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## A conceptual view of ethical aspect of financial crisis: case of B&H (Islamic) banking sector

### Abstract

Ethics and morality as well as economic issues have never caused so much attention, as the outbreak of the global financial crisis in 2008. In recent times, among the economists there is a profound opinion that the financial crisis is a sign of instability and failure of modern capitalist civilization (liberal capitalism). In this context, the financial crisis is often considered as the main reason for the unsustainability and non-functional capitalist social system, which would in future require intensive reform and its evolution toward one another (social, moral and responsible) system based on values.

The paper provides a short synthesis of economic-theoretical thinking on this topic, with special review on empirical research and analysis of (Islamic) banking sector in Bosnia and Herzegovina.

The authors concluded that the use of principles of Islamic economics and finance can be a quality prevention of similar financial crises in the future. Research has shown, also, that Islamic banks had a better performance than the conventional banks during the crisis, which led authors to an important conclusion, specially for their country (B&H), to observe the principles underlying how Islamic banking could mitigate the consequences of the global financial crisis in Bosnia and Herzegovina.

**Keywords:** ethic, financial crisis, Islamic banking, financial institutions, capitalism.

**JEL Classification:** F01, F44.

### Introduction

*“There is a sufficiency in the world for man’s need but not for men’s greed” (Gandhi).*

Despite the shortcomings of contemporary theoretical models, recent experiences in the world economy have shown that there is no relevant alternatives to the basic recipe to save capitalism from itself. Due to the overall current situation in global financial markets, there is a different thinking about capitalism in the context of restoring the moral and ethical principles in the economy. All economic analyses clearly indicate that the problem of the financial crisis cannot be solved with a simple and short-term ad hoc measures of the market mechanism. Reasons for this are many, considering that today requires a significant change in the very structure of the global financial system, in which the center is not a man, but only profit. The entire system of capitalist economy is not geared to meeting the needs of an individual, but the man has become a product that has been reduced to the process of realization of capitalist profit.

Considering the above, the subject of this paper is to determine the potential advantages and disadvantages of professional ethics of financial institutions in the global financial crisis and economic recession. Be sure to realize the defined subjects research requires a realization following research objectives, namely: to analyze the ethical aspects of the financial crisis, to try to give an explanation for the choice of the future economic system and macro-economic policy (state capitalism, the welfare state, social justice, social liberalism) emphasize the prob-

lem moral hazard and economic greed in the world economy, and socio-cultural reasons (and/or value, ethical, spiritual) distrust in the modern global financial system and international financial institutions. Due to the extent and significance of the research work, we set the following hypotheses:

- ◆ Global problems need global solutions, and in this context, it is necessary to build and establish a new network of international financial institutions with the standards and rules that will require an international consensus.
- ◆ Instead of “success ethic” needed in the future to develop the “ethics of responsibility” for the society as a whole.
- ◆ Reducing the economic behavior of the real, civilized, humane, moral and institutionalized framework, and the creation of an adequate global economic theory and policy that will focus on competition, taking into account the objective framework and relativization many market constraints, can contribute to the recovery of the world economy and building a more efficient world financial system in the future.

### 1. Overview results and methodologies of previous research

The authors Alexander Figurek and Bogdana Vu-jnović-Gligoric (2011) in their study attempted to provide a few ways to overcome the crisis and eliminate its cause, such as the return of business and human morality in general. In uncontrolled modern global financial system, banks have created such a credit policy that is based on the enormous interest rates, which is on the other side of which

undermined the economy as a whole. In this way, the crisis is incorporated into all aspects of society. The authors present the impact of interest rates on the financial crisis and define possible solutions. Also, they are able to analyze the interest-free loan, and the effects that would follow such a model using the credit. Armin Vlačić (2011) deals with the crisis of morality as the fundamental cause of the current economic crisis. In doing so, he explores the characteristics of a materialistic, basically secularist, world view and argue with some of the fundamental postulates underlying this system value. In this context, the author suggests a different approach to “human economy” in relation to “the man of faith”, or “in Islam”. Represents the Islamic view on the latest global financial crisis and stresses the importance of promoting the moral and ethical values that leave no room for man’s egotism. The moral code is long and quite clearly defined, and the man and the company’s commitment to implement it in practice. It involves quite a demanding job that assumes the moral reformation of man as the main cause of all economic and other crises. This is sure to cause substantial water removal, and thus prevent the emergence and development of new crises.

Ibreljić Izet (2009) gives a brief synthesis of the economic-theoretical, political and today’s conventional thinking on the subject of ethics and financial crisis. The author points out that capitalism no longer represents the final form of social organization, and as such requires a revision primarily in terms of functionality, but also looks to the future. Intellectual debates with possibilities “reorganization” of contemporary capitalism and its eventual substitution are specifically brought up during the recent global financial crisis. The author says that review of contemporary literature on the subject suggests primarily on the actualization of “moralization” of modern economic life, and in some cases reactualization of earlier ideas of socialism, in which the dominant freedom, justice and solidarity are dominant. Ethics in society should in any case substitute a society in which profit is the basic criterion of existence. Research on the interrelation of the capitalist system and the emergence of the crisis of ethics requires of course, much broader elaboration of a critical mass of ethical values such as “reorganization” or evolution of modern capitalism, but also the conditions and opportunities, and rearrangement of the basic directions of contemporary global economic scene.

Fikret Hadžić and Velid Efendić (2009) analyze the main causes of the global financial crisis in terms of Islamic economics and finance. Although the prohibition of interest and one of the most basic principles of Islamic economics this paper, it seeks to emphasize the importance and the other, no less

important, principles such as the prohibition of greed for wealth and avarice, ban transactions that contain a high degree of uncertainty; gambling ban, ban scams and appropriating other people’s property, ban unacceptable way of trade, ban certain goods, services and activities, and the prohibition of funding or working with, in Islam, forbidden products and activities. The authors conclude that if the participants in the financial market complied with the principles, rules and restrictions on Islamic economics and finance, the global financial crisis would not have occurred. That means, using the principle of Islamic economics and finance can be excellent prevention for similar crises in the future.

Furthermore, Hans Küng (2009) believes that the key causes for the development of the global financial crisis in 2008. The contempt was based on ethical standards and moral values. With that in mind, the author provides a critical review of the existing global financial-market structure in terms of forgetting to moral principles and excessive profit-orientation and financial well-being as well as suggestions for overcoming the global spread of market instability.

Leire San-Jose et al. (2009) focus on a comparative analysis of the similarities and differences between traditional financial institutions (commercial banks, savings banks, insurance companies, investment funds, etc.) and ethical banks, or banks that operate according to Islamic principles, and the ethical, moral and social values. According to these authors, last world financial crisis became the questionable business of traditional financial institutions and traditional banks. Turning entirely ethical values and principles by traditional financial institutions can be a positive solution for the current financial collapse of the world. Therefore, the authors determined the four (according to them) key factors that indicate the presence or participation of morality and ethics in traditional financial institutions: information, transparency guarantees and assets or “Radical Affinity Index” (RAI). They tested this index in a sample of 119 banks in the EU.

