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# A CONCEPTUAL FRAMEWORK FOR THE IMPACT OF FINANCIAL CRIME TOWARDS THE FINANCIAL PERFORMANCE OF ISLAMIC FINANCIAL INSTITUTIONS

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**Abstract**

*This paper aims to assess the reputation risk faced by Islamic financial institutions due to financial crime activities. There is an increasing trend in financial crime activities at banking institutions. For Islamic financial institutions that are founded based on Sharīʿah, the usage of Islamic financial instruments for criminal activities undermines the integrity of Islamic financial system itself. It would also tarnish Islamic financial institutions' reputation that supposed to operate with Islamic principles against any criminal activities. Trust or the public confidence towards the integrity of Islamic financial institutions would also be distracted as being associated with financial crime activities signaling that the Islamic financial institutions' profit is eroded by criminal activities. This has raised concern and questions about the reputation of Islamic financial institutions. A proposed conceptual framework discusses how trust and reputation risk affect the Islamic financial institutions' performance when the financial crimes happen.*

**Keywords**: Financial Crime, Reputation Risk, Trust, Islamic Financial Institutions, Social Finance

## 1.0 Introduction

Islamic finance was initially founded to fulfill the objectives of Islām which amongst others are to provide fairness and justice in financial activities as deeply inscribed in the objectives of *Sharīʿah*. Thus, its foundation is based on ethical and moral framework of the Islamic law of *Sharīʿah*, which is characterized by ethical norms and social commitments[1,2,3]). Therefore, the industry shall operate based on high accountability, transparency, and reflect the real economic activity as well as contributes to the economics of the *ummah*. Islamic finance industry has developed rapidly all over the world with a total asset value of USD2.4 trillion in the year 2017. Today, the Islamic finance industry operates side by side with the conventional finance industry, within a wider and sophisticated financial environment that is always evolving. For the industry to sustain and prosper, therefore, it needs to constantly advance and innovate. There are many types of Islamic financial products developed that use various types of contract and Islamic finance concepts which demand a high and deep understanding of how it operates at all level of operations. Thus, relatively, Islamic financial institutions exposed to high operational risks as compared to conventional finance. Moreover, operating in the framework of *Sharīʿah*, Islamic finance industry shall hold high ethical values that demonstrate the values of Islām which will prevent the industry from any manipulation that may lead to financial crime and scandals.

The United Nations Office of Drugs and Crime[4] estimates that every year globally, a staggering amount of USD2.6 trillion is stolen through corruption. The recent financial scandal happened in Malaysia involves Islamic financial instruments[5], which is currently

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[1] K. Ahmad, "Islamic Finance and Banking: The Challenge and Prospects", *Review of Islamic Economics*, 9, (2000), 57-82.

[2] A. Mirakhor. Whither Islamic finance? Risk Sharing in an Age of Crises. (2010).

[3] I. Warde, *Islamic Finance in the Global Economy.* (Edinburgh University Press, 2000).

[4] BNM Governor's Keynote Address at the 10th International Conference on Financial Crime and Terrorism Financing - "Reshaping Malaysia's Future – Setting the goal for greater governance and transparency", 30 Oct 2018

[5] Islamic financing instruments have been popularly used by Malaysia's government-linked companies including 1Malaysia Development Berhad (1MDB).

investigated as financial crime has gained the attention of the world on its development. Theoretically, this should not happen in the Islamic finance industry as it operates based on the *Sharīʿah* compliance and Islamic values, which shall indirectly prevent the industry from any criminal activities and manipulation that lead to financial crime and scandals. As Islamic financial institutions founded based on *Sharīʿah*, the usage of Islamic financial instruments for criminal activities undermines the integrity of the system itself. It would also tarnish Islamic financial institutions' reputations that are supposed to operate with Islamic principles against any criminal activities. Trust or the public confidence towards the integrity of Islamic financial institutions would also be distracted as being associated with financial crime activities signaling that the Islamic financial institutions' profit is eroded by criminal activities. This has raised concern and questions regarding the ethics in Islamic finance as Islamic finance supposed to be more ethical than the conventional finance. As the Islamic financial system operates by using *Sharīʿah*-compliant funds, it is crucial to ensure that the interest of the stakeholders is protected at all time, including protected from being associated with criminal activities. The system also needs to be safeguarded from being abused by the irresponsible parties for the interest in criminal activities.

