



**A STUDY OF CUSTOMERS' PERCEPTION ON THE
CODE OF ETHICS OF ISLAMIC BANKS IN MALAYSIA**

BY

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ABSTRACT

In the present growing world of banking business, code of ethics has become one of the main tools for its prospects to govern the business and enhance the external image of the bank towards the customers. Islamic Banking is on a phase of rapid growth and their Islamic ethical business character is a core aspect for their existence which focuses on the ethical dimensions to address the social problems like poverty and inequality, which conventional banking system has failed to offer. This research aims to study the published code of ethics from Islamic Financial Services Board (IFSB) with those of existing ethical codes in Islamic financial institutions. The study also examines the extent of which these principles are been adopted by the employees of IB in Malaysia through the perception of their customers. A Qualitative research methodological approach is performed by studying and analyzing IFSB code of ethics. As a part of Quantitative approach questionnaires were prepared and distributed among IB customers in Malaysia. The research findings shows that many IB practitioners believe that IBs are lacking ethical codes in their system, however based on the customers' perspective, the study found positive results in favor of IB employees that they practice and characterize themselves with morality and posses' high ethical standards when dealing with their customers. This minor research is expected to help the existing IBs to inspect and adopt the true value of Islamic code of ethics in their system.

ملخص البحث

في وقت تشهد فيه البنوك المصرفية ثورة كبيرة في عالم المال والأعمال، أصبحت مدونة قواعد السلوك واحدة من الأدوات الرئيسية لتنظيم هذا القطاع المهم ، وتعزيز الصورة الأخلاقية للبنك تجاه العملاء. من جانبها تشهده المالية الإسلامية وأسواقها في أقطار العالم اهتماما كبيرا وإقبالا منقطع النظير لهذه الصناعة. وبما أن الهدف الأسمى من ظهور البنوك الإسلامية هو إبراز الطابع الإسلامي الأخلاقي وذلك من خلال التركيز على النواحي الأخلاقية لمعالجة المشاكل الاجتماعية مثل الفقر وعدم المساواة، الذي فشل النظام المصرفي التقليدي تحقيقه. يهدف هذا البحث إلى دراسة مدونة قواعد الأخلاقيات والسلوك الوظيفي التي تتبعه البنوك الإسلامية في ماليزيا وخاصة الصادرة من مجلس الخدمات المالية الإسلامية دراسة نوعية وهذا هو القسم الأول. والقسم الثاني عمل دراسة كمية وذلك باستطلاع مدى توافق ممارسات الموظفين و العاملين في البنوك الإسلامية لهذه المدونة من عدمها ، من خلال استقراء رأي عملاء هذه البنوك. توصلت الدراسة الى أن البنوك الإسلامية في ماليزيا تفتقر برأي الباحثين والعاملين في هذه المؤسسات الى تبني مدونة قواعد وسلوك إسلامية ، لكن من جهة أخرى توصل الباحث الى نتائج إيجابية تصب في صالح منسوبي البنوك الإسلامية بشكل عام و تثبت اتصافهم بحس أخلاقي رفيع وتعامل راق مع عملائهم. وانتهت الدراسة بعرض بعض أهم الإقتراحات و التوصيات.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to the acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

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DECLARATION

I hereby declare that this Research Paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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MALAYSIA**

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I hereby dedicate this Research Paper to my beloved Parents.

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CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

Islamic banking business has grown rapidly and achieved prominence within the framework of global finance industry. According to the world Islamic banking competitiveness report (2012) by Ernst and Young, Islamic banking has experienced phenomenal growth with total Islamic financial assets around the world having exceeded \$1 trillion from a humble beginning capital base of \$10 billion in the mid-1970s. The report further stated that Islamic banking has in the recent times grown from 1.3 trillion in 2011; recording an average annual growth of 19%. This is especially true for the commercial ones who have maintained a steady growth in the last three years. The positive growth of about 50% over the overall banking Industry has been consistently recorded. Meanwhile, it is forecasted that Islamic banking assets will grow to even beyond \$2 trillion by the next year 2014 (The World Islamic Banking competitiveness Report, 2012).

