisis in the long run.

**Issues and problems:** The world has beheld several unfortunate cases that substantiate the evidence of the current financial system being inefficient and damaging to the wellbeing of society at large. This includes the financial scandals of certain corporations like Enron-Anderson, Russian Debt Default in 1998 and the investment banking scandals which involve subprime mortgage loans. Having referred to the case of collapse of Lehman brothers, a prominent and the fourth largest US investment bank as the background of this

research, it is to highlight the inherent problem entails in the conventional financial system particularly the capital market industry.

The demise of Lehman brothers was the result of the US subprime mortgage crisis in 2008. The credit crisis started in 2007 and by the end of that year, it marked the collapse of two Bear Stearns hedge funds a rival corporation to Lehman brothers. Lehman brothers continued to be the leading financial institution in the mortgage market in spite of the pressure felt by them as there was a wide speculation that they might be the next institution to be the victim of the said crisis. As such they turned to focus on improving capital and liquidity. The financial instrument involved was the Repo 105, the transactions were made to appear that they sold securities at the end of the quarter of the financial year. They planned to buy back at subsequent days later. This means that the dealings for securities were removed from the balance sheet on temporary basis only. In actual fact, it had concealed the real firm's financial condition and deceived the public that they were doing well (Michael and Sorkin, 2010).

It should be noted that Lehman brothers was a corporation which means it was a separate legal entity and thus cannot be accountable for any undesired calamities, herein the collapse of the entire corporation. As such, the concern is the several individuals and relevant parties related to the operations in Lehman brothers whom should be held liable. In short, they were the market players that had breached their proper roles which eventually led to the collapse of the entire business operation.

It has been identified that there were three wrongs committed by these market players firstly, the Chief Executive Officer who had told lies and certified the misleading accounts statement. Secondly, the Chief Financial Officers who also had endorsed the misleading accounts and had deceived the public with the statement made that Lehman's earnings was well managed. Thirdly, a well-known firm of the certified accountants cum auditors, Ernst and Young, whereby they had negligently discharge their duties in providing false accounts statements.

The root problem lies in the case of Lehman brothers is the practice of subprime mortgage loans and its attempt to raise liquidity. It is followed by the unethical practices by several personnel driven by the pressure of the mortgage system and the feeling of greediness. Hence, the capital market system which is mostly founded on debt-based structure has clearly shown that it is a handicap system and has caused the market players to misbehave. This can be seen where the Lehman brothers

tried to reduce its balance sheets in order to reduce risks and improve leverage ratio. This would improve the firm's status with rating agencies (Jonathan, 2010).

In addition, it is mostly pursued by the ideology of maximization of shareholder's value which has led to being individualistic and selfishness. This is evidenced from the doings of Lehman brothers whereby in order to materialise the reduction in balance sheets, they resorted to issue stocks or capital rigorously high in value amounting to \$6 billion. However, in the proceedings, the Examiner (who was appointed by the court) concluded that their attempt in raising capital did not breach their fiduciary duties as directors (Jonathan, 2010).

Be that as it may, the core attention of this case is that in attempt to move forward and increase the equity, deficiency was found in the auditing aspect. Instead of audited historical financial statements, the proposal was made that to provide investors with an audited opening balance sheet and disclose the prospective financial statements of next 3 years. It means that there was no full disclosure and there was an element of deception, all for the reason to increase value of shareholder's capital. Ultimately as affirmed by the examiner, Lehman brothers used an unusual accounting trick or gimmick to make its finances appear strong (Trumbull, 2010).

In observation of the above problems found in Lehman, it is believed that such setback needs to be replaced with an efficient system guided by moral and divine values. This means that Islamic financial system is not only able to offer a better inherent system whereby all types of trading are allowed and not only confined to debt-based structure but simultaneously the said system requires conforming to ethical aspect as prescribed by the Islamic principles.

**Literature review:** It has been noted that there is a limited study in respect of addressing how the market players in financial system should behave within the framework of ethical manner particularly in Islamic perspective. Nevertheless, there are many studies on ethics point of view or its issues arise in relation to the operation of financial system. For the purpose of this research, this section is further structured into several sub-sections in order to highlight clearly that the current financial crisis is due to the unethical values and practices of the people who runs the financial system. Thus, firstly, literatures that highlight on what are ethics and its philosophical views are provided. Next, covers its ethical issues underpinning the financial system industry and thus, the financial dilemmas and the last sub-section crystallizes that there is a need for a proper framework for the market players in the said industry.

**Defining ethics and its philosophical views:** Ethics is generally referred to the principles of conduct governing individuals. It "represents the attempt to resolve the conflict between selfishness and selflessness which is between our material needs and our conscience". Erhard *et al.* (2009) defined ethics in much detail whereby it is "the agreed on standards of what is desirable and undesirable; of right and wrong conduct; of what is considered by that group of as good and bad behavior of a person, sub-group or entity that is a member of the group". This means ethics is mostly dealt with human behavior whether it is acceptable or not. Another way that ethics can be understood is by looking at the ends or the consequences of actions or activities of human beings (Ahmed, 2010).