In the current practice of Islamic finance, driven by a global appetite for socially responsible financial system by the recent 'The Seventeen United Nations Sustainable Development Goals (SDGs)', in order to achieve the third goal which is to ensure healthy lives and promote well-being as well as the eighth goal of decent work and economic growth, the financial crime should not be in place. This research is motivated by a concern on the future of the Islamic finance industry, which is being exposed to reputation risk that can bring harm to its operations. Hence, this paper discusses the reputation risk faced by Islamic financial institutions due to financial crime activities that can jeopardize the development and sustainability of the Islamic finance industry. With the increasing

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According to 1MDB's audit report that is now publicly available from the National Audit Department, 1MDB had issued Islamic medium-term notes (IMTNs) of RM5 billion to fund its initial operation in 2009.

development of the financial markets and the on-going financial crises affecting across the globe, the reputation risk management, especially for Islamic financial institutions becomes more important due to its significant impact on the financial performance of the financial institutions. The remaining of this paper is organized as follows: the next section discusses various literature regarding the financial crime activity and theoretical review, and section three discusses the conceptual framework and final section concludes the discussion of the paper.

## 2.0 Literature Review

### *2.1 Financial Crime Activities*

Financial crime is a regulatory, reputational, or monetary act or attempts against financial services institutions, corporations, governments, or individuals by internal or external agents to steal, defraud, manipulate, or circumvent established rules. A well-known meaning of fraud in literature was given by the Association of Certified Fraud Examiners (ACFE)[6] as "using deception to make a personal gain for one's self dishonestly and create a loss for another." This may occur and might include activities such as theft, corruption, conspiracy, embezzlement, assets misappropriation, money laundering, bribery, and a position of trust or fiduciary relationship. Xu et al.[7] define fraud as an act in which individuals or a group of people made to gain an undue advantage in an organization. In addition, financial crime is often defined as a crime against property, involving the unlawful conversion of property belonging to another to one's own personal use and benefit. Petter[8] discusses in his study that financial crime can be categorized via check and credit card fraud, mortgage fraud, medical fraud, corporate fraud, bank account fraud, payment (point of sale) fraud, currency fraud, and health care fraud, and they involve acts such as insider trading, tax violations,

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[6] The ACFE is the world's largest anti-fraud organization and premier provider of anti-fraud training education and certification.

[7] Y, Xu, L. Zhang and H. Chen, "Board Age and Corporate Financial Fraud: An Interactionist View", *Long Range Planning*, *51*(6), (2018), 815-830.

[8] G. Petter, "Categories of Financial Crime", *Journal of Financial Crime*, 17(4), (2010), 441-458.

kickbacks, embezzlement, identity theft, cyber-attacks, money laundering, and social engineering.

Financial criminal activity has been associated with a number of bank failures around the world, such as the failure of the first Internet bank, the European Union Bank. Few financial crises happened in the 1990s, such as scandal at the BCCI and the 1995 collapse of Barings Bank as a risky derivatives scheme carried out by a trader at a subsidiary unit, had a significant criminal or fraud components. There is no specific definition for financial crime in the conventional economy and it usually referred to as white-collar crime and fraud. Federal Bureau of Justice Statistics (Dictionary of Criminal Justice Data Terminology) defined it as a non-violent crime for financial gain utilizing deception and committed by anyone having special technical and professional knowledge of business and government, irrespective of the person's occupation. In Malaysia, financial crime is referred to cases such as cloning of cheques, ATM and credit card fraud, 'Fly by Night' scams, Internet fraud such as spoofing, love scams, parcel scam, email hacking, and money laundering. Although Malaysia is not a regional center for money laundering, its formal and informal financial sectors are vulnerable to abuse by narcotic traffickers, financiers of terrorism and criminal elements. Currently, Malaysia experiences an increasing trend of financial crime. Malaysians lost RM1.3 billion between January and August 2018 due to financial crime, said by Malaysia Deputy Finance Minister II, Datuk Lee Chee Leong. There were 19,425 cases in that period, which was an increase of 2,583 cases compared to the same period in the previous year, 2016. According to the Commercial Crime Investigations Department (CCID), there was a 42 percent increase in financial crime cases, from of 18,647 cases in 2015 to 26,548 cases in 2016. The total amount lost in 2016 was RM1.96 billion[9].

In general, financial crime can be divided into two types. First, there are those activities that dishonestly generate wealth for those engaged in the conduct in question. For example, the exploitation of insider information or the acquisition of another person's property by deceit will invariably be done with the intention of securing a

[9] Cybercrime a Serious Threat to Nation. *The Star,* (September 2017).

material benefit. Alternatively, a person may engage in deceit to secure material benefit for another. Second, there are also financial crimes that do not involve dishonest taking of a benefit, but protect a benefit that has already been obtained or to facilitate the taking of such benefit. An example of such conduct is where someone attempts to launder criminal proceeds of another offense in order to place the proceeds beyond the reach of the law. Financial crime is commonly considered as covering the following offenses: fraud, electronic crime, money laundering, terrorist financing, bribery and corruption, market abuse and insider dealing information security.

