On the Significance of "Trust" for Islāmic Financial Industry: Lessons from the Financial Crisis of 2007-8

Zamir Iqbal
Ahmed Rostom*

Abstract

The notion of "trust" as social capital and an intangible asset has been discussed in the literature for some time but the financial crisis of 2007-8 has highlighted the significance of "trust" with respect to corporate governance, business ethics, confidence in leadership and policy-makers, and on financial system and the markets. In this paper we assessed the key triggers of the recent financial crises as it relates to issues of moral hazard and lack of transparency on the nature of financial instruments. We argue that this led to the lack of trust in financial systems. We provide analytical and descriptive quantitative evidence that Islāmic financial institutions undertake a sacred duty for their clients whose trust in them is invaluable. Any damage to this trust can have consequences not only for an individual institution, but can also have grave precautions for the industry as whole. The paper concludes that trust is vital to developing well-functioning financial systems. Moreover, transparency on the nature of Sharīʿah compliant financial contracts should go hand in hand with developing financial literacy to ensure deepening trust in the financial system and its ability to support growth and economic development.

Keywords: Trust, moral hazard, social capital, Islāmic finance, transparency, community governance, Sharīʿah compliance.

KAUIEI Classification: I0, J33
JEL Classification: E58, E65, F53, G18, G28, N27, O55

* **Dr. Zamir Iqbal** is Lead Financial Sector Specialist with Finance and Markets Global Practice of the World Bank. He heads World Bank Global Islamic Finance Development Center in Istanbul, Turkey. **Dr. Ahmed Rostom** is a Financial Sector Specialist with the Finance and Markets Global Practice of the World Bank in Washington, D.C., USA and also affiliated with The George Washington University in Washington, D.C.
Views expressed in this article are of the authors and do not reflect the views of their affiliated institutions.

Introduction

The notion of "trust" as social capital and an intangible asset has been discussed in the literature for about two decades, but financial crisis of 2007-8 has highlighted the significance of "trust" with respect to corporate governance, business ethics, and confidence in leadership and policy-makers, and on financial markets and systems. We argue that trust is an inherent device in the Islāmic financial system, if properly implemented and leveraged, it would help minimize moral hazard, which was the main trigger of the recent crises. The objective of this paper is to establish an evidence based link between indicators relating to trust and financial development in general with particular reference to the Islāmic finance industry. Trust is an organizational issue which is predominantly overlooked by Islāmic financial institutions (IFIs). We argue that the IFIs undertake a sacred duty for their clients whose trust in the institutions' efficiency and ability to perform its intermediary as well as Sharī'ah compliance due diligence is invaluable. Any damage to this trust can have grave consequences not only for individual institution but can have grave precautions for the industry as whole. As a consequence, the reputational risk could be beyond repair and reversibility.

Section 1 highlights key triggers of financial crisis and the linkages to the notion of trust. Section 2 discusses trust as a significant aspect of 'social capital,' its importance for a firm, particularly for an Islāmic financial institution which is based on implicit trust, and finally trust as critical component of corporate governance. This is built on the well-established theoretical foundations that emphasize social capital as a critically necessary element to remedy the market failures and ensure proper enforceability of contracts. Section 3 elaborates on the notion of trust in the Islāmic view, as per injunctions in religious scripture and historical references to the early days of economic and commercial transactions. Finally, section 4 offers policy considerations for policy-makers and Islāmic financial institutions to improve the level of trust to reap full benefits from this intangible asset and concludes the paper.

Section 1: Key Triggers of Financial Crisis

Contrary to common understanding, the sub-prime led financial crisis was not simply the result of excessive risk taking and inadequate capital but it was brewing for some time as a result of a gradual deterioration of ethics of business leadership, lapses in governance and regulatory framework (particularly for derivatives markets), and of an ineffective risk-management framework. There is consensus among researchers that the regulatory and supervisory framework was not adequate to the task of forecasting and preventing the crisis. The crisis has highlighted several regulatory and governance related issues like, for example, the market-discipline mechanism proved to be very weak; the decision-making of corporate leaders was overly driven by short-term goals; trust in corporate leadership declined; corporate boards were slack in their oversight and risk control; business ethics and values were compromised; risk management and supervision failed due to narrow view; the quality of supervision was compromised; and finally, the corporate incentives and remuneration system was questionable and involved conflicts of interest. The speed by which the crisis spread and the slow recovery was due to major blow to "trust" in the financial markets and the system.

The consequences of the crisis on the way financial intermediation and markets operate will be felt for many years to come and it may re-shape the business in a drastic manner. This impact will be felt not only for conventional financial institutions but for Islāmic financial institutions as well. Other than obvious causes of crisis, i.e. overleveraging and over-financialization of economy, there are several triggers which have been identified as discussed briefly below: [each of these causes has directly or indirectly link with the element of trust].