Mehmet Akif (2011) highlights the lack of an ethical dimension, which is defined as the key cause of the global financial crisis in 2008. The author’s primary goal was to prove that ignoring ethical and moral elements of the financial and economic life can cause a huge economic crisis. Author gives a special emphasis on the Protestant ethic, which according to him, has had a great influence on the development of so-called “Casino” capitalism as we know it today, and that has led to a large-scale crisis in society. The solution to this author finds the complete reorganization and reorganization of the company.

On the other hand, Lahem Al Nasser (2009) analyze performance of Islamic banking during the global financial crisis compared with a reed in the wind "... reed writhes, twists in the wind direction with the help of the flexibility and power of their own stem roots. However, when the storm blows over, it returns to the upright position, the tall, proud and dignified". According to this analyst, Islamic banking with the international financial crisis, proceeded in the same manner in which the reeds bending in the wind. Also, research in the period since 2006 by 2009 by Parashar Sat Paul and Jyothi Venkatesh (2010), showed that Islamic banks had a better performance than the conventional banks. This study included 12 banks (6 Islamic and 6 conventional) of the GCC (Gulf Cooperation Council) group of countries (economic group composed of 6 from the following countries: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia and the United Arab Emirates), which have assets of 10 million and more.

## 2. Profit as elegy in economic life

Discussions about potential causes of ethical recent financial crisis have started extensively after its escalation and spread throughout the world. The overall situation on the world financial markets, primarily refers to the consideration of issues of ethics and morality in the economic sphere. Several occasions raised the issue and stressed that the best solution for world economic policy, theory and practice is the spiritual revival in the capitalist economic system, and the modern concept of living.

During the last three decades of research of the causes and consequences of the financial crisis were often on the agenda in many countries of Latin America, Asia, Russia, the US, etc. The forms and reasons for these crises were changed each time. However, it can be said that one aspect of their essence remained significantly neglected – ethical aspect. The fact that in most cases their occurrence wing greed as the motive, it was finally the outbreak of the global financial crisis in 2008. The emerged, competition and profit-obsession, they were creating pressure on prices, exchange rates and interest rates to come back to the market-appropriate levels, which have eliminated the usual profit margins and created market inefficiencies. Then the profit in the business, and wealth in the private life became only goal. Profit is pushed to the margins of the business ethics of business and private wealth morality of everyday life. The motives of the individual no longer remained the same as the motives of the community, in its greed for wealth, threatened the sustainable development of the whole world.

Any activity that is undertaken on the advice of neoliberal economists, for the vast majority resulted in increased poverty. For a few it was accompanied with huge profits, because they realize that they can

grow in their earnings through various speculative measures do not contribute to moral values. Neoliberalists were not satisfied with the domination of profit in the economic sphere, but at all costs introduced the principles of profit and non-market sphere, and in social activities.

Analyzing the financial crisis in the contemporary context, with the full right to conclude that this phenomenon is a moral crisis as the first, the value, and the resulting crisis of society primarily as a result of a poorly-driven paradigm that ruled the world in the last 100 years. Also, several recent escalation attentive observer of the global financial crisis has seen underneath much deeper civilization crisis and some of its very foundations, and spiritual crisis that led to the recent neo-liberal ideologies and premises which were exposed by the concept of hedonism, human greed and over-consumption. Thus, any attempt to understand the phenomenon of the financial crisis only in terms of economic science is experiencing a definite failure, because the loss of philosophical, ethical and religious causes. Specifically, economic and scientific dimension is rarely emphasized the role of the man, his ethos, behavior, instincts and interests. Thus, the causes of the financial crisis have, besides the economic, social, social and political content, neglected human dimension (Ibreljić, 2007, p. 33).

Therefore, it asks the following fundamental questions: whether it is a crisis of capitalism or is a betrayal of the fundamental values of capitalism, as it became clear that at the time of the global financial crisis has been the collapse of universal principles and rules, and to impose harsh social values? Whether it is a deliberate strategy (and/or conspiracy theory) which is carried further redistribution of wealth in favour of the richer and more powerful? Whether it is in fact, the same strategy that led to the collapse of the stability of the banking, credit, mortgage and financial system, which has caused a chain reaction and global social crisis? Will the financial crisis in the world change the behavior of *homoeconomicus*, in terms of moral values, etc. Basically, the most important generators of ethical financial crisis are:

- ◆ Phenomenon called "casino" capitalism based on printing dollars without coverage, "inflated" financial bubble by issuing risky financial derivatives, over spending measures, etc.
- ◆ Extravagance, which is especially prevalent in the consumer society in which a large number of requirements imposed, where man no longer has the desire to do something different, but is compelled to buy and spend.
- ◆ Lack of empathy and elemental feelings for another man, and enormous greed, whose proportions are not so far been seen in the history of the world.

Exploring connections between ethical and globalist capitalism is one of the most interesting topics. Whatever the long-term adaptation of arguments and/or counter-new conditions of economic life, history has not been given a definitive winner in this debate.

Table 1. Ethical versus globalist capitalism

Globalist capitalism	Ethical capitalism
Power elite and capitalistic class	Priority of human, social and ethical value
Customer society	Preservation of moral and ethical value
Profit orientation	Democracy and socialism
Profit maximization	Support for international peace
The existence of a free market	Ensuring the public goods
Neglect of social relations	Ensuring the global standard and material wealth
Class of free workers separated from the means of production	New development global institutions
Moral crisis	National capitalism
Market fundamentalism	Fair globalization
Excessive accumulation of profit	
Happiness connected with material wealth	

Source: Created by authors.

From the previous Table 1 can be seen that the basic characteristics of globalist capitalism, among other things: profit orientation, the existence of a free market and class of free workers separated from the means of production, a positive attitude towards the acquisition of profit, increasing material wealth, profit maximization, neglect of social relations, social differences (deeper gap between rich and poor countries), etc. Therefore, in a time of world financial crisis, global capitalism has proved to be unsustainable, because it is unfair, thereby producing a profound social inequality between men. Thus, we come to a conclusion about the urgent need for change in the concept of functioning of the world financial system, and therefore need more today strive for ethical capitalism that would include: freedom of entrepreneurship, state ownership, equitable and fair globalization, the national economy and national identity, banning privatization of natural resources, the creation of a sustainable environmental plan, raising middle class, poverty eradication, poverty, raise living standards of the very poor classes, free basic medical treatment, education, public administration and reducing taxes, the development of science and technology, the rule of law and democracy, spiritual rebirth, the global cooperation of and solutions to the international economic, financial and political level.