Today, financial crime becomes more sophisticated and the criminals are also expert in the banking process. There are few factors that contribute to this situation such as globalization, the proliferation of banking channels, rising transaction volumes and accelerated technology advancements such as fast changes of digital tools and intelligent automation. Criminals continuously attack banking as a platform for their activities through innovative algorithms and complex schemes across channels and vectors. On the other hand, regulators also play crucial roles by imposing a comprehensive risk management process such as close supervision, compliance, and many others. At the country level, the regulators instructed the banks to take greater responsibility to prevent financial crime and report suspicious activities. In response to this, banks have also made continuous efforts to mitigate the criminal activities such as the implementation of “Know Your Customer” Policy (KYC), transaction monitoring systems, and availability of expertise in risk management. Even though these processes are difficult for banks, it should be noted that the existence of financial crimes due to lack of monitoring and supervision which can be even more costly. The costs involve includes fines as imposed by the regulators, remediation, termination of business lines and temporary or permanent restrictions on selling certain products, and the most important things is the unquantifiable impact of reputational damage to the banks.

Banks are impacted by financial crime in many ways. Their approaches to risk and the identification and prevention of crime can leave the bank exposed. A report by KPMG[10] demonstrates how

[10] KMPG. “Clarity on Financial Crime in Banking. Agility, Risk and Culture: Three

Switzerland banks have been affected by financial crimes over the past three years from 2015 to 2017. The report states that the types of financial crime which were used in the banking industry are, with the highest of 22 percent of money laundering, 12 percent of an identity thief, 11 percent of embezzlement and the others include of credit card fraud, bribery/corruption, Ponzi schemes, terrorist financing, and others. Based on the report, 49 percent of offenders have no relationship with the bank, while 25 percent of offenders are among the current/former bank staff members. Majority of cases reported are from cybercrime, information security attacks and fraud.

The existence of financial crime activities in the financial system, especially in Islamic financial institutions operations will lead to a negative perception of the public which will give impact to its reputation. The negative perception of Islamic financial institutions will damage stakeholders and public trust and confidence in Islamic financial institutions. Back to the abovementioned definition, reputation risk as a result of financial crime will then affect the performance of Islamic financial institutions.

### *2.2 Theoretical Review of Financial Crime*

This section discusses three theories related to financial crime, namely; fraud triangle theory, fraud diamond theory, and game theory.

#### *2.2.1 Fraud Triangle*

The fraud triangle theory is developed in 1971 by Cressey[11], from his studies of criminology area (Figure 1). This theory focuses on the behavior of fraudsters which describes the factors that propel them to commit fraud in an organization. This study was developed at first to examine the embezzlers. However, it is also adopted by researchers to support their research pertaining to fraud, which is also one of the corporate crimes. Skousen[12] and Skousen et al.[13] had applied the

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Priorities for Change", (2018)

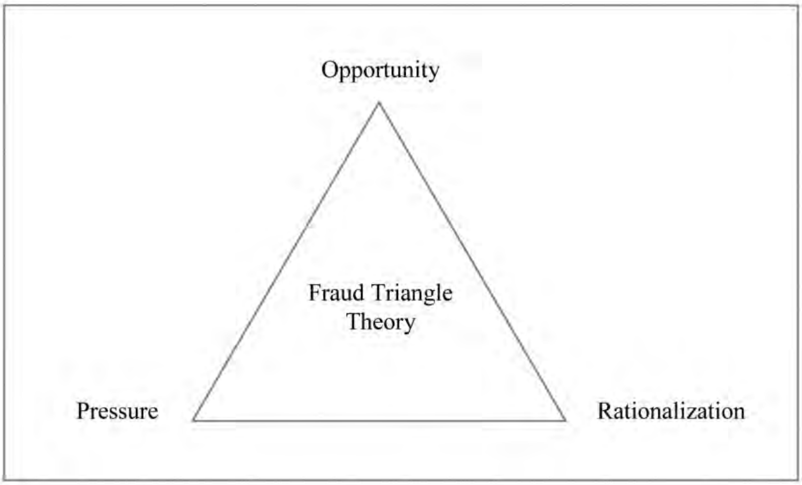
[11] D. Cressey, "Other People's Money", Montclair: Patterson Smith. (1973).