The understanding of ethics as what has been stated by Ahmed above is in fact signifying the concept of ethics which was founded by the contemporary views on ethics, particularly the utilitarianism. John Stuart Mill introduced that utility is the foundation of morals whereby it could also be referred to as the greatest happiness principle. It refers to the actions that are right in proportion as it would promote happiness whereas the actions are wrong if there is no happiness resulted (West, 2004). The emphasis of utilitarianism is on the consequences of an action and not the means but at the same time focuses within the domain of pursuing happiness.

George (2011) explained that utilitarianism is not about determining whether the action is good or bad but actions are to be judged by their consequences. He further added that actions take on moral value only when considered in conjunction with the effects that followed suit. He pointed out that the core concept of this ethical view is human satisfaction that is valuable in itself. This means in anything that would give people the feelings of joy, happiness, comfort and pleasure are deemed as valuable.

On the other hand, ethics in Islamic perspective reflect divine and moral values. Indeed, Islam gives guidelines that encompass every aspect of human lives. Abul-A'la-Maududi (1967) indicated that basic moral norms and values are given in Islam as guidelines for human beings. It provides a comprehensive code of behaviors for individuals and shows the highest possible moral excellence and ethical principles in order to create a righteous society.

Departing from the view of utilitarianism, Imam al-Ghazali's ethical ideas are mostly similar to the Greek philosophers in terms of its meaning but he reiterated that such philosophical statements were merely reflecting his independent ideas which were essentially referring to the

revelations of God and hence its dependence upon religion. Quasem (1975) Imam al-Ghazali reasoned out that the foundation of moral philosophy is not an invention of the Greek philosophers as it is actually based on the doctrine of religion. Zaroug (1999) argued that ethics should not be treated in an isolated field of study as it is highly regarded as one of the objectives in Islam. It is undeniable that ethics and morals are closely intertwined to each other.

Naquib-Al-Attas (2001) provided that ethical concept in Islam derived from the *din* (religion) and *tawhid* (unity of God). It is also extended with the concept of man being created and its role in the *din*. He said that, reference to the man presupposes the emergence of him to the higher type of man who is capable of aspirations towards self-improvement.

Ahmed (2010) reiterated the view of Sheikh al-Attas, whereby the understanding of ethics in Islam must start from the beginning, i.e., the origins of everything which recollecting the essence of Islamic worldview. This worldview implies the concept of *tawheed*; unity and oneness of God. As such, it ensue further aspect that God is the only source of values and norms.

**Ethical issues vis-a-vis financial dilemmas:** The conduct of ethics in the financial sector is generally referred to as business ethics. This is because financial industry is synonymously related to the business world. Business would definitely involve several key players consisting of individuals and corporations to do business decision making. As such, the behavior of these constituents is relevant to look upon. As described by Velasquez (2006), business ethics relate to the moral standards applicable to business policies, institutions and behavior and it will be analyzed in terms of moral norms and values.

It is undeniable that there are array of ethical issues arise in the conduct of business and the financial industry as a whole. It has become rampant especially with the uprising failures of big firm corporations and corporate governance scandals for the past recent years. Federwisch (2006) found that ethical issues in the financial services industry affect everyone. The financial industry is large as it encompasses a wide range of financial institutions or corporations such as commercial and investment banks, insurance companies and mutual fund institutions. It is inevitable that due to the large industry which may garner great amount of money tantamount to trillions of dollars of assets and billions of transactions, it has drawn many ethical lapses and misdeeds.

Indeed, it is the financial system itself in which particularly the operation of capital market that infiltrates

the ethical and moral elements. This has been pointed out by Gassner whereby the problem with financial crisis with ethical implications are mostly revolves with the housing price bubbles, the mess in derivative swaps, the mismatches between assets and liabilities in hedge funds and the unmanageable debt policies. Sorenson (2007) affirmed that the current financial crisis is also a moral crisis and much of the crisis is based on the entanglement of parties in derivatives and the uncertain value of the instruments.

The most frequent matters in finance that face ethical violations are related to inter alia the interest of stakeholders against the interest of shareholders and investment management. Some of the examples given on the ethical violations are fraudulent financial dealings, mispricing customer trades, cheating customers of their trading profits, misuse of customer funds for personal gain and corruption have become common occurrences (Sifah, 2012).

It is interesting to note that the consequences of financial crisis have led to several deficiencies and ills. Fernandez (2012) declared the reason that the financial ill the world is facing now is the disconnection between ethics and finance. As a result, the emergence of financial ills is inter alia, recession, unemployment, bankruptcies, poverty, greater inequality and loss of trust.