In coping with (today's) world economic crisis and recession, all eyes are focused on economic policy, and it could happen that the way out of this abyss both on the ethics of how and forgotten. The authors conclude that building a moral society in the current conditions, indeed, become imperative!

**2.1. Of morality and financial crisis in theory known economic thinkers.** Economists around the world have had for a long time to research the subject of people's behavior, their greed, and obsession with profit as potential causes of global imbalances and systemic financial crises. So the founder of modern economic science, Adam Smith assumed rational economic behavior of people in his "Theory of Moral Sentiments" published in the 1759 (Smith, 2005, p. 112). This is interpreted in a way that people are like calculators always counted the costs and benefits of their economic processes and thus choose first best solution. Such best solution for the individual was also the best solution for the company. For this purpose, the state should not interfere in economic activities, because the free market leads all in turn. In "The Theory of Moral Sentiments" Smith defines of man as an individual who is capable of making moral conclusions based on other elements, not just selfishness, by it the ability to solve this problem compassion. Now it is the basis of altruism, compassion and morality. However, he did not see any selfishness or greed as important values in capitalism, but it is believed that all areas of human activity (economic, social, moral, political and other) are mutually dependent. According to him, it is impossible to be successful in any of these areas, and ignore the others.

Economic science are well known concepts competition, the willingness to take risks, profit-obsession, etc. This economic terms, but also non-economic phenomena (alienation of workers, capitalist greed) dealt with Karl Marx in his "Capital" (Marx, 1971, p. 553) at the same time trying to uncover the essence of the contradictions of the capitalist system. In his opinion, within bourgeois society enriching its part is based on the impoverishment and subjugation of another part of it.

Furthermore, the initial discussion on the crisis of ethics or encountered in the works of Max Weber. For him, the relationship between economics and ethics have always been important to the functioning of the economic system. Weber as the founder of modern sociology has addressed the problem of erosion of moral values in early twentieth century in his famous essay entitled "The Protestant Ethic and the Spirit of Capitalism" (Weber, 2004, p. 25-29). The development of capitalism Weber largely tied to the specific characteristics of the Protestant ethic stemming Calvinism. According to him, the Protestant capitalists costs are modest, hardworking, honest and socially responsible. His motto is based on the fact that honesty is the best policy. In this capitalist system, ethics is not just a matter for the individual, his faith and conscience. Upon personal morality exists and religious community which belongs to the capitalists, and belonging to a community is the only proof of his integrity and guarantee to all who

come to him in business relations, and on the other hand not to a community probably mean the end of his business career. Weber elementary analysis was based on the thesis that the capitalist spirit marks a positive attitude towards economic activity. So, where there is this spirit, the desire for profit and growth through acquisition of material wealth will become the duty of every man. Contrary to the traditional view that economic activity is seen as something shameful or as a necessary evil, capitalist spirit entails the acquisition of material goods. This spirit does not set limits on the pursuit of wealth that fosters innovation, thrift, discipline, performance or professionalism. In fact, the capitalist spirit is the highest expression of economic rationalism (Milardovic, 2009, p. 85). It is not the property of individuals, but has become a way of life a significant portion of the population, something mundane and ordinary. It can be said that this very Protestant reaffirmation encourage the emergence of capitalism as a rational economic system because it contributed to the origin of man as an industrious and orderly, and the same type of man has created the capitalist economy.

The connection between ethics and economics was also the subject of a special investigation of Stiglitz in "Contradictions of Globalization". All its considerations about the World Bank and the IMF, globalization, transition, and the role of government in the modern economy, Stiglitz was devised on the strong historical and ethical analysis method, which can be seen in his attitude towards the role of government, which is defined as follows: ... role of government can and should be essential not only to alleviate market abortions, but also in securing social justice ... there is broad agreement in the fact that she needs to ensure that such a society and every economy functions effectively and humanely (Stiglitz, 2004, p. 229). So, according to Stiglitz, economics and ethics are not in opposition, but in unity, calling upon the attitudes father of economic science – Adam Smith about human morality and compassion as a human characteristic that reduces the dominance of personal interest.

**2.2. Spiritual life as a viable concept of defence financial crisis.** Excessive acquisition profits has led to the level of developed countries in which it is currently located. Therefore, solutions of recent world financial crisis is a social, economic and political structures of capitalism (Safrański, 2008, p. 29) studying the community, the models and the premise on which it is based, since the beginnings of capitalism, one can come to the conclusion that without a fundamental change of thinking the whole world is doomed. Change must start with the individual, who is most capable of initiating changes in society. Specifically, the system in which the supreme profit category is not

able to change it from the inside, but stimulus must come from each individual who correlated could do a new view of the world. In addition, you need a union state and the market, because he could not depend only on the market economy. It is necessary to regulate the market and its functioning, develop a preference for the general good, and generosity, and it takes a deep trust in the world's financial institutions. Therefore, the main criticism of capitalism is based on the fact of the existence of serious shortcomings of the market mechanism, and the erosion of moral values (collective interests of society, social values, etc.) at the national and international level. The global capitalist system is to allow the market mechanism, motives and obsession for profit to enter into the realm of human life in which they do not belong.

It is well known that the market value can be measured with monetary values, but what about social values? How are they measured? Is it time to man again finds true inner values? The answer to this question is partly gave Andre Compte-Sponville in his book, "Is Capitalism Moral?" (Sponville-Compte 2006, p. 11). In this regard, Sponville-Compte proposes formation of clear grounds of action, deciding and taking professional, moral and political responsibility versus various challenges imposed by the today's world of modern civilization. This author wants to offer some thoughts on the relationship of economics and morality. In his opinion, the richest and the poorest can not even get away from morality and capitalism. Before the 30-odd years ago, it was believed that the policy can replace morality. However, the error is that today people believe that morality, even renamed the Human Rights cannot replace politics. In doing so, Sponville-Compte describes a world order, with which modern civilization is facing, in the form of four orders, namely: (1) economic-technical-scientific; (2) legal-political order, (3) had to queue (duty prohibition), and (4) ethical rules – the order of love. Furthermore, he points out that capitalism is not moral, and that in the modern global financial system the government has a moral crisis, in the true sense of the word. Liberal – the capitalist mode of production functions based on selfishness, and is accompanied by a variety of structural tension between equality and inequality of wealth and poverty, and winner and lost cause, integration and disintegration that simultaneously feed their development and encourage moral issue. Regardless of whether and amoral interpreted moralistic approach to the functioning of capitalism, the previously mentioned settings of André Compte Sponvillea have today their proper place in economic theory and practice.