[12] C.J. Skousen, "Empirical Investigation of the Relevance and Predictive Ability of the SAS 99 Fraud Risk Factors." PhD diss., Oklahoma State University, (2004).

[13] C.J. Skousen, R.S. Kevin and J.W. Charlotte, "Detecting and Predicting Financial Statement Fraud: The Effectiveness of the Fraud Triangle and SAS No. 99",

fraud triangle theory to create a fraud prediction model. The study by Huang[14] relates this theory to identify risk factors. Meanwhile, Roden et al.[15] applies this theory to assess the predictor of corporate fraud.

Figure 1: Fraud Triangle Theory




According to Cressey, for fraud to occur, three conditions must exist which are: pressure, opportunity, and rationalization. The pressure is actually what causes people to commit fraud in an organization. Pressure comes in many ways; financial needs, work-related pressures, material possession, and others. This would result from one's ability to pay bills, medicals as well as a desire for luxury materials. Thus, what accounts for the rise of the incidence of fraud is an opportunity. An opportunity comes when there is a weak internal control in an organization. But if stringent internal control is being practiced, lesser opportunity there would be for the employees

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*Corporate Governance and Firm Performance*, (2009): 53-81.

[14] S.Y. Huang, L. Chi-Chen, C. An-An and C.Y. David, "Fraud Detection using Fraud Triangle Risk Factors", *Information Systems Frontiers*, 19(6), (2017), 1343-1356.

[15] D.M. Roden, R.C. Steven and Y.K. Joung, "The Fraud Triangle as a Predictor of Corporate Fraud", *Academy of Accounting and Financial Studies Journal*, 20(1), (2016), 80.

to commit any fraud. It is very imperative that internal control should be effective to prevent future occurrence of fraud. Rationalization is the last factor that Cressey discusses in this theory where the fraudsters come up with reasons to justify their actions. It is sort of a belief that their wrongdoings are not illegal and, therefore, not morally wrong. Fraud is usually motivated by poverty and tax evasion by greed. Moreover, gambling, financial strain either personal or business and the feasibility of business under the influence of others are the major factors stimulating fraud[16]. In fact, these criteria are related to the fraud triangle elements, where it relates to the reason for people committing a crime. Omar et al.[17] study the profile analysis of corporate crimes in Malaysia. The four criteria are the corporate profiles, details on the crime committed, perpetrators profile and, finally, the offense. The study finds that top-level management, especially the directors, usually commit such crime and many of them are male.

### *2.3.2 Fraud Diamond Theory*

The fraud diamond theory as Figure 2 below is the extension of the earlier one, fraud triangle theory. Besides of the three-element (pressure, opportunity, and rationalization); there is an additional element taken into consideration to make the element of committing crime complete[18]. The said element is capability which is interpreted as the benefits of having necessary traits and abilities to be the right person to pull off the string (in this case is a crime). The person who has the capability is the one who is having the opportunity to turn the crime into reality. It is most likely related to the power the person holds. The components of capability are position/functions, brains, confidence, coercion skills, ability to lie and immunity to stress[19].

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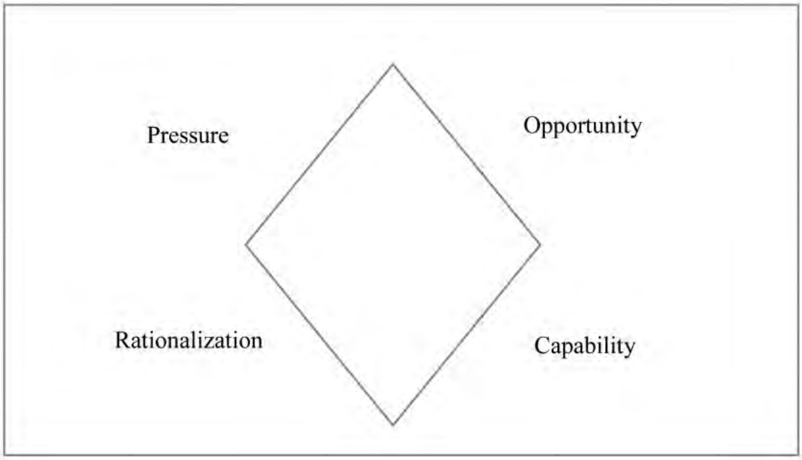
[16] M, Gill and G.W. Janice, "Theft and Fraud by Employees", *Handbook on Crime, Cullompton, Willan* (2010), 100-119.
[17] N. Omar, R. Said and A.Z. Johari, "Corporate Crimes in Malaysia: A Profile Analysis", *Journal of Financial Crime*, 23(2), (2016), 257-272.
[18] D.T. Wolfe and D.R. Hermanson, "The Fraud Diamond: Considering the Four Elements of Fraud." (2004).
[19] N. Omar, R. Said and A.Z. Johari. "Corporate crimes in Malaysia." 257-272, op cit.