1.1 Moral Hazard and Misuse of "Trust"

Trust is considered one of the main foundations for an efficient financial market. With trust in place, and controlling for external factors, both debtor and creditor, or the financier and fund user as in Islamic finance, would look after each other's interest and hence the debtor would put the maximum effort to ensure that optimal return is realized and that creditor is duly paid the agreed amount he was promised to be paid. On another front, trust is also needed between the saver/lender and the financial intermediary that acts on behalf of the saver in case of credit / financial markets. The saver should trust that the intermediary is acting prudently taking investment decision that would ensure, other factors held constant, the optimal return on investments.

However, if trust is missing, usually one side of the market will not be able to observe the actions of the other and inefficiencies in resource allocations and hence expected returns would prevail. Either one or both sides of the market might not necessarily have the incentive to watch for their actions; in which case moral hazard or hidden actions give rise to market inefficiencies and resource misallocation (Varian 2006; p.700). A standard example of moral hazard in textbooks of economics is a worker with an incentive to shirk on t he job. Financial examples include the following:

- Selling a financial product knowing it is not in the buyer's interests to buy;
- Receiving excessive bonuses by executives, may be on t he ground that they earn licurative profits for their employers /shareholders on t he cost of other stakeholders; or in the words of Dowd (2009), " I might pay myelf excessive bonuses out of funds that I am managing on your behalf", or
- Taking risks that others don't have to bear.

Moral hazards such as these are a pervasive and destined feature of the present financial system and of the economy more generally. Dealing with them and keeping them under reasonable control—is one of the principal tasks of institutional designs. In fact, it is no exaggeration to say that the fundamental institutional structure of the economy—the types of contracts we use, and the ways that firms and markets are organized—has developed to be the way it is in no small part in response to these pervasive moral hazards (Dowd 2009; p. 142) [*sic*].

Financial intermediaries/creditors' actions can involve moral hazard if they involve excessive risk taking without providing full information to savers/lenders. Moral hazard arises as savers are not able to observe the risk taking behavior of financial intermediaries while in fact they are subject to losing all their savings in case of realizing the bad state of the nature. This was common in the recent 2008 crises known as sub-prime crises. The sub-prime crises evolved in mortgage markets as financial intermediaries provided mortgage loans to high risk individuals (sub-prime borrowers) without adequate screening. These intermediaries started spreading this class of toxic loans to other institutions at tempting returns compared to alternative investment opportunities in capital markets with inadequate information regarding the inherent risk of holding such assets as borrowers (sub-prime home owners) couldn't systematically meet their debt obligations, hence putting holders of these toxic assets on stake since they hold worthless papers.[1]

Financial systems with high degree of trust will minimize moral hazard problems and vice versa. Before the financial crisis, the degree of trust was high and therefore, perceived moral hazard problem was low and

[1] Dawd (2009) provides a detailed exposition to the involvement of moral hazard in the recent crises.

once the crisis broke down and moral hazard problem became evident, breach of trust increased the level of perceived moral hazard—thus slowing the recovery.

1.2 Breach of Trust

The financial crisis of 2007-8 has done significant damage to aspects of social capital. The Edelman Trust Barometer, which tracks the level of trust in different countries, observed that people began to lose trust in business leaders and became critical of their irresponsible actions, especially in the US (Edelman, 2009). In case of United States, home to some of the largest corporate collapses, trust in business leaders dropped 20 percentage points as a result of the crisis. At just 38 percent, this was even lower than the levels witnessed during the Enron and dot-com crises and came close to the levels in Western Europe, which has historically displayed the lowest trust levels in business among all nations surveyed by the tracker. Similarly, survey clearly showed a sharp decline in the trustworthiness and credibility of CEOs in all major industrial economies. The trust was not restored immediately despite drastic measures by the governments because the crisis damaged the trust in all players of the financial system including regulators, business leaders, media and the intermediaries.

1.3 Failure of Market Discipline

> *"What has occurred is a shock to a set of intellectual assumptions about the way that markets work, about their self-equilibrating character."*
>
> Lord Turner, IOSCO, June 11, 2009

The financial crisis has delivered a blow to the widely held view that the invisible hand of the market would work to make market players resolve conflicts through market discipline and that there was, therefore no need to take any direct actions to regulate the market. It was soon realized that not only was financial-market information incomplete, but that the market could be manipulated by its players for their personal interests. This observation is particularly applicable to the derivatives and structured markets, where the level of complexity is higher than markets for other financial products. This failure of market discipline led by financial innovation undermined the effectiveness of a regulatory model that rested, at least in theory, on transparency, disclosure, and market discipline to curb excessive risk taking (IMF, 2009).

The notion of market discipline rested upon fair-play and high degree of trust among market players, but once the trust came under question, the notion of self-regulatory market discipline became under suspicion.

1.4 Failure of Corporate Governance and Risk Management

"*Corporate governance is one of the most important failures behind the present financial crisis.*" De Larosière Group (2009)

"*This Report concludes that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements.*" OECD report (2009)

Corporate governance caught attention of the policy-makers after the Asian crisis of 1997-98 and the issues were highlighted to strengthen the governance and risk management framework. However, current financial crisis showed that although the governance and risk management frameworks were in place, but they failed to deliver the promise of preventing a crisis before it erupted. Managers focused on short-term profit generation and the Boards neglected their tasks to probe tough questions.