However, many scholars have argued that despite the persistent growth in Islamic finance, it still falls short of some basic objectives. Islamic banking, similar to the conventional banking, carries out financial intermediation services which involve channeling funds from surplus sector to the deficit sector for productive activities. The fundamental relationship between the two sectors is debt-credit relationship that demand proper appraisal of the creditworthiness of the customer and the project itself. Here

lies the professional responsibility of the practitioners to conduct the due diligent and due process appropriately to facilitate constructive engagement between the banks and the customers. In situation where the bank employees engage in unwholesome practices such as committing fraud and manipulation in the financial transactions, this could invariably put the bank's customers in particular and in general the public in financial distress. Undeniably, the conventional financial system is fraught with several weaknesses which allow the practitioners to behave unethical. Perhaps the underline ethics and virtues of capitalism, an ideological path that produced the banking system is mostly driven by greed and often disregard of well-being of the society(Jani, Hamat, & Hassan, 2013). Expectedly, this drive for greed could influence the bank employees as mentioned earlier. According to Hassan et al (2013), the crux reason for the failure of several number of large and prominent financial institutions (i.e. Lehmann Brothers) are basically pinned down to the unethical practices of the market players, whereby the weak linkages inherent in the system are exploited maximally to satisfy their greed.

The emergence of Islamic banking ideally is to serve as viable alternative to the intermediation performed by the conventional banks, by offering different spectrum to the current practices whereby the unique features of it must be adhere to Islamic laws and principles. Correspondingly, it is important to note that ethical virtues are an aspect of Islamic value that is clearly provided in the Quran and Sunnah teachings. Islamic banks is perceived to have superior ethical values derived Islamic principles and rules that can serve as an ethical compass for the overall financial industry. This perception is in line with the thought that Islamic finance being firmly rooted

in Islamic principles and rules should promote social order, social justice as well as economic prosperity (Siddiqi, 2004)(Ahmed, 2012).

From the foregoing, it is imperative that the establishment and enforcement of ethical standards and code of conduct guide by Islamic laws and principles will help address the vices and other weaknesses in the existing practices particularly among the Islamic banking practitioners since most Islamic bank still adopting the ethical standards stipulated for the conventional banks. Understandably, ethics (*Akhlaq*) is a fundamental part of Islamic laws and principle (*Shariah*). According to (Lahsasna, 2013) the adherence to ethical code and standard that protect the integrity and support efficiency of the institutions will in the long run promote right conduct, behavior, brotherhood, mutual assistance and cooperation between the practitioners and the public. Therefore, the value proposition of Islamic banking and finance dictates that the practitioners must be an example of honesty, integrity and highest moral standards of behavior and conduct that define their credibility in all their dealings and in society at large.

Although achievable, it is been noted by researchers, that despite the claim of the Islamic financial institutions to provide more ethical financial services, there is disconnect between moral conducts and the exact modes of implementing the financial transactions. Meanwhile, many also criticize the discrepancy of Islamic financial institutions, how they overstress their standing on *Shariah* regulations in the advertisements, instead of putting into practice appropriate ethical standards that governs Islamic finance. Moreover, researchers discovered that, there are contradictions between the communicated ethical identities of many Islamic banks' annual reports and

the ideal ethical values that based on the framework of the Shariah moral (Haniffa & Hudaib, 2007).

World over, Code of Ethics and Business Conduct is not only seen as an expression of commitment to integrity, but it also represents the guiding values of organization and helps to instil ethically sound behaviour and accountability among all corporate bodies (Davis, 2013). Therefore, (Daras, 2013) states ethical standards are an important element in Islamic finance to meet its growing demand besides its complexity in market structure and other risks.