Figure 2: Fraud Diamond Theory




*2.3.3 Game Theory*

Another theory related to financial crime is game theory. Dixit and Nalebuff[20] illustrate the general ideas of game theory using examples drawn from sports, business, and other familiar contexts. The study emphasis of the theory was on games of pure conflict. According to the theory, the essence of a game is the interdependence of the player's strategies and decision making strategically. There are two distinct types of strategic interdependence, sequential and simultaneous. In the former, the players proceed in order with each being aware of the others' foregoing actions. In the latter, the players act at the same time with each being ignorant of the others' actions[21]. Several players must make choices that potentially affect the interests of the other players. Relating to this theory, while maintaining fraud policy and training, annual auditing, good remuneration, employee's background checks, bank reconciliation, and good corporate governance in financial institution industry are crucial constituents that require strategies and decision making. The banking industry has

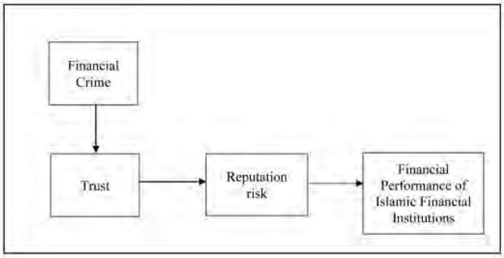
[20] A. Dixit and B. Nalebuff, "*Thinking Strategically: The Competitive Edge in Business, Politics and Everyday Life*", W. W. Norton & Co.: New York, NY, (1991).
[21] C. Montet and D. Sierra, Game Theory and Economics, Palgrave Macmillan. (2003), p. 487

many players in which each outwits the other' self-gain. Every financial institution's aim is to gain profits for expansion, while that of the customers is to receive value for the monies and services. If such aim is not met, customers will use alternative ways to recover them. It was clearly demonstrated that finite games must always have equilibrium point, at which all players choose actions which are best for them given their opponents' choices, which in this case the customer to run away from the banking itself.

## 3.0 Conceptual Framework

This section discusses the impact of financial crime on the reputation of Islamic financial institutions. As financial crime is against the norms and objectives of Islām carried by Islamic financial institutions, its existence in the Islamic financial institution's operations will lead to a negative perception of the public which will give impact to its reputation. The negative perception of Islamic financial institutions will damage stakeholders and public trust and confidence in Islamic financial institutions. Back to the abovementioned definition, reputation risk as a result of financial crime will then affect the performance of the Islamic bank as illustrated in Figure 3 below. Based on the said figure, this paper discusses two important elements namely, trust and reputation risk of Islamic financial institutions as a result of financial crime activities.

Figure 3: Conceptual framework




### *3.1 Trust*

Trust is the main asset of services-based business such as banking institution that plays intermediaries roles. Trust is defined as the willingness to rely on a partner engaged in the exchange in which one has confidence[22]. According to Laaksonen et al.[23], trust is defined as a belief by one partner in a relationship exchange that the other partner will not act against their interests, where this belief is held without undue doubt or suspicion and in the absence of detailed information about the actions of the other partner. Thus, trust is very important to establish and maintain an effective long-term relationship[24,25,26,27].

Referring to the related theory, fraud triangle theory; there are three conditions that must exist which are pressure, opportunity and rationalization. Trust is the most important part which covers these three conditions in order for the person to commit the crime. In the context of banking where the core business is to provide financial services, previous studies have identified trust as the key factor for the sustainability of banking operations [28, 29, 30]. In relation to this, Hassan et al.[31] have emphasized that trust is a fulfillment of a

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[22] S. Ganesan, "Determinants of Long-Term Orientation in Buyer-Seller Relationships." *Journal of Marketing,* 58(2), (1994), 1-19.

[23] T. Laaksonen, P. Kalle and H.I. Kulmala, "Co-Evolution of Trust and Dependence in Customer–Supplier Relationships", *Industrial Marketing Management,* 37(8), (2008), 910-920.

[24] S.P. Gounaris, "Trust and Commitment Influences on Customer Retention: Insights from Business-To-Business Services", *Journal of Business Research,* 58(2), (2005), 126-140.