Consequently, due to the much financial ills, there have been numerous studies that aim to redirect to fundamental cause which is on the ethical values. Swamy (2009) maintained that there was a lack of higher human and social values and it was responsible for the futile human actions that eventually led to unethical and immoral actions in the financial markets. This was corroborated with his study that many unethical practices were found in the corporate banking sector which mostly had the function of investment business in nature (capital market).

Greycourt discussed all the destructive financial crisis and citing examples of the prominent downfall of financial firms or corporations such as Lehman brothers. Consequently, it suggests that the common root cause of all the disparaging activities in the financial system was the collapse of ethical behavior across the financial industry and it emphasizes further that there was also the fading of any sense on the fiduciary responsibility to the stakeholders.

**The need for ethical framework:** Greycourt proposed that the financial industry needs to demand ethical behavior across the board from its executives and employees. These ethical behaviors need to be exemplified and enforced by the top executives. In other words, there

should be a proper code of conduct and enforceable within the corporation. This code of conduct must be derived from the ethical principles. The code is a vital feature in a corporation in the same way as a pillar or foundation of a building. Code of ethics must be highly observed in order to create a culture of accountability and honesty in the corporation and in the public at large which ultimately resulted to protect its integrity.

Othman and Rahman (2010) carried out a study on the need of ethics in governance context to concur that ethics have been identified as a significant factor to solve the corporate governance flaws phenomenon. The research introduced components of a formal ethics structure, integration of ethical culture, ethical leadership and established corporate value as the social process and it should integrate in the part of corporate governance. This is to establish elements of transparency, accountability and responsibility of corporations business conduct.

There have been numerous suggestions on formulating standards that should be based on values, whereby a proper code of business conduct and ethics to ensure effective operation identified that an ethical framework should be developed for the resolution of ethical dilemmas that may be faced in the banking and finance context. They have suggested an ethical framework that incorporates both secular and religious ethical principles and professional ethics are also taken into consideration. This is to serve as a guidance mechanism for resolving banking and financial dilemmas.

## **MATERIALS AND METHODS**

The methodology used is mostly based on the secondary data as it is only an explorative study in the light of examining the Islamic ethical principles provided in Islamic financial system. Many studies have been made addressing Islamic financial system as the best alternative and could be the solution to the current economic meltdown. Conversely, there is not much of it being dealt according to the Islamic ethical perspective. Several disastrous cases such as the Lehman brothers highlighted that unethical practice is one of the contributing factors that lead to financial crisis. Hence, this study aids to fill such gap whereby financial dilemmas can be overcome with the solution given by the Islamic ethical aspects which are embedded in the Islamic financial system.

**Analysis:** Therefore, in light of the current operation of financial system and its financial crisis, it is significant to address the problem from the direction that cannot be visualized and conceptualized from the external factors

but from the determination of human inclination and spiritual insights. As such it is imperative to understand what ethics are and how those are instrumental in human's daily lives.

**Ethics and its philosophical views:** Generally, ethical norms concern with human behavior whereby there is a consciousness of human being to act either in a right or wrong manner within the purview of the morality principles. It comprises elements of truthfulness, honesty, integrity, respect for others, fairness and justice in which essentially these are related to all aspects of life. It is vital to maintain the stability and harmony in social life as people must interact with one another. We can develop the instinct of not only care to ourselves only but a conscience to care for others.

Ethics is a kind of guideline for human beings to pursue values and it serves as a platform to balance the individualistic traits and social responsibility. In this respect, ethics could be synonymously related to morality whereby it is often contemplating between good and bad. The following points are an analysis of philosophical views on ethics from three different scholars. One view is from the contemporary conventional perspective and the other two discussed ethics in the Islamic perspective.

**John Stuart Mill's utilitarianism:** Philosophical views on ethics have differed according to the evolving era. As such, the contemporary scholars define and develop philosophical ethics in a different perspective but do not deviate wholly from the original ideas from the Greek philosophers with the likes of Aristotle and Plato. This can be seen with the emergence of the ideology on utilitarianism in the 18th century. The moral theory of utilitarianism is based on human nature. Utilitarianism is an evaluation to the action by looking at its consequences weighing the good effects against the bad effects on all the people affected by it. If the good outweighs the bad, it is considered to be a good action and vice versa.

John Stuart Mill, an advocate of utilitarianism who had a conflicting view that the ultimate aim is to attain the greatest happiness principle when the actions are right. In his description, utilitarianism was introduced by the following: "The creed which accepts as the foundation of morals, Utility or the Greatest Happiness Principle, holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness" (West, 2004). It is submitted that the doctrine of utilitarianism is incorporating ideas of both happiness and unhappiness. Happiness is meant by pleasure and the nonexistence of pain whereas

unhappiness denotes pain and the absence of contentment. The method used for utilitarianism is maximizing good or also known as the principle of utility.

Subsequently, it is perceived that utilitarianism stresses on the importance of objectives. It is more concerned with achieving fulfillment of people's preferences and consequences of the actions would be able to satisfy such preferences. John Stuart Mill emphasized that human beings are determined by the pursuit of happiness and they are given the freedom to choose or reject their individual path. Unfortunately, his view seems to be individualistic.