For the reasons mentioned above, it is considered that the moral crisis is one of those that shook the world, because it is trying to impose Western values as a global system, including ethical and moral as well

as universal. Sources moral crisis (as the global crisis) in man, the general human nature that, despite the different ethics, codes and moral upbringing, hardly improving. In any case, this discussion arises one inevitable question whether it is a potential solution to the financial crisis may have religious socialism, taking into account the basic postulates of the Scriptures? In this connection, the Islamic, but some Western authors believe that the solutions to global financial instability found in Islamic economics. Renowned expert in the field of Islamic financial transactions Šehatah Hussein believes that Islamic economic system could be a viable solution for the emerging global spread of financial instability and crisis (Mannan et al., 1992, p. 45). Also, Maurice Allais, Nobel prize-winning economist believes that the contemporary world economic system is based on some concepts that will be in the final, alone be the cause of destruction of the system, unless something changes quickly for the better (Hadžić, Efendić, 2009, p. 66). In his opinion, most of the capitalism of today is encouraging people to go for instant gratification, ignoring the long-term consequences and seeking short-term selfish demands.

Contemporary global financial crisis, we can say, expose the myth of capitalism, producing the possibility of Islamic finance system to come to the global scene. The Islamic economic system is based on the ideals, values and moral norms such as honesty, reliability, transparency, cooperation and solidarity (Ibreljić, 2009, p. 113). These moral standards are mandatory because they provide stability and security for all those involved in the world's financial transactions. However, Islamic law prohibits economic and financial transactions involving lying, gambling, cheating, taking risks, ignorance, monopoly, greed, dishonesty and unfair to take someone else's money. At the same time, Islamic economics is committed to participation in the profit, loss, money exchange and trade and real estate. In essence, there must be a real interaction between rich, employees, workers, and financial experts. No party that always gets lost or permanently, but the earnings and loss of share. Economic experts in the field of Islamic finance believe that the system of financial derivatives can bring real economic development. Financial derivatives only create money without real value, causing inflation and deterioration of moral standards and principles.

Today in Islamic countries intensify their efforts to establish a new economic system based on Sharia principles (Ibreljić, 2007, p. 34) on which the interest rate is strictly prohibited. According to some authors, out of place to think about the justification of the existence of interest (in the Bible and the Koran it is forbidden), because it is intended to retain the existing relations between rich and poor, as well as the continuity of the financial crisis. Islamic

economics stand for a fairer distribution of profits to the rational allocation and distribution of capital, speculative motives of modern capitalist economic system. As for the debt, Sharia prohibits all forms of selling debts, such as checks and selling securities with deferred payment. That is forbidden by Sharia download debts with the highest interest rate possible (because there is an interpretation that is selling the debt deepened the financial crisis). Also, the Sharia permits the financing and investment that is based on the division of profit and loss, where there is an interaction between the capitalists (the property owners) and workers. Sharia call the parties involved in the transaction to act honestly and transparently, and prohibits gharar, Jalal and unfairly taking someone else's money. Islamic oriented man puts himself in front of other goals, this means that the goal of maximizing their own pleasure to replace a view to maximize the satisfaction of God. Doing what he is allowed and recommended, and avoiding what is prohibited, it will contribute to achieving this goal. Islamic oriented person will comply with the economic principles of Shari'ah, and fear of God's punishment, it will try to adjust their economic behavior. Respecting the principle of moderation, he will also try to avoid stress as a widespread disease of modern man. In addition, should avoid excessive and wasteful consumption. They will realize that only by persistent, long-term commitment they can acquire the necessary material resources for themselves and their families. Will forgo consuming products which God forbid, such as alcohol, drugs, and other drugs.

These examples of Islamic-oriented economic behavior of man are in stark contrast with modern economic theory. However, it is also the Islamic economy what makes it different from the traditional one. In fact, the Islamic economy is characterized by the effort to the economic theory of the ethical and moral principles of Islam as a religion. In this regard, we can say that most of the activities that directly led to the global financial crisis, are prohibited in the group, analyzing them in terms of Islamic economics and finance. Experts who support Islamic economic principles emphasize their sense of equality and benefits to the wider community. While some see the Islamic model as an alternative, others see it as a complementary system to the Western world. There are deep-rooted opinion that the Islamic way of doing business is limited mainly to the Islamic countries. However, Islamic finance has long been engaged in the world's biggest banks and financial institutions that have established specific affiliate. Successful Islamic banks looking to expand their businesses out of the market in Muslim countries. For them, the time when the global financial crisis proved to be ideal.

**2.3. Islamic financial system and global financial crisis.** Previous studies have shown that the financial assets in accordance with Islamic law increased from 5 billion dollars in late 1980s to about 1.2 billion dollars in 2011. These assets, which is the main characteristic of the division of risk between financial institutions and customers, has avoided much of the worst effects of the global financial crisis that started in 2008. Because of these results, but, of course, and other important characteristics of Islamic finance are increasingly popular today.

Leading economists like Kenneth Rogoff and others, are considered to have the advantages of Islamic finance in the form of equity capital and risk-sharing in relation to conventional propensity for debt instruments. Islamic financial institutions during the crisis, has remained rather stable for a few specific determinants, as follows (Štulanović, Hadžić, 2007, p. 4):

- ◆ Emphasize the importance of Islamic finance capital support, thus ensuring a direct correlation between financial transactions and real economy. Thus, these institutions are savings and investment returns are closely linked, because they are determined exactly realistic, and not the financial sector. This creates a flexible mechanism to adapt to unforeseen shocks or crises, and provides continuous real equity capital and the value of debts. At the same time prevents excessive debt financing, as well as several forms of complex securitization.
- ◆ Islamic finance are largely unbiased, which means that lenders and borrowers to share risks and gains, increasing the focus on long-term goals and discourages excessive short-term involvement in the risks.
- ◆ Islamic financial institutions by their customers treated as business partners. It is important to note that they have strong incentives to evaluate significant financial requirements and help borrowers who find themselves in trouble, thus reducing the pressure for asset sales or capital at too low prices, and minimize the likelihood of financial contagion outbreak.
- ◆ Islamic financial system protect “deposits balance” banking institutions and prevent excessive growth of loans.

Islamic financial instruments at present in at least 70 countries around the world, and represent about 0.5% of world contemporary global assets. However, as things stand, the chances continue their rapid growth. Specifically, in the report “Global Islamic Banking Report” from December 2011, Deutsche Bank has forecast annual growth of Islamic common assets of 24% over the next 3 years. According to its knowledge, there are several main rea-

sons for this forecast (Global Islamic Banking Report, 2011, p. 5-6):

- ◆ Islamic finance offers savers and investors practical alternative to conventional instruments. The quality of their financial services are constantly improving and they are not reserved for certain clients.
- ◆ The usual multinational financial institutions increasingly have to offer and Islamic capital, so the interest in it in London, Luxembourg and other world financial centres increasing.
- ◆ Rapid development of commodity markets in certain Muslim countries has caused the creation of surplus to be distributed through financial intermediaries and government financial funds.
- ◆ Islamic financial instruments comply with Sharia, Islamic religious law and moral, and send signals about changes compatible with the latest developments in several countries with a majority Muslim population.