[25] J. Svensson, "Eight Questions about Corruption", *Journal of Economic Perspectives.* 19(3), (2005), 19-42.

[26] R.W. Palmatier, P. Rajiv, D.G. Dant and R.E. Kenneth, "Factors Influencing the Effectiveness of Relationship Marketing: A Meta-Analysis", *Journal of Marketing,* 70(4), (2006), 136-153.

[27] T. Laaksonen, P. Kalle and H.I. Kulmala, "Co-Evolution of Trust and Dependence in Customer–Supplier Relationships", *Industrial Marketing Management,* 37(8), (2008), 910-920.

[28] C. Erol and and R. El-Bdour, "Attitudes, Behaviour, and Patronage Factors of Bank Customers towards Islamic Banks", *International Journal of Bank Marketing*, 7(6), (1989), 31.

[29] C. Erol and E. Radi, "Conventional and Islamic Banks Patronage Behaviour of Jordanian Customers", *International Journal of Bank Marketing*, 8(4), (1990), 25.

[30] M. Rashid and K.M. Hassan, "Customer Demographics Affecting Bank Selection Criteria, Preference, and Market Segmentation: Study on Domestic Islamic Banks in Bangladesh" *International Journal of Business and Management*, 4(6), (2009), 131–146.

[31] M.T. Hassan, A. Bilal, A. Saleem, H. Umair, R. Saim, M. Nadeem and A. Abia,

promise and expectation that the bank will act to protect customers' long-term interests. Trust is also viewed as an important factor in determining customer loyalty towards Islamic financial institutions[32]. Hence, banks must ensure that they can provide intermediaries roles effectively to gain and maintain customers trust in order to sustain its operations.

As for Islamic financial institutions, the concept of trust goes extra miles than in conventional banks. Islamic financial institutions operate based on Islamic principles and do not involve in activities/ transactions that are prohibited in Islām[33]. Previous studies suggest that the customers do not only trust and have confidence in the Islamic financial institutions' role as financial services providers, they also trust in terms of the bank adhering to and complying with *Sharīʽah* principles[34,35]. There are many studies that found adherence to Islamic principles to be the main reason for choosing an Islamic bank[36]. According to Ahmad[37], the main feature of Islamic financial institutions that carrying banking activities in line with *Sharīʽah* requirement helps to build customers trust and committed to the Islamic financial institutions. Moreover, as the Islamic financial system operate by using *Sharīʽah*-compliant funds, it is crucial to

"Measuring Customers Loyalty of Islamic Banking in Bahawalpur Region", *International Journal of Learning and Development,* 2(2), (2012), 101-111.

32 K.S. Lim and A.R. Mohammed, "Brand Loyalty and Situational Effects: An Interactionist Perspective", *Journal of International Consumer Marketing,* 9(4), (1997), 95-115.

33 M.T. Hassan, A. Bilal, A. Saleem, H. Umair, R. Saim, M. Nadeem and A. Abia, "Measuring Customers Loyalty of Islamic Banking in Bahawalpur Region", *International Journal of Learning and Development,* 2(2), (2012), 101-111.

34 M. Amin and I. Zaidi, "An Examination of the Relationship between Service Quality Perception and Customer Satisfaction: A SEM Approach towards Malaysian Islamic Banking", *International Journal of Islamic and Middle Eastern Finance and Management,* 1(3), (2008), 191-209.

35 M.Z. Hoq, N. Sultana and M. Amin, "The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector", *South Asian Journal of Management,* 17(1), (2010), 70.

36 A. Samreen, J. Robson and Y. Sekhon, "Consumer Trust and Confidence in the Compliance of Islamic Banks", *Journal of Financial Services Marketing,* 20(2), (2015), 133-144.

37 K. Ahmad, "Islamic Finance and Banking: The Challenges and Prospects", *Review of Islamic Economics*, 9 (2000): 57–82.

ensure that the interest of the stakeholders is protected at all time, including protected from being associated with criminal activities. The system also needs to be safeguarded from being abused by the irresponsible parties for the interest in criminal activities. Having said this, Islām has also placed the uppermost importance on trust in all aspects of life and reflects being trustworthy as an obligatory personality attribute. Thus, trustworthy should be exercised from an individual level up to the organizational level activities, including banking activities.