Although the role of the Boards of financial institutions has increased dramatically over the last decade, they have been criticized for being too complacent and unable to prevent collapses (Van Den Berghe, 2009). Weaknesses in safeguarding against excessive risk-taking behavior in a number of financial-services companies were exposed during the current financial crisis. Again, the shareholders' trust in governance mechanism and the role of the Board suffered and impacted the value of equity.

1.5 Deteriorating Business Ethics and Values

The financial crisis also highlighted the issue of a decline in moral and ethical values in senior management, who seemed to care more about circumventing regulatory constraints and finding loopholes in the law than about morally acceptable behaviour. Increasing greed and personal empire-building became the norm on Wall Street, with little emphasis being placed on producing moral and ethical business leaders.

While the issues relating to risk management and deficiencies in effective regulations that govern financial intermediation and its links to the recent crises has been the focus of a global policy and academic debate, little have been done on the actual moral and ethical side of the story and how Islāmic economic and financial principles provide a relevant framework to deal with challenges of unethical and immoral financial transactions that might be the seed of future global financial turbulences and meltdowns.

Having established the linkage of "trust" with major lessons to be learnt from the financial crisis, in the following sections we will focus on the notion of social capital and trust as a necessary condition for contract enforcement in financial transactions, followed by the relevance of the concept of trust in Islāmic finance.

Section 2: "Trust" as Social Capital [2]

Trust is a significant foundation for financial system and transactions. Virtually, every commercial transaction, and certainly any financial deal conducted over a period of time, has within itself an element of trust. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence (Arrow 1972).

The notion of "trust" lays significant foundations to business ethics, confidence in leadership and policy-makers, and corporate governance system as a whole. This is built on the well-established theoretical foundations that emphasize social capital as a critically necessary element to remedy market failures and ensure proper enforceability of contracts. Moreover, social capital plays a significant role to invigorate trust and support financial and economic development. Francois and Zabojnik (2005) argue that trustworthiness is the economically relevant component of a s ociety's culture and hence comprises its social capital. They emphasize that individuals are trustworthy when they perform actions as they have promised, even if these do not maximize their payoffs. The usual focus on incentive structures in motivating behaviour plays no role here. Instead, they emphasize more deep-seated modes of behaviour and consider that trustworthy agents are socialized to act as they do.

In high social capital communities, people may trust each other more because community's networks provide better opportunity to punish deviants (Coleman 1990; Spagnolo 1999). This was in conformity with earlier work of Banfield (1958) that found a direct relation between levels of social capital and fulfilling promises as a result of a moral attitude imprinted with education. This was further developed to associate trust, contract enforcement, social capital and financial development. Actually,

[2] As the consensus over the exact definition of social capital has not been reached among scholars, this limited the scope for using this concept in economic analysis. In a nut shell, social capital is defined as the network effect related to individuals participation in formal or informal organizations, associations or other social movements where some shape of accumulation and sharing of knowledge and experience takes place.

finance literature analyses financial contracts as promises today to fulfil an obligation tomorrow, hence it is understood that fulfilment of promises implies trust.

More recently, (Guiso, Sapienza, and Zingales 2005) provided evidence that trust level is directly linked to stock market participation. As per those authors, “the subjective probability that individuals attribute to the possibility of being cheated” affects their investment decisions. Their findings confirm that high level of trust is associated with investment in equities through stock markets. They also provide evidence that the rules of law and contract enforcement were seen as significant determinants for investment in stock markets.

Advancement in ‘Development Economics’ recognized the fundamental impact of ‘social capital’ on s ustainable development. Extensive research has been done to measure the effect of trust on inter-organizational and interpersonal trust on pe rformance (Zaheer, Mc-Evily and Perrone 1998). Another novel interpretation to the ties of trust to development considered that social capital generally refers to trust, concern for ones associates, willingness to live by the norms of one’s community and to punish those who do not. This approach regarded such behaviours and dispositions as aspects of “community governance” that significantly contributes to sustainable development and growth (Bowels and Gintis 2002).

From the previous exposition, we can deduce the importance of trust to economic development and to strengthening the institutional foundations of the economy hence fostering contracts enforcement and governance. Trust makes people comfortably interacting economically and financially, it also facilitates intermediation and exchange/sharing of resources. This then leads to the facilitation of division of labor and specialization and fosters economic development and growth. On the other hand, trust reinforces the institutional setup of the society and strengthens moral values. In religious worldviews, this constitutes the basis for what is referred to as ‘good character’. Abiding to such moralities and values reflect on members of the society fulfilling their contractual and social obligations towards others and enhance the trust that they will command. The trust comes, in turn, from the observance of the society’s norms by the people. (Chapra 2003)

Section 3: Trust as an Inherent Device in Islāmic Finance

Mirakhor (2005) emphasized that Islāmic economics places a strong focus on trust and considers being trustworthy as an obligatory command. The root of the word belief "*īmān*" is the same as that of trust "*amānah*". Moreover, abiding by one's contracts and remaining faithful to promises with other members of the society derives from the need to remain faithful to the original, primordial covenant between human beings and the Supreme Creator (Qur'ān, 7:172). Qur'ān, in a number of verses, insists that a strong signal of true belief is faithfulness to contracts and promises made, and makes clear that performing the obligations one has contracted or promised is mandatory for a believer. Indeed, fidelity to one's promises and the terms of contracts one enters into as well as maintaining trust are considered important characteristics of a true believer.[3]