Despite the aforementioned specifics, it is considered that the potential of Islamic finance requires substantial supervision and regulation. Financial institutions need to step up inspection before issuing loans and supervision after borrowing. The problem is that in many countries debts have preferential treatment in taxation, which again, is in favor of debt rather than equity and agreements on the division of profits and losses. Also, the Islamic mortgage finance, insurance and microfinance are not sufficiently developed, the need to improve procedures related to insolvency and bankruptcy, and should establish mechanisms for action due to being unable to repay the debts. Finally, Islamic financial institutions should address the uncertainties regarding liquidity risk management, compliance with the regulations laid down Basel III, and international accounting standards and rules of business management.

Thus, it is clear that only a reasonable risk management in Islamic finance can greatly determine his future success and development. If you successfully resolve existing shortcomings, Islamic finance could spur major growth in many developing countries. Resolve the key regulatory issues as well as problems related to the management of the business, they certainly have the potential to meet the banking and investment needs of a larger number of people, contribute to greater financial stability, and involvement in the developing world.

### **3. Comparative analysis of conventional and Islamic banks during the global financial crisis: general indications**

It is clear that the activities that led to the global financial crisis with the forbidden aspect of Islamic

economics. Man, in modern conditions of life, trying to earn as much in a short period of time and thus maximize their satisfaction. This is why people often eat quickly and easily earn an income, which in most cases is unauthorized in terms of Islamic finance. This strong desire for material goods is the main generator of the financial crisis. The Islamic economic system is treated equally both materially and spiritually, seeking a middle path, because the exaggeration is both unauthorized and unacceptable. Although the majority of people of Islamic Banking and Finance is only related to the prohibition of interest, it is only one segment of the Islamic financial institutions. Islamic banks have a variety of products that are increasingly attracting and conventional banks are beginning to offer their customers certain products with growing interest of in Western and Eastern Islamic economic systems.

The Islamic financial system has proved to be a viable alternative that does not generate a crisis, and what is Islamic banks survived the crisis is and that they did not invest money in risky western financial products. Somewhat surprisingly, Islamic banking had seen the biggest rise just in time for the global financial crisis, when most conventional banks collapsed. Different principles of Islamic banking has shown that this type of bank is extremely resistant to the crisis. The differences in the behavior of conventional and Islamic banks during the global financial crisis can be summarized in tables in the following way.

Table 2. Behavior of conventional and Islamic banks during the global financial crisis

Conventional banks	Islamic banks
Bankers greed	Prohibition of greed for fortune and nearness
Naked short sale	Prohibition of transaction with high level of uncertainty
Short sale of shares	Prohibition of fraud and appropriation of someone else fortune
Gamble on price of real estates	Prohibition for gambling
Securitization	Prohibition selling debt for debt
Bankers using drags	Prohibition using drags
Interest payment to banks for long-term debts	Prohibition for using interest
Using bonds	Prohibition for using financial instruments with high level of uncertainty

Source: Hadžić, Efendić (2009, p. 169-174).

The financial crisis, which is primarily disrupted the functioning of the U.S. financial market, and immediately after it, and all other financial markets in the world, has once again demonstrated the benefits of Islamic banking. Problems in the conventional banking crises have led to decision in the principles of Islamic economics, which can be further seen from the following Table 3.

Table 3. Problems and solutions cause the global financial crisis

	Conventional banking	Islamic banking
Profit maximization	In desire to have a lot of credits they forget ability of repayment	Doesn't have priority for profit maximization
Securitization	Multiplication of selling debts	Prohibition
Financial derivatives	One of the causes of the financial crisis	Prohibition – one of the reasons why crisis didn't reflect on Islamic banks
Risk sharing	Client have to take risk of losing his money for realization of their business	Banks share risk with their clients
Profit sharing	Banks can predict their profit by using interests, besides of success of the project	Banks are sharing profit with clients depending on their concernment in project
Non-performance loans	Their expansion is one of the causes for uncontrolled and overly borrowing	Prohibition – every financial activity have real estates in their background

Source: Bukvić (2010, p. 2).

Conventional banks have become more reliant on high levels of provision of loans by collateral, while very few entered the financial analysis of clients. Loans from conventional banks were able to get all those who were able to come back regularly borrowed money and interest, regardless of whether they had a permanent job, or if they could prove that they will be able to return the borrowed money. In case inability to repay a loan, the bank simply took the collateral and the clients were going out the purchased property. Islamic banking completely forbids these transactions that are based on non-purpose loans and transactions that have behind them some real value. Although most conventional financial institutions, and between them and conventional banks, struggling for survival, Islamic banks are still resistant (resistant) to the crisis, while some of them recorded an increase in profit. Some of the reasons for this are that most Islamic financial institutions do not deal with those aspects of operations that lead to the crisis, most Islamic banks have adequate liquidity, most clients of Islamic banks are honest and for years supported the bank in times of crisis, most banks have excess funds and have problems related to liquidity (especially Gulf Bank), etc.

Total losses associated with the crisis “delete” a significant portion of capital from the world’s banking system, which ultimately led to the decreased amount of credit available to companies and households. What are the real effects of the mortgage crisis is still difficult to assess. As the extent of the financial crisis is very large and is deeply influenced by the global financial market. Increasing the price of gold at a very high level is one indicator of unsafe environment, which is why this crisis is often



compared to the great depression of 1929, which began in the U.S. (at that time the United States experienced severe damage and unemployment peaked). For years, the U.S. has remained under the influence of this crisis, and it is believed that it will be with the current financial crisis. At the beginning of 2009, on 9th January, the Nobel prize-winning economist, Paul Krugman, cited in the New York Times, the most influential magazine, this view of the U.S. and world economic situation (Letica, 2010, p. 3): "... the fact is that the current economic indicators are not terrible in the United States, but around the world. Industrial production falls everywhere. Banks do not lend, businesses and citizens consume. Not mincing: this [current economic recession] looks an awful lot like the beginning of another Great Depression".

It can be concluded that Islamic economics is strictly forbids all that led to the global economic crisis, so that Islamic banks (more than 350 of them in 80 different countries) achieved dizzying success in 2011 because their funding billions amount to 1,000 dollars, which is 18% higher than a year earlier.