Researchers used different concepts and indicators for measuring trust[38]. Among other dimensions used to measure or define trust are benevolence and credibility (e.g. Zand[39]; Ganesan[40]; Doney and Canon[41]); integrity (e.g. Doney and Canon[42]; Kenning[43]); reliability (e.g. Morgan and Shelby[44]; Zaheer et al.[45]; Svensson[46]); predictability, fairness (e.g. Zaheer et al.[47]); honesty, competence, goodwill, constancy (e.g. Kenning[48]). For the Islamic banking

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38 R.M. Morgan and D.H. Shelby, "The Commitment-Trust Theory of Relationship Marketing", *Journal of Marketing,* 58(3), (1994), 20-38.

39 D.E. Zand, "Trust and Managerial Problem Solving", *Administrative Science Quarterly,* (1972), 229-239.

40 S. Ganesan, "Determinants of Long-Term Orientation in Buyer-Seller Relationships", *Journal of Marketing*, 58, (1994), 1-19.

41 P.M. Doney and I.P. Cannon, "An Examination of the Nature of Trust in Buyer-Seller Relationships", *Journal of Marketing*, 61, (1997), 35-51.

42 Ibid.

43 P. Kenning, "The Influence of General Trust and Specific Trust on Buying Behaviour." *International Journal of Retail & Distribution Management*, 36(6), (2008), 461-476.

44 R.M. Morgan and D.H. Shelby, "The Commitment-Trust Theory of Relationship Marketing", *Journal of Marketing*, 58(3), (1994), 20-38.

45 A. Zaheer, B. McEvily and V. Perrone, "Does Trust Matter? Exploring the Effects of Inter-organizational and Interpersonal Trust on Performance." *Organization Science,* 9(2), (1998), 141.

46 G. Svensson, "Mutual and Interactive Trust in Business Dyads: Condition and Process." *European Business Review,* 17(5), (2005), 411-427.

47 A. Zaheer, B. McEvily and V. Perrone, "Does Trust Matter? Exploring the Effects of Inter-organizational and Interpersonal Trust on Performance." Organization Science, 9(2), (1998), 141.

48 P. Kenning, "The Influence of General Trust and Specific Trust on Buying Behaviour." *International Journal of Retail & Distribution Management*, 36(6),

system, the measurement of trust can be understood as a representation of trustworthiness, honesty, equity, equality among human beings, and moral values that are customary to increase the business relationship between banks and clients[49]. Likewise, integrities and agreement with Islamic principles are highly observed and continued as leaders in successively Islamic banking activities founded on trust[50]. Although the description of trust in a business to the business association has been recognized, there should be an agreement in understanding trust as honesty, confidence, integrity, and trustworthiness[51].

### *3.2 Reputation*

Reputation is a key asset for any business that operates based on trust, such as a banking institution. According to Basel Committee on Banking Supervision[52], reputational risk is defined as "the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debtholders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding". Soprano et al.[53] have further defined reputational risk as the risk of damaging the institution's trustworthiness in the marketplace. This according to them includes the impact of a specific event that could worsen, or affect negatively, the perception of a company's reliability, of its

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(2008), 461-476.

[49] J.B. Sauer, "Metaphysics and Economy–The Problem of Interest: A Comparison of the Practice and Ethics of Interest in Islamic and Christian Cultures", *International Journal of Social Economics*. 29(1/2), (2002), 97-118.

[50] R.N. Kayed and M. K. Hassan, "Saudi Arabia's Economic Development: Entrepreneurship as a Strategy", *International Journal of Islamic and Middle Eastern Finance and Management,* 4(1), (2011), 52-73.

[51] M. Amin, I. Zaidi and R. Fontaine, "Islamic Banks: Contrasting the Drivers of Customer Satisfaction on Image, Trust, and Loyalty of Muslim and Non-Muslim Customers in Malaysia", *International Journal of Bank Marketing*. 31(2), (2013), 79-97.

[52] Basel Committee on Banking Supervision. Proposed Enhancements to the Basel II Framework, Consultative Document, (2009), p. 19.

[53] S. Aldo, B. Crielaard, F. Piacenza and D. Ruspantini, *Measuring Operational and Reputational Risk: A Practitioner's Approach*. Vol. 562 (2010).

services' quality, its management fairness, or more generally, its trustworthiness. This negative or worsened perception could then, spread from its own employees or customers to financial markets, investors, shareholders, counterparties, governments and/or regulators. As stated in the fraud diamond theory, the conditions of pressure, opportunity, rationalization and capability are the element of committing crime, which give the impact to the reputation risk of the institution.

Interest in reputational risk in the financial sector has grown over the past two decades after the occurrence of some prominent examples:

(i) operating losses due to internal frauds[54]. Examples of fraudulent trading in the Allied Irish Bank, Barings and Daiwa Bank Ltd generating operational losses of $691 million, $1 billion, and $1.4 billion, respectively.