More emphasis on trust has been emphasized in the chapter of the "*faithful*"—Chapter 23, Verses 1-8; maintaining trust and fulfilling promises are two of the major characteristics of the *faithful* "*mū'min*". In the first verse of Chapter 5 of the Qur'ān, the faithful are ordered to abide and meet the terms and obligations of contracts that they voluntarily agreed to be part of. Similarly, in Verse 17:34, the faithful are commanded to keep their promises, for they will be asked about their faithfulness to promises. There are other verses of the Qur'ān that emphasize the duty of the *faithful* to remain fully conscious of Allah (swt) while entering into contract or making promises, or being trustworthy when they are entrusted with objects for safekeeping (see, for example, Verses 2:58 and 2:283). The Qur'ān also identifies a chief characteristic of prophets and messengers of Allah (swt) as trustworthiness (for example, see 42:107, 125, 143, 162, 178, 193) and chastises betrayal of trust (see 8:58 and 12:52). In short, Islām has made trust and trustworthiness obligatory—as well as keeping faith with contracts and promises—and has rendered them inviolable without explicitly permissible justification.

The life of the Prophet Muhammad (pbuh) is a shining illustration of the implementation of guidance of Allah (swt) in maintaining trust and remaining trustworthy in his own life, both individually and within the community. Regarded as eminently trustworthy even before his divine appointment, the community conferred upon him (pbuh) the title of *Al-Ameen* (Trustworthy). The Prophet expended a great deal of effort, from his divine appointment until his passing, in modifying when possible and changing when necessary the behaviour of the members of community toward trustworthiness.[4] There are numerous statements, actions, and circumstances attributed to him in which trust was the pre-eminent

[3] Mirakhor (2005) provides details on ethical foundations of an Islāmic economy.
[4] See Iqbal and Mirakhor (2011) for details.

concern. For example, in a f ew very short, but highly significant statements, the Prophet (pbuh) declares:

لا إيمان لمن لا أمانة له ولا دين لمن لا عهد له.

The person who is not trustworthy has no faith, and the person who breaks his promises has no religion;

إن حسن العهد من الإيمان.

Maintaining promises perfectly is a sign of faith.

This is in addition to many other sayings by the Prophet (pbuh) that proscribe real Muslims from being hypocrites even if they strictly fulfil their duties of fasting, prayers and even perform bigger and smaller pilgrimages. The Prophet's teachings also emphasized that traits of a real Muslim include delivering promises and, respecting trust. Also, there are many examples of respecting trust and trustworthiness in Islām and respecting values and ethics, critical to build a healthy Islāmic society as a whole and particularly to undertake economic and commercial transactions.

Section 4: Policy Considerations for the IFIs

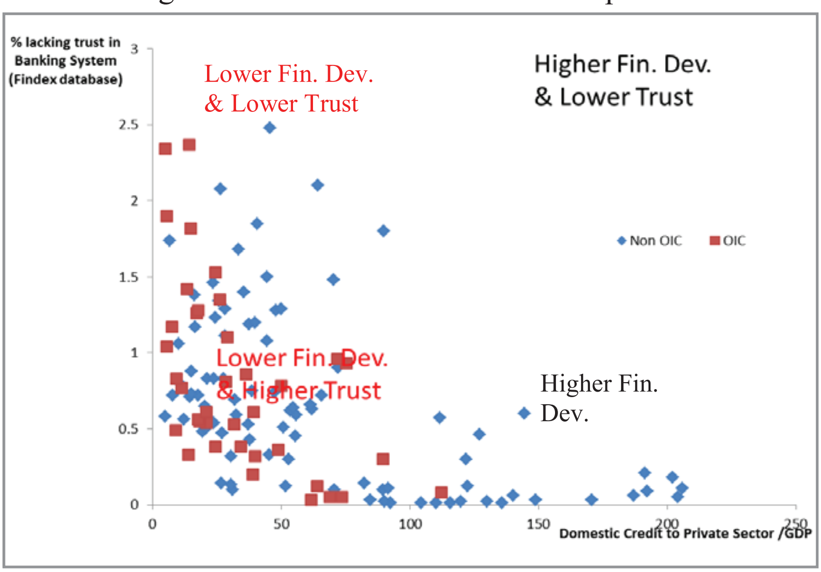
Current state of overall economic performance in OIC countries is below its potential and one could attribute this to low level of trust in their economic and financial systems. However, building and restoring trust is long-term process and requires long-run planning and careful policy choices. These economies need policies to strengthen institutional structure of the society which can be achieved by enhancing transparency, governance, information disclosure and contract enforcement. Enhancing trust lies in the heart of all intervention to build the institutional structure needed for developing any financial system but more so for Islāmic financial system. Following are some key policy recommendations for the policy-makers to consider who are interested in developing Islāmic financial system.