Financial consultant of Belgian bank branch Chaab (SABI), Mohamed Bulif explained it by saying: "Muslim banks operate according to Sharia principles, and that means honestly and responsibly. Our banks avoid interest and are socially responsible because they do not deal with funding or in any way participate in the production of and distribution of alcohol, drugs, pornography, prostitution, gambling, tobacco, media and media programs and movies that promote violence, perversity and immorality, or weapons or anything else for which science has established that harms man" (<http://www.haber.ba>).

Renowned expert on Islamic banking, Michael Saleh Gassner, raises the question: "Are we really to believe that the financial crisis could have been avoided Islamic banking?" To which I shall respond by saying: "not for believe, if you look at what rules apply." One of the most important rules is the prohibition of interest. If you take the example of German or U.S. government debt, these are debts that have been increasing for a year. The second rule is that it is permissible to take a loan and therefore may require money, that kind of income, but it must be a job that is based on the real rules of market economy. That is, it is necessary to analyze in detail the work that it intends to invest (<http://www.haber.ba>).

It is this detailed analysis of which Gassner says is what matters most when approving loans. That in the United States analyzed the conditions for granting loans, the crisis could be avoided. Also, the Sharia board, which oversees the work of Islamic banks, approving contracts and new bank products and control their use, consumption approves humanitarian fund, and takes account of the application of the

Shariah in all business activities of the bank, is one of the reasons why the Islamic banks had better performance during the global financial crisis compared to conventional banks. In addition, the fact that these banks do care about transparency, is one of the advantages of Islamic banks (<http://www.rijaset.ba>).

According to Jakovčević Drago, Professor of the Faculty of Economics in Zagreb, there are two reasons why Islamic banks more resistant to the crisis than conventional banks, namely: first, the Islamic banks are not greedy bankers, and secondly, the Islamic banks have a broad deposit base, so may not be too vulnerable in the event of massive withdrawals of deposits and savings is crucial for each bank. (Jakovčević, 2009, p. 39).

**3.1. Empirical research (with special review on (Islamic) banking sector of Bosnia and Herzegovina).** The global financial crisis has not bypassed the bank in Bosnia and Herzegovina. An important factor in the crisis in our country is to raise the lending criteria by banks, which dealt a severe blow to investment, and consumption of durable consumer goods. Experts in Islamic finance in our country believe that adherence to the principles that underpin Islamic banking could mitigate the current global financial crisis. In Bosnia and Herzegovina, currently operates only one Islamic bank, Bosnia Bank International (BBI), which seeks to implement Islamic banking, although the Banking Law in our country allows that Islamic banking can be applied in a very small capacity.

Regarding to already mentioned the *main object of this research* is to analyze what is the relationship between conventional and Islamic banks in Bosnia and Herzegovina during the global financial crisis. Actually, the *research question* of the study is to explain and to show that in our country consider adherence to the principles underlying Islamic banking could mitigate the consequences of the global financial crisis. To be concrete, the *main research question* of the study is to show the relationship conventional and Islamic banks in Bosnia and Herzegovina to risks, as one of the main causes of the global financial crisis.

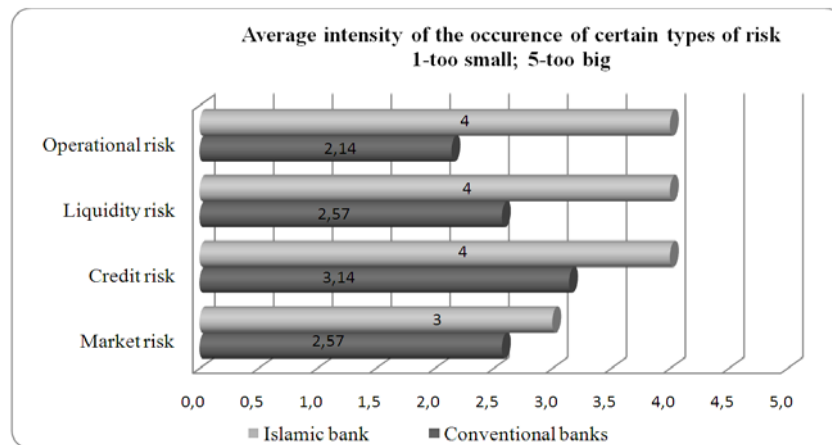
Primary research for this paper was based on the application of writing the test method, in which the data were gathered on the basis of a questionnaire. Survey questionnaires are delivered to all banks in B&H, totalling 29 (of which only one Islamic and all others are conventional). This research seeks to show the relationship between Bosnian conventional and Islamic banks to risk, as one of the main causes of the global financial crisis.

The results that were obtained in this study reflect the fact that there are some limitations, such as lim-

ited application of Islamic banking or comparing methods of risk management of a bank compared to the average of the other eight respondents conventional banks.

When it comes to the intensity of the action of certain types of risks in conventional banks and Islamic Bank, there are certain differences. In Figure 1 can be seen that Islamic bank has greater intensity to report all types of risk. The intensity of respondents reporting risks in Islamic bank are listed in the follow

ing types of risk: credit risk, liquidity risk and operational risk, and market risk are said to have a “medium” intensity of appearance. Conventional banks have a lower intensity of reporting all risks in relation to the Islamic bank. All risks of respondents said they have a “medium” intensity of appearance. As one of the other risks that are present in the banks, conventional banks have led the foreign exchange risk, which stated that there were “small” intensity of occurrence, but that has an impact on the bank’s operations.

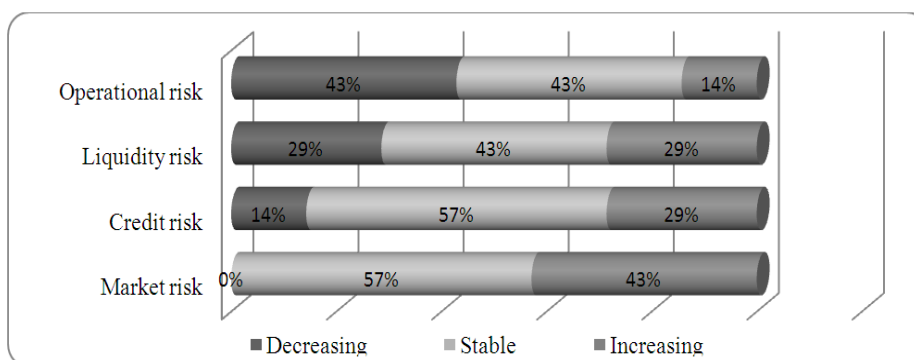


Source: Created by authors.