**Imam Al-Ghazali's view on ethics:** Imam Al-Ghazali developed his theory on ethics during his mystical period of life. It was during this time that he regained steadfast belief in God and build a strong relationship with God spiritually. The main concern of his life was to achieve well-being and happiness in the hereafter. Guided by such spiritual aim had made his ethics religious and differs from the mainstream ethical beliefs founded from the Greek philosophers which are mainly concerned with human good in this worldly life (Quasem, 1975).

The spiritual aim denotes that his view on ethics is fundamentally depended on the religious belief. As such his ethical study is very much influenced from the guidelines evidenced from the Quranic verses and Sunnah. His philosophical view on ethics can be individualistic in certain aspect and simultaneously concern with other human beings on the other aspect. The former focuses on the significance of an individual soul because God does not look on outward appearances. The latter concerns on dealings with others in society are also important. Both motivate to achieve the vital aim which is the well-being in the Hereafter.

Ethics deal with the rightness and wrongness of actions as highlighted by Imam al-Ghazali. Actions are considered to be either good or bad according to the effect of the actions. It determines the consequences to the soul from the said actions and relates it to the theory of happiness for the soul. In this regard, his philosophical view on ethics is similar to the contemporary view of utilitarianism as discussed above. However, the uniquely distinguishing feature of his views is the reliance on religion and the ultimate aim is the pursuit of happiness in the Hereafter.

Apart from that, he managed to reconcile the importance of worldly sciences (reason) and religious sciences (Shariah) as both are complementary to improve one's soul in achieving well-being in the Hereafter. The

integration of ethics with religion reflects both reasoning and Shariah as the sources of moral obligation (Quasem, 1975). This also proves that moral acts and religious acts are mutually exclusive as moral actions towards other human beings are directed by God and the Prophet S.A.W. In the long run, ethics should be achieved by man in order to be good and virtuous human beings through their character qualities.

**Syed Muhammad Naquib Al-Atta's view on ethics:** The view of this renowned Muslim contemporary scholar shares the same aspiration as Imam Al-Ghazali on ethics, whereby the core substance is religion. Interestingly, he elaborated further the foundation of Islamic ethics and morality in a different angle. First and foremost, he identified the root cause of all other problems that affected modern society is the problem of human identity and destiny. This dilemma is due to a different spirit of knowledge that has been imbued on people. The knowledge that Western civilization has been disseminated for centuries hold a different purpose, aiming for extreme and injudicious love of the world and secular life. In other words, the notion is based on materialistic view and fully reliance upon the powers of the human intellect. Such foundation has formulated different understanding on ethics for example the Utilitarianism as highlighted above.

Therefore, Sheikh Al-Attas introduced the concept of Islamic worldview whereby in this notion, it scrutinizes the meaning of din (religion) and coincides with the role of man. In addition, he emphasized that knowledge is important as it is one of the cardinal elements which cannot be in isolation from the whole concept of Islamic worldview. Knowledge is treated as the pre-requisite for man to understand religion (din) and oneness (tawhid) of God. Subsequently, one is able to comprehend that din connotes natural submission of man towards God and it covers the whole way of life. Any form of manifestation by man must be attributed to God.

Another important component in the sphere of Islamic worldview is the reference to man. It is essential to know what the purpose why man is created by God. Undeniably, man is created to worship and obey Allah. This can be evidenced from the Quran (Surah Ad-zariyat, Verse 56):

“And I (Allah) created not the jinns and humans except they should worship Me”

This verse clearly indicates that man is a servant to Allah and must give full submission to Him and consequently, it is emphasized that man has an obligation

to fulfill his duty as a vicegerent as directed by God. This is provided in the Quran (Surah Al-baqarah, Verse 30):

“Behold, Thy Lord said to the angels: I will create a vicegerent on earth”.

Hence, in any doings of man must be attributed to God on account of being a servant and a trustee of Allah to administer the worldly matters as instructed by Him.

In view of the above, it is submitted that the foundation of ethics is from the understanding of the whole concept of Islamic worldview. It is to be reiterated that the importance of seeking knowledge is to inculcate virtues to become a good man. The term good herein consist of of being good to his self and to the society. This is considered as a form of ibadah (worship) as this is what God has commanded human beings to do.

Consequently, it is understood that ethical values formulated is actually based on the vision of truth and reality upon revelation and religious belief and not upon cultural tradition based solely on man's mental and intellectual faculty as what has been advocating by the Western civilization. As mentioned by Naquib-Al-Attas (2001) in his writing, “In Islam, because for it religion encompasses life in its entirety, thus all virtue is religious”.