4.1 Development of Financial Sector is Vital

Relationship between trust and the degree of financial sector development is interactive one. As financial sector gets developed, it establishes much needed trust in the financial system and as this trust grows further; it leads to further development of the financial sector. Similarly, this relationship could be reversed, i.e. distrust could dampen the development of financial sector which can become an obstacle in building the trust.

Figure 1 depicts the relationship of trust in the banking sector with the level of financial sector development measured by the ratio of domestic credit to private sector to GDP. The chart if divided into four quadrants—upper left (high trust but less developed financial sector), upper right (high trust and highly developed financial sector), lower left (low trust and less developed financial sector), and finally, lower right (low trust and highly developed financial sector). One can observe that the relation between trust and financial development is negative, in OIC countries (red spades in the graph). This is simply interpreted by the fact that less sophisticated financial systems seems to exhibit less trust. On the other hand, in the developed economies (blue squares), the relation is positive. It is evident that there is a threshold of around 60% of GDP, where the slope depicting the relation between trust and financial development becomes flatter. Above this threshold, the financial development index increases indicating larger trust in the financial system as it becomes more advanced. The immediate interpretation is that as financial systems become more advanced this couples with institutional development that reinvigorates public's trust in the system and its performance.

Figure 1: Trust and Financial Development:



Source: World Bank Global FINDEX Database, 2011.

This reinforce the fact that policy-makers in OIC countries should pay special attention to this relationship and take measures to develop financial sector through improving legal institutions, investors' protection, transparency, information disclosure, and better governance.

4.2 Enhanced Trust needed to Promote Risk-sharing Instruments

Ng, Ibrahim, and Mirakhor (2013) point to the significance of social capital (especially the trust component) for a risk-sharing financial system such as Islāmic finance and argue that when the risks of life are shared among society, it promotes the wider use of equity-based contracts and the corresponding reduced reliance on interest-based debt financing. Trust also facilitates rule-compliance and cooperation which are key ingredients for a risk-sharing financial system. Islāmic financial system is a risk-sharing system in its ideal form, but its current implementation is far from being ideal because of dominance of debt-like products[5] whom the policy makers or finance managers outspokenly term as 'debt securities'[6]. Without adequate level of trust in the financial system, the industry will keep replying on debt-like or risk-transfer financial products.

Therefore, the policy-makers interested in promoting Islāmic finance need to undertake measures for enhanced trust to provide confidence to investors and depositors to invest in risk-sharing Islāmic products such as *Muḍārabah* and *Mushārakah*. If such trust in the financial or banking system does not exist, the investors and financial intermediaries will have preference for debt-like products. The needed measures to promote trust in the financial sectors include reduced information asymmetry, enhanced transparency, enhanced financial literacy and developed capital markets.

4.3 Enhanced Quality of Information and Transparency

There is critical need to enhance the quality of information and the transparency of disclosures in OIC countries. Theoretically, enhanced quality of information and transparent disclosure reduce information asymmetry in the financial systems and transactions and as a result provide enabling environment for risk-sharing financial products in the system as opposed to a debt-based risk-transfer financial system.

For markets, policy makers, financial authorities and multi-laterals (IMF and World Bank) appropriate coverage and quality of information is becoming increasingly critical for their capacity to assess risks and vulnerabilities. Regulators are looking for better information on range of financial institutions' activities such as 'off balance sheet' risks (involving better consolidated supervision), and the risks of financial inter-linkages.

---

[5] See Askari, Iqbal, Krichene, and Mirakhor (2012) and Askari, Iqbal, and Mirakhor (2010)

[6] See, for example, Pakistan Economic Survey, 2014-15 [… five debt securities were issued which include two domestic Sukuk amounting to Rs. 26 billion, one international Sukuk of Rs. 100 billion (US$ one billion) and two Privately placed Term Finance Certificates amounting Rs. 6 billion] http://www.finance.gov.pk/survey/chapters_15/Highlights.pdf

New regulatory and supervisory environment will be “information-focused” and financial institutions will be required to enhance the information collection and disclosure as required by the regulators (IMF, 2009).This means that the financial institutions will have to improve, enhance, and upgrade overall flow and the quality of information in their operations and business.

Quality of information is relevant to both investors and the regulators but in several countries where Islāmic banks operate, general quality of information is considered low. Table 1 shows a comparison of information disclosure index of Middle East and North Africa (MENA) countries with G7 countries while Table 2 shows depth of credit information in the region. This index measures the rules and the practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau. The index shows relatively low levels compared to developed economies of G-7.

Table 1- “Extent of Disclosure Index Protecting Investors” Index

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
Average MENA	5.86	5.86	5.94	6.13	6.44	6.56
Average GCC	6.5	6.5	6.5	6.83	6.83	6.83
Average MENA Non-GCC	5.6	5.6	5.6	5.7	6.2	6.4
Average G7	7.71	7.71	7.71	7.71	7.71	7.71

Source: Doing Business Database, World Bank.