**Fig. 1. The intensity of the occurrence of certain types of risk in Bosnian conventional banks and Islamic bank**

When it comes to the trend of certain types of risks in banks in the past three years, respondents from Islamic banks have stated that all risks have been stable over the past three years. So, although there are a large intensity for all types of risk, the bank keeps them at a certain level and stop them from increasing. In conventional banks, the situation is somewhat different for each type of risk 57% of respondents say that market risk is stable and 43% that it is on the rise. As for the credit risk 14% of respondents say that it decrease to 57% stable, and

29% of that is on the rise 29% of respondents believe that liquidity risk it is decreasing or increasing, and 43% say that it is stable. Operational risk for this type of bank is reduced according to the 43% of respondents. The same percentage believe that this risk is stable in their banks, while 14% of respondents believe that this risk is increasing. For foreign exchange risk, which is listed as one of the major risks in conventional banks, the majority of respondents indicated that it was stable in the last three years.



Source: Created by authors.

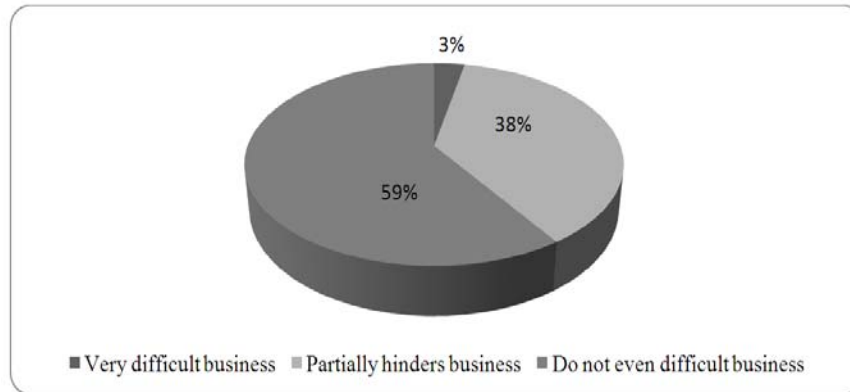
**Fig. 2. Trend in the risk of certain types of conventional banks**

Active risk management for individual types of risks banks made 75% since inception, while 25% of banks with active risk management starts a few years after its founding. According to the state-

ment of the respondents, the process of active management of all types of risk leads to improved financial performance, and enables to avoid significant losses in the business. All respondents said

that most of the total risk (59%) do not even difficult business and the banks so far been able to control these risks. A smaller proportion of total risk (38%)

is in partially hinders business, and only 3% of all the risks is in very difficult business and banks have big problems in managing these risks.

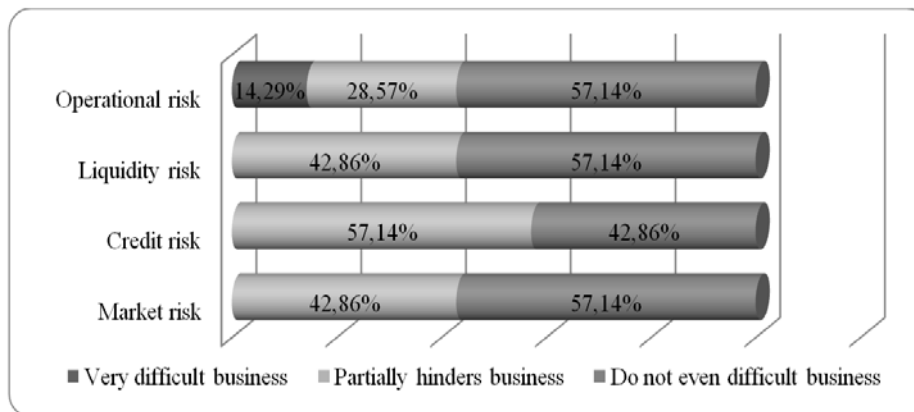


Source: Created by authors.

**Fig. 3. Influence of overall risk to the business of banks in B&H**

However, the impact of certain types of risks to the business of conventional banks is not the same, as can be seen in Figure 3 for Islamic banks, respondents to respond to all kinds of risks that they gen-

erally do not hinder business. The main reason for this lies in the fact that Islamic banks use different principles of operation and use different types of products.

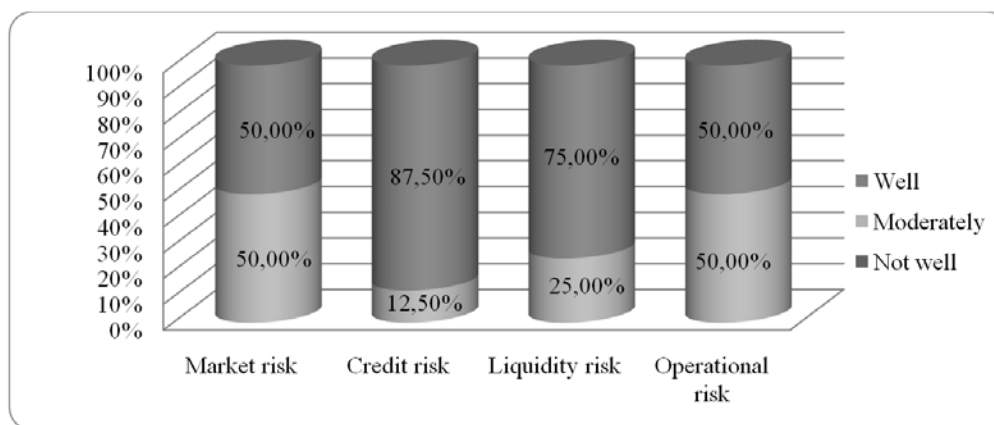


Source: Created by authors.

**Fig. 4. The influence of certain types of risks to the business of conventional banks**

The global financial crisis has brought into question the survival of many banks, and in this study, among other things, sought to investigate how BH banks, is trained to manage risk in such conditions. As we can observe from Figure 5 none of the participants said that his bank was not well trained to handle any kind of risk, which is a very positive/commendable of Bosnian bank. With some types of risks, banks are best equipped to manage credit risk (87.5% of respondents said that they are well trained to manage this risk, while 12.5% of respondents indicated that the moderately trained). To manage liquidity risk, 75% of respondents believe that they are well-

trained, and 25% of them are moderately trained. This fact is very important in terms of global financial crisis, which has largely contributed to the inadequate management of credit risk and liquidity risk. For market risk and operational risk the results of the survey are the same. 50% of respondents believe that their banks are well trained to manage these risks, while 50% said that their bank moderately trained. The survey showed that Islamic banks are well equipped to manage all types of risk, whereas most conventional banks properly equipped for credit risk and liquidity risk, and moderately trained to market and operational risk.



Source: Created by authors.

**Fig. 5. Current ability of banks to manage identified risks**

As possible causes of the increase in the level of risk in banks, respondents indicated the financial crisis, the increase in funding sources, the possible collapse of euro, illiquidity of the economy, reduced access to capital, deposit withdrawal, strict requirements of the Banking Agency of the Federation B&H and Republic of Srpska, the outflow of experts and etc.