**Business ethics in the financial system:** It should be noted that business ethics is considered as a sub-set of ethics and in light of this study which is highlighting the financial system and its crisis, it is very much relevant to discuss business ethics herein. Business ethics confine the ethical manners within the domain of commercial dealings or business activities made by individuals, corporations or organizations. Accordingly, business code of conducts is required to be observed by every individual; board of directors, shareholders, stakeholders of the financial institutions. This is to ensure integrity, honesty, sincerity and other core values that are pertinent to achieve the goals and objectives of the said institutions.

Ethical values may differ according to different individual's perspective and interpretations and thus, the challenge lies in reaching consensus among them. The financial institutions need to specify the framework of conduct based on the moral and ethical point of view. They must determine and define what are the objectives and goals of the institutions to enable them converting it into ethical framework (George, 2011).

With the aim to achieve and maintain viability, the common practice of financial institutions is resorting to

adopt code of conduct that envisaged the ethical concept of utilitarianism. In recapitulation of the said concept as discussed above what is envisioned within is very much applicable to the practice of conducting business. This is because business is often sought to make profit. It has fairly underlies the principle of maximizing as the objective of a business is to make money and thus it could be said that if any action that able to generate more money is considered as a good action (George, 2011).

**The effect of business ethics-utilitarianism view:** Based on the utilitarian concept, the objectives and goals are placed at higher consideration as compared to the means and thus, incorporating interest-bearing practices in the business ethics is permitted. Unknowingly, it has slowly crept to cause the downfall of financial system as it has induced people towards interest, making unfair earning, bribery, theft, hocus-pocus and fraud (Hashim, 2012). In other words, it triggers more unethical practices. Moreover, the objective rested in the financial institutions is aiming for viability only. They are thinking of survivorship for a long term period in the current financial system which mostly practiced subprime lending despite its flaws as described in the early part of this study. As a result, notwithstanding the numerous codes of conducts that can be found in the practice of financial institutions, those are unable to resolve the financial crisis. The market players are yet found to misbehave and often easily violate the said prescribed codes. The Lehman brothers also had their own code of ethics (Lehman brothers code of ethics as amended February 17, 2004) but unfortunately, having it codified does not protect them from the shameful downfall.

The ethical view of utilitarianism put emphasis on pursuing happiness. As such, the primary goal in most of financial institutions is maximization of shareholder's value which is deemed to be realizing happiness and contentment. The focus is to maximize happiness and minimize harm and as long as it is perceived that pleasure can be felt by majority, it can condone to injustice. This has led to a major drawback of such goal by prompting the feeling of greediness whereby too enthralled with happiness, it has slowly turned into greediness.

This can be seen in the examples of several scandals of firms such as the case of Lehman brothers whereby the capital was issued and raised extensively but it was only a sham. Managers of citigroup were allowed to resign with hundred million dollar retirement when the subprime mortgage under their watch collapsed had created moral hazard. It has been highlighted that the common factor that caused the shameful failures of financial firms is due to the unusual combination of circumstances which they

are characterized by the feeling of greediness and attraction of short-term incentives in subprime mortgage lending.

**Subprime mortgage lending:** Subprime mortgage lending is the inherent problematic financial system. The moral and ethical issues can arise from the financial crisis is fundamentally due to the operation of such system itself. This is because the subprime mortgage lending system and its facilities are highly involved with interest-bearing loans. Accordingly, when many loans are being issued without realizing, there is a growing problem of risk in loan defaults (Rahman, 2010). Many financial institutions have suffered this losses and one of them were the renowned investment bank and a major holder of mortgage-backed securities in the United States, Lehman brothers which had defeated to bankruptcy.

Consequently, with the background of the mortgage system, it could be the origin of the collapse of ethical behavior. This is also because the financial institutions are mostly confined their objectives to profit-making and sustaining it for a long-term period. Thus, with such aims, they also have eventually made the personnel involve in the financial system (i.e., market players) becoming greedy and instigates the image of being self-centered and discards social responsibility. It is to be noted that the market players must understand carefully their roles in the financial system. They are not merely referred to shareholders and stakeholders but also extended to the roles of other external personnel whom are also instrumental in the financial system. These other constituents can be consisted of the government, valuers, lawyers, auditors, accountants, etc. Examples can be seen from the Lehman brothers case. The unethical behavior identified by the market players with the setting of subprime mortgage market are delineated as follows.

**Financial institutions:** Financial institutions no longer sought their profit from long-term mortgages but reaped them from origination fees or from commissions on making loans which they sold to others who in turn bundled them, divided them and sold them to investors. In this case, Lehman brothers was too occupied in mortgage markets as they believed it was a good investment. They would get handsome payment for writing mortgages. They knew if the customers had higher risks to default but they still issued loans to them. This is because their aim and job were to provide loans and get commission from it via earn interest generating from the loans.