According to financial services on an effective code of conduct for banking (2006), a code of conduct or better put ethics policy should address pertinent issues which include among others:

- Safeguarding confidential information
- Ensuring the integrity of records
- Providing strong internal control over assets
- Providing candour in dealing with auditors, examiners and legal counsel
- Avoiding self-dealings and acceptance of gifts or favours
- Observing applicable laws
- Implementing appropriate background checks
- Involving internal auditor in monitoring corporate code of conduct or ethics policy
- Providing a mechanism to report questionable activity
- Clear penalties for a breach of the code of conduct or ethics policy
- Providing periodic training and acknowledgment of policy

- Periodically updating policies to reflect new business activities

Consequently, the above mentioned guidelines are implemented to achieve best practice in all corporate organizations especially financial institutions such as banks. Therefore, we can conclude that fair and ethical practices by all parties and stakeholders (i.e employees, customers, management, shareholders, communities, etc) involved within the banking institutions are a fundamental rallying-point to support the mission and business operations of the banks.

1.0.1 Codes of Ethics and the Banking Practice in Malaysia

Generally speaking, human beings appreciate the need for fundamental ethical values and so developed certain values to guide their affairs. This explains why a host of corporate bodies and institutions particularly in the developed worlds and also in any conventional setup, efforts have been made hitherto to introduce ethical standard into their corporate activities. In Malaysia, for instance, the conventional banks under the umbrella of Central Bank of Malaysia or Bank Negara Malaysia (BNM) have instituted a code of conduct bureau that oversees the activities of all stakeholders at individual level as well as corporate. Although whether or not this code has produced the desired result is a debatable, its availability has continued to serve as check and balance for the stakeholders in the financial institutions.

The Malaysian financial system and especially the banking institutions in particular which are highly regulated by the (BNM) are mandatory to follow the guideline on code of ethics BNM/GP7 1994 (BNM, 2001). This guideline is set and required to be observed by the directors,

officers and employees of the licensed institutions under BNM. BNM/GP7 is instrumental to affect the banking governance in order to increase the awareness among the board members about their responsibility towards the issue of conflict of interest in self-dealings and transactions (Lum Chee Soon, 2005). This guideline's main goal is to insure and maintain the integrity and credibility of financial institutions across the following six principles:

- 1- To avoid conflicts of interest.
- 2- To avoid misuse of the Occupation.
- 3- To prevent the misuse of information that has been collected through the banking institution.
- 4- To ensure the completeness and accuracy of the relevant records
- 5- To ensure the confidentiality of communications and transactions between the banking institution and its customers.
- 6- To ensure fair and equitable treatment for all customers” (Graduan, 2012).

In the case of Islamic financial Institutions (IFIs), no doubt, they are meant to be the foundation of promoting the ethical base business activities, and that is the main reason for their existence. However, unfortunately, in Malaysian Islamic banking system, especially the individual Islamic banks, they have no desire to codify a formal system or a set of clear rules of behavior and conduct that people have to commit and follow in the work place, in both personal and professional dealings. Additionally, Islamic banks in Malaysia are adopting and applying BNM/GP7 guideline along the line with their conventional counterparts. Although the BNM corporate governance gives the freedom and allows making changes and formulating

more comprehensive guideline to the suitable condition that fit any particular institution (BNM, 2001), however, since the overall set of rules on ethics in such guidelines are primarily meant and based on the conventional best practice, and cannot serve the uniqueness of the Islamic ethics and moral values.

On the other hand, the international Islamic financial organizations have made an effort to produce and publish codes of ethics for the directors, supervisors and employees of Islamic financial institutions (IFIs). In fact, the aim of which is to enhance the ethical behavior culture and promote more Islamic moral design to the institutions which offer Islamic alternative business activities around the globe. Among those are, Islamic Financial Services Board (IFSB, 2009), and the Accounting and Auditing the International Financial Institutions (AAOIFI, 2002).