Based on the foregoing it can be concluded that all the banks in B&H quite well acquainted with the necessity of active risk management, but they still do not have a sufficiently developed methods to manage the risks. As for the differences between conventional banks and Islamic banks in the country, the Islamic bank is exposed to more risks than conventional banks, mainly due to the special products that the bank offers to its customers. Also, certain hedging instruments are less available, and mostly limited to the Islamic bank. However, a special way of doing business and actively manage risk allowed the Islamic bank to exercise favorable financial results and to be competitive with other conventional banks.

## Conclusions

Having in mind all the above objectives of research, the authors can conclude the following:

- ◆ The basic ethical generator of global financial crisis is egotistical greed for personal wealth in large scale. So, there is a need to develop a humane approach to globalization as an alternative concept of neoliberal capitalism.
- ◆ To develop ethical capitalism that would have the following determinants: the priority of human, social and ethical values of economic, maintaining ethical and moral values so-called *democratic socialism*, supporting international peace, the provision of public goods, ensuring global standards

and material well-being, new development of world institutions, develop so called *national capitalism*, fair globalization, etc.

- ◆ A proposed main research in this paper, which refers to (Islamic) banking sector in B&H, where authors tried to show the relationship of conventional and Islamic banks to risks, as one of the main causes of the global financial crisis. The results are: for Islamic banks, the respondents to respond to all kinds of risks that they generally do not hinder business. The main reason for this is the fact that Islamic banks use different principles of operation and use different types of products. The research showed also, that Islamic banks are well equipped to manage *all types of risk*, whereas most conventional banks are well qualified for the credit risk and liquidity risk, and moderately trained to market and operational risk.
- ◆ All the banks in B&H are quite well acquainted with the necessity of active risk management, but they still do not have a sufficiently developed methods to manage the risks.
- ◆ As for the differences between conventional banks and Islamic banks in the country, the Islamic bank is exposed to more risks than conventional banks, mainly because of the particular products that the bank offers to its customers. Also, certain hedging instruments are less available and mostly limited to Islamic banks.
- ◆ However, a special way of doing business and active risk management has enabled the Islamic bank to obtain favorable financial results and to be competitive with other conventional banks.

The International Monetary Fund (IMF) estimated that in the period from 2007 to 2009 the lost value of assets associated with bad mortgage securities exceeded one billion dollars. Estimates of the Fund also foresee how it will be as a result of the mortgage crisis in the future still have to write off at least 1.5 billion dollars. Therefore, most countries of the world has agreed to

<sup>1</sup>[http://hr.wikipedia.org/wiki/Svjetska\\_financijska\\_kriza\\_od\\_2007.\\_godine](http://hr.wikipedia.org/wiki/Svjetska_financijska_kriza_od_2007._godine) (Accessed: 15 March 2012).

the following measures that are supposed to alleviate the effects of the global financial crisis<sup>1</sup>:

- ◆ greater control rating agencies;
- ◆ greater regulation of speculative funds and other previously unregulated financial products;
- ◆ the definition of evaluation standards for complex financial products;
- ◆ increase of capital in financial institutions;
- ◆ harmonization of accounting and auditing rules;
- ◆ the orientation of incentive systems for managers in medium-term objectives;
- ◆ protection against unfair competition “tax oases”;
- ◆ strengthening the IMF;
- ◆ better protection of consumers through transparent information, etc.

A lot of the facts that show that the application of the principles of Islamic banking, if it would apply to conventional banks, led to mitigate some of the effects of the global financial crisis. Naturally, the application of these principles cannot fully resolve the crisis, but in any case it can help more easily overcome. Banks need to be more “turn” diversified sources in the financial sector, and greater use of capital and invest that capital into projects that will result in the creation of real value, which in turn should be consistent with the volume growth of the real economy.

The main risks for the B&H banking sector and region lie in the possibility of the crisis spilling over from the countries of origin of foreign banking groups and the EU. What is needed for banks in

B&H is to achieve adequate liquidity to avoid systemic risk. This can be done with proper capitalization of each bank and the holding adequate amounts of cash in their vaults. Also, adequate lending of each bank, avoiding unfair competition, and appropriate communication with internal and external public relations are basic factors for risk avoidance and prevention of crisis spill over from neighbouring countries into our country.

What banks in B&H can do *to reduce the negative impacts* of the crisis on their business and also to avoid the emergence of new crises is the following:

- ◆ to coordinate the growth in loans and total volume of financing with an increased risk, as it would not take too much risk a bank cannot bear;
- ◆ ensure that all newly approved loans subject to monetary policy measures and measures of control and surveillance;
- ◆ ensure that the increase in the market share of the bank is a result of economic growth rather than speculative behavior, which in most cases is caused by collapse of the entire financial system;
- ◆ to improve the provision of liquidity management policies at the level of each bank;
- ◆ to improve the quality of management and supervision in banks;
- ◆ to increase the transparency of operations of any bank;
- ◆ and the last one, to improve the quality of bank supervision in order to determine all possible unstabilities in banking sector

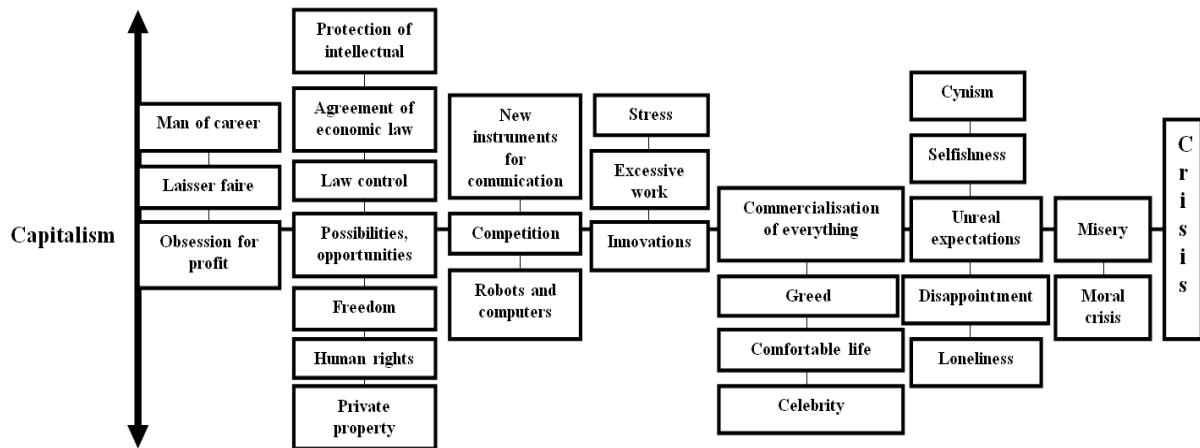
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**Appendix**



Source: Stojanović (2008, p. 9). Innovated by authors.

**Fig. 1. Scenario development of “casino” capitalism**