**Board of directors:** The board represents the interest of shareholders and thus it is assumed of fiduciary duty

towards the shareholders and to optimize their long-term value. The board has to discharge their duties diligently and avoid conflict of interests in order to protect the integrity of the firm. In Lehman brothers, there was a violation of trust. The CEO had clearly breached his fiduciary duty by proceeding into mortgage-backed security investments and continuously increasing the firm's asset portfolio which had gotten into unreasonable high risk. Public disclosure made by on its financial performance stability was not actually disclosed properly. In other words, the positive remarks that the company would not need to build up more capital were merely a sham and a lie to the investors.

**Accountants:** Accountants are expected to be honest and impartial in all professional and business relationships. Hence, conflicts of interest and unwanted influence in interfering with professional or business judgments must not be allowed. They should act in caution within the professional standards and the prescribed laws and regulations. However, this ethics of accountants were violated in relation to the Lehman brothers case. The accountants, Ernst and Young committed gross negligence and lack of corporate responsibility. They failed to certify accurate and reliable information to shareholders. They turned a blind eye by concealing financial problems in Lehman brothers because the latter was a sizable and lucrative client of them.

**Auditors:** Auditors are responsible to evaluate some aspects and the efficiency of the business firms. They are expected to give sound recommendations for the firms to overcome any negative foreseeable impacts. In Lehman brothers, it all started with the Chief Financial Officer that had committed the fundamental wrong when he endorsed the balance sheets that indicate moving assets away into its subsidiary company. This was clearly a manipulation to the stakeholders as concealment that the firm was actually unsecured and unstable. Accordingly, the auditors approved of those financial statements and this means that they were also in breach of their duties.

**Government:** Government has lack of regulation and absence of a proper monitor. Corporations or organizations supported by the government are also actively involved in purchasing and selling the mortgage-backed securities such as Fannie Mae and Freddie Mac. They hold worth of billions of dollars of these mortgages on their balance sheets (George, 2011). These corporations acted like private corporations by prioritizing shares and denying the public which finds the housing prices are not affordable. In subprime mortgage



market, there are an insufficient regulations or standards such as requirements for customers to engage into loans, failed to provide the proper highest amount that insurance companies can issue. The sad fact in Lehman brothers is the government was criticized for unable to help and let the collapse of the company.

**Customers A.K.A borrowers:** In relation to the subprime mortgage market, it is indeed unethical for the customers to buy house when they could not even afford to buy one. The reason they engage into buying more houses is due to the rising cost of estate. They see it like an investment and as a result, they had to resort to engage into loan facility which is the subprime loans. The reality is they had to pay low in the initial payment and ended up to pay more than they initially paid. This also impliedly show there is misrepresentation and considered as unethical.

**Rating agencies:** Rating agencies such as Standard and Poor's gave 'false' ratings. It is to be noted that the higher the rating, the more secured and can get more return (which means more interest). They rated the packaged mortgage-backed securities as high quality triple A (AAA) securities but in fact those turned out to be of lower quality due to the decline in the real estate market and the non-performance of the mortgages market (George, 2011).

## RESULTS AND DISCUSSION

**Findings and recommendation:** As discussed in the previous study, it has clearly proven that the modern financial system stemmed from the subprime mortgage market leads to the collapse of ethical behavior. The mistakes identified above done by the market players are definitely due to being greedy. Greediness allows immoral and unethical practices such as manipulation, deception and breach of trust. The root cause of this greediness is due to the understanding of ethical norms and values based by human thoughts only. Pursuit of happiness seems the ends to justify and fulfill human's desires.

The current practice is that code of ethics mostly found governing financial institutions in the current financial system is essentially derived from the main doctrine of ethics itself, i.e., the pursuit of happiness. It is evident that such codes do not reflect any religious belief. This is because the modern civilization which has embedded the ideology of secularism disregards religion in the worldly matters.

However in Islam, the code of conduct in relation to the ethical virtues is essentially related to religion and could be said to be a direct connection to God. Indeed, it

is a natural inclination for human wanting to be good. This is in fact has been addressed in Islam long time ago whereby the Quran affirms that man is the best of creations:

“Verily We have created the human being in the best of moulds” (Surah At-Tin, Verse 4).

This verse infers that human being is naturally inclined towards something that is good and this includes ethical norms and values.

Nevertheless, driven solely by human thoughts will draw many loopholes. This has been practicing in the current financial system. The ethical norms are greatly human thoughts and desires oriented. This can be seen from the focus of the financial institutions which is mainly to be viable at all times. And as for human beings, the pursuit of happiness and concurrently minimize harm is the ultimate aim. Such ideology is flawed ethically as it creates more mischief of human beings. Hence, it is important that human beings are guided by the reliance upon religion in which Islamic financial system is able to provide that aspect.

Meanwhile, it is important for us to understand the proposition values of Islamic financial system. The said system entails a philosophy of risk sharing and promoting socio-economic welfare which is definitely beyond the objective of profit maximization per se (Ibrahim, 2007). It limits the risk-taking individual for the betterment of society as a whole. This means that the objectives of Islamic financial institutions are different from the conventional financial institutions. The latter only focuses on the aim of viability, whereas the former is premised with two more objectives other than viability which are religion and social responsibility. This is because the inherent principle in any dealings done by human beings must be within the commandment of God.