1.0.2 Islamic Financial Services Board:

Islamic Financial Services Board (IFSB) is the international standard-setting organization that aims to promote and enhance soundness, safety and stability for the Islamic financial services industry. In order to meet that goal, they issue global prudential standards and guiding principles for the industry of IFIs. IFSB started to operate since 2003, and it is been hosted by Malaysia, which is one of its founding countries. In fact, its establishment was also been facilitated by the International Monetary Fund (IMF) in order to tackle and assure fitting regulatory framework, new financial instruments and institutional arrangements to provide an enabling operational environment for Islamic finance (Errico, 2002). Moreover, the areas that have mainly been on

the focus are banking, capital markets and insurance sectors (Takaful). Also, according to the IFSB's main website on internet, it says that, they coordinate researches and conduct initiatives on issues related to the IFIs, as well as they organize round tables, seminars and conferences for regulators and industry stakeholders (IFSB, 2010).

1.0.3 The IFSB's Codes of Ethics of:

One of the products of Islamic Financial Services Board (IFSB) is codes of conduct, which been named as (Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services). The Council of IFSB had waded and affirmed at its ninth meeting held in Jeddah in 2006 the initiative to form a working group for the establishment of a code of ethics for the Islamic financial institutions. Additionally, the aim behind promoting this was to develop a framework that completes and "add value" to the other existing frames in the same regard, which has been internationally adopted, and based on a sound behavioral principles of best practices, doing so, by injecting and taking into consideration the particularity and specialty of Islamic financial services industry. And it was finally published on 2009 (IFSB-9, 2009).

1.1 PROBLEM STATEMENT

Despite the growth of Islamic banking system in Malaysia coupled with the latter's role as Islamic finance hub in the Southeast Asia and its recognition in the global international market, there has been hitherto no specific code of ethics guiding the stakeholders in Islamic banks in Malaysia. The absence of

this code has been worrisome to some practitioners and industry players. In fact Islam categorizes ethics (Adab) as an integral part of a Muslim and regards it as an important element of Shariah makes it mandatory on us to include such in our dealings especially in the financial sector(Musa, No date).

However, the Islamic Financial Service Board (IFSB), an international organization based in Kuala Lumpur Malaysia has come up with a code of ethics guideline which is supposed to guide all the stakeholders in Islamic financial institution in Malaysia and abroad. The IFSB's codes of conduct (Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services) serves as a saving grace for Malaysia and other countries that do not have any existing Islamic code of ethics in their institutions to adapt, adopt and practice the code. Therefore, the issue at stake now with the level of pockets of unethical practices that characterize some Islamic financial institutions, a study will be imperative to determine the depth of compliance with the IFSB code of ethics. The present study thus attempts to find out the impact of this standard on Islamic financial institutions in Malaysia.

1.2 RESEARCH OBJECTIVES:

- 1- To analyze the extent to which IFSB has incorporated Islamic values in its codes of ethics for Islamic banking
- 2- To investigate from Islamic banks' customers' perspective the extent to which the following code of ethics in IFSB guiding principles has been adopted by Islamic banks.
 - (i) Truthfulness, Honesty and Fairness

- (ii) Due care and diligence
 - (iii) Capabilities of the employees of Islamic banks
 - (iv) Understanding the needs of the customers
 - (v) Disclosing of information to customers
 - (vi) Conflict of interest and duty
 - (vii) Shari'ah compliancy
- 3- Provide appropriate recommendations and suggestions.

1.3 RESEARCH QUESTIONS:

- 1- What are the Islamic moral values introduced in IFSB-9 codes of ethics
- 2- What is the customer's perception about the ethical standards of Islamic banks on the following principals
- (i) Truthfulness, Honesty and Fairness
 - (ii) Due care and diligence
 - (iii) Capabilities of the employees of Islamic banks
 - (iv) Understanding the needs of the customers
 - (v) Disclosing of information to customers
 - (vi) Conflict of interest and duty
 - (vii) Shari'ah compliancy
- 3- What are the possible recommendation and suggestions?