Table 2 - Depth of credit information index (0-6) Getting Credit

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
Average MENA	1.93	2.21	2.69	3.13	3.5	3.69
Average GCC	3	3	3.33	3.83	3.83	3.83
Average MENA Non-GCC	1.5	1.9	2.3	2.7	3.3	3.6
Average G7	5.71	5.57	5.57	5.57	5.57	5.57

Source: Doing Business Database, World Bank

General level of transparency and disclosure of information is low in the Islāmic financial services industry. The impact of quality of information on Islāmic financial institutions could be from two directions. At the institutional level, they would require to enhance the flow and quality within the institution which could demand automation of manual monitoring processes, upgrading information systems, and improving the transparency of data and information for reporting purposes. This could be a challenge considering that majority of Islāmic financial institutions are of small size and do not have surplus funds to invest in the information infrastructure.

National authorities and regulators need to take concrete steps to enhance information at systemic level so that all participants in the system can benefit from it. Enhancing the flow and quality of information can be considered as a key driver where Islāmic finance industry needs to pay attention.

4.4 Trust as Important Determinant of Stock Markets Depth and Efficiency

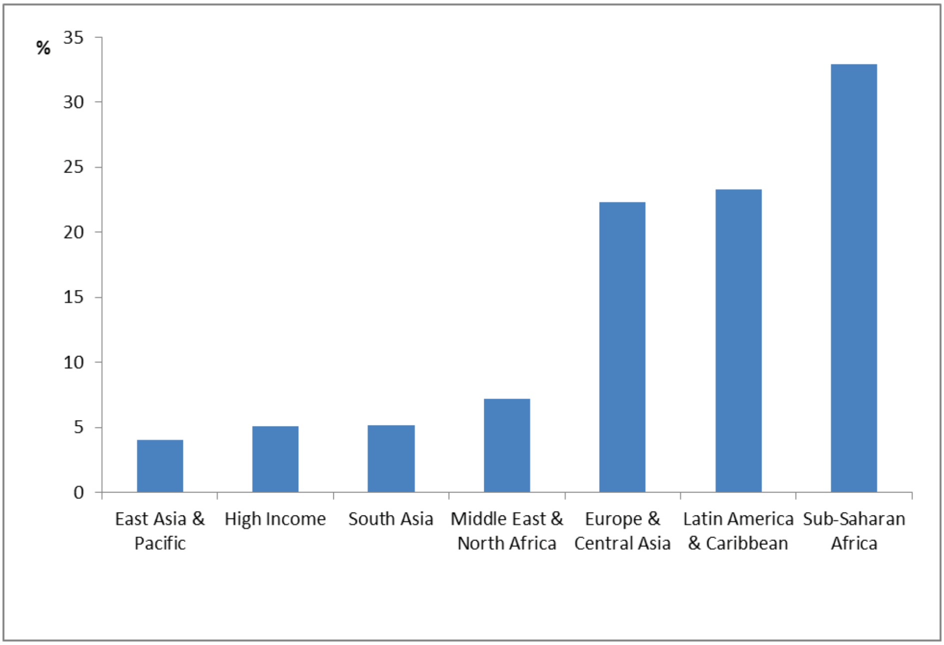
Several studies have documented the relationship between capital markets especially the stock markets and the level of social capital including trust in the economy. Using data from 73 jurisdictions covering the period from 2009 through 2011, Ng, Ibrahim, Mirakhor (2014) examine the existence of social capital thresholds in the stock market development and macroeconomic performance nexus. Their empirical results demonstrate that stock market liquidity is significant and positive in influencing GDP and Total Factor Productivity (TFP) growth respectively only after the attainment of a certain threshold level of firms' ethical behavior. They find that market liquidity is also significant and positive in promoting GDP and TFP growth in cases of high trustworthiness and confidence. The evidence is supportive of productivity growth as an important channel where stock market development promotes economic growth.

Vibrant stock markets are vital for developing risk-sharing financial system and Islāmic finance. In absence of interest based debt securities due to prohibition of *ribā*, raising capital through equity financing in stock markets becomes vital for economies to operate on the principles of Islāmic economics and finance. Given the relationship between trust, stock markets, and impact on economic growth, policy makers need to take measures to strengthen operations for stock markets through improving legal environment, transparency, and governance. A damage to trust in the market place will have a negative and serious impact on the economy.

4.5 Enhance Trust in Redistributive Instruments of Islām to Enhance Financial Inclusion

Low financial inclusion and access to finance is a serious issue in OIC countries as documented by Mohieldin, Iqbal, Rostom, and Fu (2012). Figure 2 shows percentage of individuals in different regions who do not account with banks because of lack of trust. The problem is more sever in OIC countries belonging to Africa region.

Figure (2): Trust in Banks: A Regional Perspective:



Source: World Bank Global FINDEX Database, 2011.