The mechanism of Islamic financial system is based on the guidelines provided from the revelation. This is proven when mankind is allowed to engage in trading businesses and it is even encouraged to do profit. The provisions in the Quran highlight that:

“Believers, when the call for prayer is made on Friday, hasten to the remembrance of Allah and give up all trading. That is better for you if you only knew. When the prayer is ended, disperse in the land and seek Allah's bounty and remember Allah much so that you may prosper” (surah Al-Jumu'ah, Verse 9 and 10).

This connotes that do trading is allowed in Islam. However, trading must be done in accordance with

the Islamic principles and values. Other guideline given such as the practice of usury and interest-bearing are explicitly prohibited in Islam in which Allah says:

“Allah has permitted trading and forbidden Riba (usury)” (Surah Al-Baqarah: Verse 275).

This is deemed as one of the ethics in business in Islamic point of view. This is completely the opposite of what the current conventional financial system is practicing.

In addition, debt-based transactions are allowed in Islam as it will assist others in need. This is in line with the Islamic teachings as the Prophet S.A.W had quoted that:

“Whoever removes a worldly hardship from a believer, Allah will remove from him one of the hardships of the hereafter. Whosoever alleviates the needy person, Allah will alleviate from him in this world and hereafter”.

This hadith clearly highlights that helping others is one of the Islamic ethical teachings and it also observes the social responsibility. However, engage in debt-based dealings for consumption should be kept in minimum as derived from the moral teachings of the Prophet S.A.W. The one that is practiced in the current financial system which is highly involved loan-based dealings such as subprime mortgage market is not allowed in Islam.

Therefore, if the financial institution's objective is to expand business by financing goods and services and results in higher indebtedness among individuals, it leads to immorality which is certainly contravened to the teachings of the Prophet S.A.W and accordingly, if such practices are widely spread and it affects moral values, it would be considered as unethical (Ahmed, 2010). It is to be borne that Islamic financial institutions have religious, moral and social responsibility. As such in spite of the encouragement of doing profit-making, it should be set aside if it results in the disruption of the society (Dusuki, 2011). This is supported with the authority of Quran states that:

“But seek with that wealth which Allah has bestowed on you, the home of the Hereafter and forget not your portion of legal enjoyment in this world and do good as Allah has been good to you and seek not mischief in the land” (Surah Al-Qasas, Verse 77).

In view of this verse, it has beautifully underlined the balance in worldly matters and the hereafter and concurrently the significance of ethical practices to attain success in the world and the hereafter. Islam places high emphasis on ethical teachings and values in every aspect

of human lives which also include the conduct of business. Interestingly, there are many Islamic ethical values can be found in the Quranic and the Prophet S.A.W teachings that are applicable in financial dealings. These formulate a definite and strong framework to govern an ideal way balancing out various stakeholders in terms of their rights and responsibilities. The moral injunctions are being translated into codes of Islamic ethical disciplines in Islamic commercial transactions to reflect good manners and decency in which has been successfully pointed out by Hassan. These Islamic ethical codes could be the solution to overcome the financial crisis as it addresses the core problem. The ethical conducts that are encouraged in commercial dealings are as follows:

- Wariness of doubtful property and work. Any doubtful matters occurred should be avoided for the purpose of purification for the religion and integrity.
- Doing business early in the morning
- Trustworthiness in the dealings. Dishonesty is discouraged and is seen as a sinful act
- Generosity and modesty in claiming debts
- Giving time to debtor to pay his debts
- Voluntary rescission of an unwanted sale
- Generosity in business which is strongly recommended to purify wrongfulness

The ethical conducts as provided above underlie that commercial or business dealings should not be driven by greediness. Generosity is highly recommended for the betterment of societal well-being. In the hadith, where the Prophet S.A.W said that:

“The truthful merchant is rewarded by being ranked on the day of resurrection together with the prophet, the truthful ones, the martyrs and the pious people”

This connotes that trustworthiness is seen to be the virtuous act in dealings and it is very highly encouraged and will be rewarded by God. The following remaining five guidelines are the conducts that should be discouraged in commercial dealings:

- Business transactions in the mosques as the place are for worship
- Raising voices during the transactions as it causes inconvenience and less adab
- False swearing is sinful act despite the transaction may be valid
- Lies and concealment in sale will render loss of blessings
- Fraudulence in trade which has caused misrepresentations

The underlying principles found in the code of conducts above are to ensure justice, honesty, transparency and fair dealings in business ethics. In the same vein from the Quran, this has clearly permits justice and prohibits mischief:

“And O my people, Give full measure and weight in justice and reduce not the things that are due to the people and do not commit mischief in the land, causing corruption” (Surah Hud: 85)

At the same time, it is also required to highly observe that the businesses or commercial transactions should be protected from the elements of prohibitions prescribed by Islam such as *riba* and uncertainty. Subsequently, it has been mentioned clearly in the Quran that Islam is the true religion:

“Truly, the religion with Allah is Islam” (Surah Al-Imran, Verse 19)

This verse is directed and referred by God to human beings. Thus ethical issues must be addressed by human beings individually and not restricted to societal and organizational approaches only. Hence, the market players in the Islamic financial system must realize that they must act according to their roles ethically as they are accountable not only to the institutions and society at large but more importantly to God.