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

The dearth of study with respect to addressing how the practitioners in banking sector should behave within the framework of ethical code of conduct particularly in Islamic perspective has been widely acknowledged. Nonetheless, there are many studies on ethical point of view in relation to the operation of banking system. This chapter begins from the general ethical and philosophical views of both Islamic and western faces which is followed by business ethics particularly its significance on the banking sector. In the final part of this chapter we discuss the code of ethics and ethical framework in Islamic Banks.

2.1 ETHICS AND ITS PHILOSOPHICAL VIEWS

Ethics is a branch of philosophy that addresses questions about morality, concepts such as good and evil, right and wrong, virtue and vices. It is generally referred to the principles of conduct governing individuals. (Erhard, 2009) broadly defined ethics “ as the agreed on standards of what is desirable and undesirable; a system of rules governing the ordering of values and can also be referred to as the rightness or wrongness of the decisions and behaviors of individuals and the organizations of which they are a part (Hellriegel, 2001). Ethics is basically addressing human behaviors whether acceptable or otherwise, on the other hand, ethics can be understood by pointing at the ends or the consequences of actions or activities of human being (Ahmed, 2012).

However, before we considered Islamic ethical standard, it is imperative to reflect ethics from the western perspective. This study analyse ethical norms of John S. Mills in order to have a general view of western and Islamic ethics. Mills (1806-1873) was a British philosopher and political economist who were famous for his ethical theory extensively articulated in his classical text *Utilitarianism* (1861) – built on the ethical theory of Jeremy Bentham. His goal was actually to justify the utilitarian principle as the foundation of morals. John Stuart Mill came in contact with utilitarian thought at a very early stage of his life remained a utilitarian throughout his life. Mills believed that morality should be built on social rules. He regards morality as a social practice and not as an autonomous self-determination by reason. According to him, our moral obligations result from the *justified* part of the moral code of our society; and the task of moral philosophy consists in bringing the moral code of a society in better accordance with the principle of utility (Schefczyk, 2012).

(West, 2003) noted that this principle says actions are right in proportion as they tend to promote overall human happiness and thus Mill focuses on consequences of actions and neither on rights nor ethical sentiments. Utilitarianism is said to be useful in any business decision that aims at maximizing positive effects (moral and financial) and minimizing negative ones. The theory of utilitarianism in business ethics is primarily concerned with outcomes rather than process. Thus, if the outcome brings about greatest goodness (or in some cases, the least harm), for a host of people, in that case, it is assumed the end justifies the means. In other words, Mills believes that the most ethical action is that which brings the most people the greatest amount of happiness. Following the line of thought of Mills, it can be concluded that a morally good person could with the best of motives perform an impermissibility action. A succinct analysis of this theory reveals that apart of many shortcomings of Mills'

theory viz-a-viz distastefulness, impracticability and impossibility, it also fails to recognize divine sources of values. Hence, this view of ethics is myopic in nature and inhuman. The outcome of this is that it will not bring about the desired peace and harmony but rather promote a state of lawlessness, insecurity and anarchy.

In another perspective, (DeGeorge, 2009) describes that utilitarianism is not about determining whether the action is good or bad instead, actions are judged by their consequences. He advances further that actions take on moral value only when considered in conjunction with the effects that follows upon them. He is of the view that the core concept of ethics is human satisfaction that is valuable in itself. This broadly includes anything that will give people the feeling of joy, happiness, comfort, and pleasure are considered as valuable.

Ethics answers the question of who we are and so a code of ethics will be needed to address the spiritual component of man. This is so because a human body consists of two main components: physical and spiritual. The physical component comprises the body and the flesh while the spiritual component contains certain elements or forces such as reasoning, instinct, emotion, sentiment and desire. A full understanding of the right perspective of ethics with respect to these forces will make an individual to be mindful of himself, his action and integrity, his whims and caprices and of course his immediate and far environment.

2.2 ETHICS FROM AN ISLAMIC PERSPECTIVE

Ethics in Islamic perspective is referring to divine and moral values. Islam gives guidelines that encompass all aspect of human lives, thus provides a comprehensive code of behaviors for the individual and indicates the highest possible moral standards and principles for just and righteous society.