Several studies have argued for revitalizing Islām’s instruments of re-distribution such as *zakāh*, *qarḍ al-ḥasan*, *waqf*, and *ṣadaqāt*.[7] Although, these instruments were used effectively and successfully through the Muslim societies, their effectiveness in recent times have been less than the expected and below their potential in enhancing inclusion. The main cause of low effectiveness is lack of trust in managing the collection and utilization of funds generated through them. In those countries where the

[7] See Mohieldin, Iqbal, Rostom, and Fu (2012) and Iqbal and Mirakhor (2013).

public sector has taken responsibility of collecting and managing funds, the levels of contributions are often below potential because of low trust in public sector to manage the funds transparently. Instead, the contributors prefer informal channels and NGOs.

Several OIC countries even do not have adequate regulatory framework for these important institutions of Islām. Policy-makers should take initiatives to develop enabling environment for optimal use of such institutions /instruments by enhancing the trust in utilization of funds. Some of the suggested measures are to (i) institutionalize Islām's instruments of redistribution[8] through adequate legal environment, (ii) develop adequate regulatory framework[9], (iii) enhance transparency and disclosure, (iii) eliminate misuse and corrupt practices in utilization of funds, and finally, and (iv) enhance governance through adequate reporting, effective leadership and management. All these measures will lead to development of sustainable *trust* in the system which will attract increasing collection of funds and their effective utilization resulting in enhanced social and financial inclusion in the economy.

4.6 Be aware of Reputational Risk due to breach of Trust

As we have shown and argued earlier that lack of or deterioration of trust could severely damage the reputation of financial industry as witnessed by the financial crisis. A skari, Iqbal, and Mirakhor (2009) argue that the stakeholders of Islāmic financial industry should pay special focus to this risk. T hey cite case studies on Egypt, South Africa, and Turkey where trust in Islāmic financial services was severely damaged due to mis-governance and mis-management which led to serious negative reputation which prevented development of Islāmic financial services in those countries for long time.

It is joint responsibility of the management of Islāmic financial institutions, policy-makers, regulators, and Sharī'ah-boards to watch closely the practices, products, and services offered by IFIs to ensure that the customers or clients have high degree of trust in the market that the products and services are fully Sharī'ah-compliant and any controversial practice has to be corrected immediately. This can be achieved by adequate prudent supervision, effective Sharī'ah-governance, and education of the customers.

[8] See one of the earliest writings on the subject by Mirakhor (2004).

[9] For example, Indonesia has recently taken an initiative to develop regulatory framework for *zakāh*. Several countries have similar frameworks for *waqf*.

4.7 Enhance Financial Literacy to Foster Trust in the Markets

Finally, one key element in enhancing trust in the economy and markets is through enhancing financial literacy. Financial literacy is crucial for enhancing financial inclusion, promoting entrepreneurship, promoting SMEs, and deepening the financial and banking services in any country. This is more critical for OIC countries the most of which have low education levels especially among the poor. Financial literacy has special relevance to Islāmic finance as the industry is in its early stages of development, lack of standardization is an issue, and the process of product development and approval is not very transparent. Muslims in several Islāmic countries who wish to engage in Islāmic finance do not have trust worthy resources to understand difference between Islāmic and conventional financial products and services. It is therefore, important that adequate measures and policy actions are taken to spread financial literacy through marketing campaigns, education, public awareness programs, and simplified explanation of complex concepts and products for common man.

4.8 Conclusion

To conclude, the paper has tried to emphasise that trust is vital to developing well-functioning financial systems. Trust is influenced by ethical behaviour in business and managerial perspectives to become a crucial component of ‘social capital’. It facilitates frictionless economic and financial transactions and enhances transparent intermediation and exchange of resources in a society. Moreover, disclosure and transparency on the nature of Sharī‘ah compliant contracts should go hand in hand with developing financial literacy to ensure deepening trust in the financial system and its ability to support growth and economic development. Particularly, trust is an inherent device for promoting a risk-sharing financial system such as Islamic finance. The policy-makers, regulators, IFIs’ management, and the Sharī‘ah scholars need to watch closely the products, practices and services offered by IFIs to ensure that the stakeholders have high degree of trust in them with regard to Sharī‘ah-compliance and their impact for fair and equitable distribution of economy’s wealth and resources. A breach of this trust could be devastating for the Islamic finance industry which is still in the process of development and requires to take strong roots before it could grow in a sustainable fashion. Given current low levels of trust in OIC countries, building trust should be high on the policy-makers’ agenda.

References

Askari, Hossein, Zamir Iqbal, Abbas Mirakhor, *"New Issues and Challenges in Islāmic Eocnomics and Finance"*, John Wiley (Asia), 2009.

Askari, Hossein, Zamir Iqbal, Noureddine Krischne, Abbas Mirakhor, "*Stability of Islāmic Finance: Creating a Resilient Financial Environment for the Future"*, John Wiley (Asia), 2010.

Askari, Hossein, Zamir Iqbal, Noureddine Krischne, Abbas Mirakhor, "*Risk-Sharing Financial Systems: Islāmic Finance Perspectiv*e", John Wiley (Asia), 2011.

Arrow, Kenneth, "*Gifts and Exchanges, Philosophy and Public Affairs",* 1972, 343-362.

Banfield E. G., "*The Moral Basis of a Backward Society",* Free Press, New York, 1958.