Therefore, the conceptual structure that can be deduced from discussion above is depicted in Fig. 1, whereby to create a robust Islamic financial system that can replace the current thorny financial system and overcome financial crisis or dilemmas, it must rely upon the religion. This is the doctrine that Imam al-Ghazali and Sheikh al-Attas believe in. Consequently, Islamic ethical values can be instilled in every market players and ensure effective smooth running of the Islamic financial institutions. Besides that, it is also important to highlight that the objectives entail in Islamic financial institutions are exclusively distinctive from the conventional financial institutions, whereby its aim is to serve religion and social apart from the viability. The objectives are integral so that it can be converted into the institution's code of ethics. Figure 2 illustrates the three objectives of Islamic financial institutions which can facilitate in determining the Islamic ethical framework for Islamic financial institutions.

Interestingly, the framework serves two dimensions as it is also regarded as an important guideline for Islamic financial institutions to materialise the three objectives. Therefore, it is suggested that these ethical values must be inculcated through education to prepare and

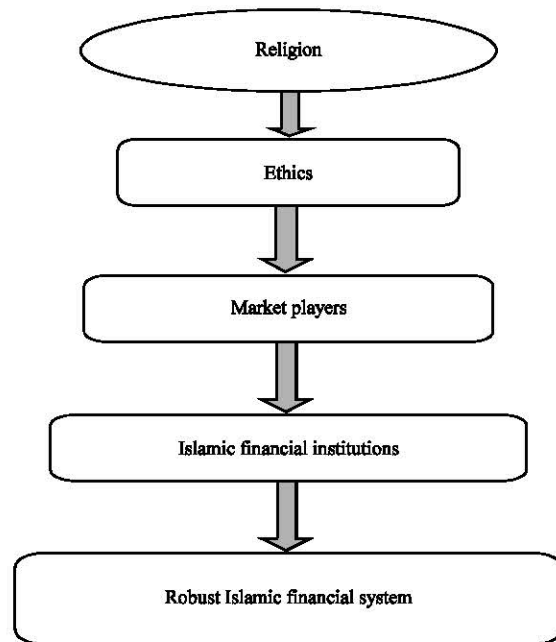


Fig. 1: The conceptual structure of robust Islamic financial system

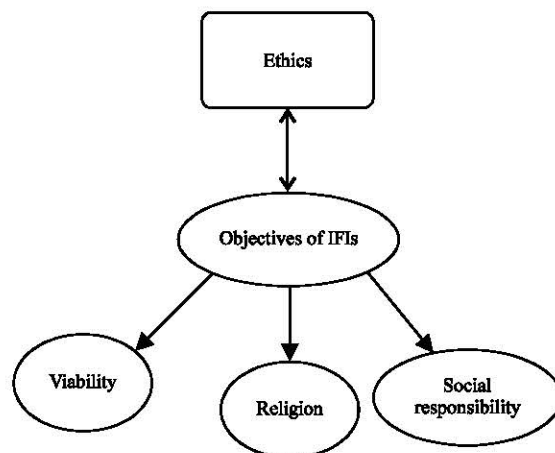


Fig. 2: The institution's code of ethics

would better generation of people who would become the market players and ultimately ensure a better operation of Islamic financial system.

## CONCLUSION

The cause of financial dilemmas is the unethical practices but interestingly, it works in a cycle as financial dilemmas will lead to more unethical practices. This is because when there is a financial disaster or the economy is in a bad shape, the market players are inclined to do

mischievous or misconduct out of greediness to survive from subsequent financial mishaps. It is unfortunate that despite the existence of numerous ethical guidelines, the root problem is the perception on the doctrine of ethical values itself, i.e., pursuit of happiness.

On the other hand, Islamic financial system is able to provide a solution as it is inevitable that the system is founded on the Islamic ethical principles. It should be borne in mind that Islamic ethical values and moralities are part of the entire Islamic faith. Hence, it should be observed and understood clearly that virtually, the rightful conducts are the platform to attain happiness in the life Hereafter and to procure God's blessings.

These Islamic teachings must be incorporated in the business dealings in order to create a sense of accountability and responsibility amongst the market players. Eventually, this can address the financial dilemmas caused by the conventional financial system and its unethical practices. A positive impact on the social well-being of the community can be ensured as the Islamic ethical values are part of the Islamic financial system which is able to provide better policies and procedures.

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