Becht, M., "*Corporate Governance and the Credit Crisis, Financial Regulation and Macroeconomic Stability — Key issues for the G20*", London: Centre for Economic Policy Research: 2, 2009.

Bowles, S. and H. Gintis, "*The Inheritance of Inequality"*, Journal of Economic Perspectives, 2002, 16(3): 3-30.

Buttler, J., P. Giuliano and L. Guiso, "*Trust Values and False Consensus"*, NBER Working Paper 18460, 2012, http://www.nber.org/papers/w18460

Chapra, U., "*Development Economics: Lessons that Remain to be Learned",* Islāmic Studies, 42:4, 2003.

Claessens, S., G. Dell'Ariccia, D. Igan, and L. Laeven, "*Lessons and Policy Implications from the Global Financial Crisis",* Working Paper WP/10/44, 2010, IMF, Washington, DC. USA.

Coleman, J., "*Foundations of Social Theory"*. Cambridge: Harvard University Press (1990).

Dowd, K., Cato Journal. "*Moral Hazard and the Financial Crisis"*, 2009, Vol. 29. Available from; http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2009/1/cj29n1-12.pdf

Durate, Jeffeson, Stephen Siegel and Lance Young, "*Trust and Credit",* Rev. Financ. Stud., 2012, 25 (8): 2455-2484.

Edelman, "*Edelman Trust Barometer*", Strategy One, New York. www.edelman.com/trust , 2009.

Francois, P. and Zabojnik, J., "*Trust, Social Capital and Economic Development*". Journal of the European Economic Association, 2005, 3: 51–94.

Guiso, L., P.Sapienza, and L. Zingales, "*Trusting the Stock Market*", CEPR Discussion Papers 5288, 2005, C.E.P.R. Discussion Papers.

Hersh, Emily Sarah, *"Islāmic Finance and International Financial Regulation*", Journal of International Services, 2011, Vol. 20, No. 1, Spring 2011. http://journalofinternationalservice.org/wp-content/uploads/2011/01/4Hersh.pdf

IFSB and IRTI, "*Islāmic Finance and Global Financial Stability*", Islāmic Financial Service Board (IFSB), April 2010, Kuala Lumpur. http://www.ifsb.org/docs/IFSB-IRTI-IDB2010.pdf

IIF (2010), "*Basel III—Liquidity Standards-IIF Preliminary Analysis,"* The Institute of International Finance (IIF), Washington, D.C. USA. December 2010

IMF (2009), "*Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management,*" International Monetary Fund (IMF), Washington, DC. USA. http://www.imf.org/external/np/pp/eng/2009/020409.pdf

Iqbal, Zamir and Abbas Mirakhor, "*An Introduction to Islāmic Finance: Theory and Practice*", 200, John Wiley & Sons. Asia, Singapore.

Kirkpatrick, G., "*The Corporate Governance Lessons from the Financial Crisis*", 2009, OECD, http://www.oecd.org/dataoecd/32/1/42229620.pdf.

Mohieldin, M., Z. Iqbal, A. Rostom, and X. Fu, "*The Role of Islāmic Finance in Enhancing Financial Inclusion in Organization of Islāmic Cooperation (OIC) Countries*", Islāmic Economic Studies Vol. 20, No. 2, December 2012 (55-120).

Mirakhor, A., "*Islāmic Finance and Instrumentalization of Islāmic Redistributive Institutions*", 2004, Paper presented at Ibn Rushd Memorial Lecture, London, April.

Mirakhor, A., *"Globalization and Islāmic Finance"*, Keynote Paper Presented in the Sixth International Conference on Islāmic Economics and Finance, Jakarta, Indonesia, November 2005, 21 – 24.

Ng, A., I. Mansor and A. Mirakhor, "*Does trust contribute to stock market development?*", Economic Modelling, accepted October 2013, Available online 21 November 2014, ISSN 0264-9993, http://dx.doi.org/10.1016/j.econmod.2014.10.056

Ng, A., I. Mansor and A. Mirakhor, "*Contextualizing and Developing Social Capital in Risk-Sharing Finance",* November 2013, Available at SSRN: http://ssrn.com/abstract=2218074

Portilla, A., "*The G-20, Proposals for a New Financial Regulatory Framework and Implications for Emerging Markets"*, 2010, The Institute of International Finance (IIF), Washington, D.C. USA.

Spagnolo, G., "*Social relations and cooperation in organizations"*. Journal of Economic Behavior & Organization, 1999, 38 (1), 1-25.

Turner, A., "*Priorities for the Reform of Global Regulation"*, The 34th Annual Conference of IOSCO, 2009.

Van Den Berghe, Lutgart A., "*To What Extent is the Financial Crisis a Governance Crisis?"* From Diagnosis to Possible Remedies, 2009, Available at SSRN: http://ssrn.com/abstract=1410455

Varian, H., R, . "*Intermediate Microeconomics - A Modern Approach",* 2006, 7th Ed. W. W. Norton and Company

Zaheer, A., McEvily, B., & Perrone, V., "*Does trust matter? Exploring the effects of interorganizational and interpersonal trust on performance",* 1998, Organization Science, 9(2), 141-159.

****