(ii) external fraud. e.g. the $611 million operational losses at the Republic New York Corporation for fraud committed by custodial clients.

(iii) damage to physical assets. e.g. Bank of New York suffered $140 million operational losses to damage to facilities related to September 11, 2001.

(iv) business disruption and system failures. e.g. Salomon Brothers suffered $303 million operational losses because of a change in computer technology that resulted in un-reconciled balances. The credit turmoil from 2007 onwards has definitively increased the attention of academics, regulators and practitioners on bank reputation. Reputation risk is also one of the important elements in Basel III. According to Basel III, reputation risk will lead to the operational losses of the banks. Financial institutions that rely on the proceeds of financial crime such as money laundering have additional challenges in adequately managing their assets, liabilities, and operations. Money laundering activities will place monies at a banking institution just for a cleaning process and suddenly

[54] D. Alexander, A. Morse and L. Zingales, "Who Blows the Whistle on Corporate Fraud?" *The Journal of Finance* 65(6), (2010), 2213-2253.

> disappear without notice. This can result in liquidity problems and runs on banks. Indeed, financial criminal activity has been associated with a number of bank failures around the world, such as the failure of the first Internet bank, the European Union Bank.

Based on a report issued by KPMG[55], it was highlighted that there is an increasing trend of financial crime activities at banking institutions. Surprisingly, recent biggest financial crime, particularly, money laundering activities happened in Malaysia involving Islamic financial instruments. Theoretically, this should not happen in the Islamic finance industry as it operates based on *Sharīʿah*-compliance and Islamic values, which shall indirectly prevent the industry from any criminal activities and manipulation that lead to financial crime and scandals. As Islamic financial institutions are founded based on *Sharīʿah*, the usage of Islamic financial instruments for criminal activities undermines the integrity of the Islamic financial system itself. It would also tarnish Islamic financial institutions' reputation that supposed to operate with Islamic principles against any criminal activities. Public confidence towards the integrity of Islamic financial institutions would also be distracted as being associated with financial crime activities which may signal that the Islamic financial institutions' profit is eroded by criminal activities. This has raised concern and questions about the reputation of Islamic financial institutions. The negative reputation that results from money laundering activities diminishes legitimate global opportunities and sustainable growth for the Islamic banking industry. It will also attract international criminal organizations with undesirable reputations and short-term goals. This can result in diminished development and economic growth. Furthermore, once an Islamic banking industry reputation is damaged, reviving it is very difficult and requires significant government resources to rectify a problem that could be prevented with proper anti-money-laundering controls. Particularly for Islamic financial institutions, the reputation risk as a result of financial crime activities will tarnish the image and lead to

[55] KMPG. "KPMG Forensic: Fraud risk management. Developing a strategy for prevention, detection and response", (2014).

loss of public trust towards Islamic financial institutions that carry the Islamic finance business activities. According to Haron et al.[56], the reputation risk has an impact on their financial performance; on the other hand, reputation has a positive impact on the Islamic financial institutions if the banks have strong trust from the customers. Therefore, reputation is a key asset of a banking institution and adequate management of reputational risk is vital[57].

Therefore, the hypotheses of the study are as follows:

H1: Financial crime has a significant effect on customers' trust and reputational risks

H2: Customers' trust has a significant effect on the Islamic financial institutions' performance.

H3: Reputation risk significantly mediates the relationship between customers' trust and Islamic financial institutions' performance.

## 4.0 Conclusion

Even the Islamic financial institutions have evolved over more than thirty years there are still needs for more control and supervision by the authorities and the institution of regulatory organization of the Islamic financial institutions itself. If the Islamic financial institutions have no control on the financial crime laundering activities, it will tarnish their reputation which subsequently affects customer's trust on the institutions, thereby driving away customers, investors, shareholders, and counterparties. It is expected that the Islamic financial institutions pay more attention to managing the reputation risk, of which the responsibility is held by all stakeholders of the industry.

This study provides a conceptual understanding for the policy implication of the linkage of financial crime towards the impact to the financial performance of Islamic financial institutions. The

[56] M.S. Haron, R. Ramli, M.M.Y. Injas and R.A. Injas, "Reputation Risk and its Impact on the Islamic Banks: Case of the *Murabaha*", *International Journal of Economics and Financial Issues*, 5(4), (2015), 854-859.

[57] F. Franco, S. Maria-Gaia and P. Schwizer, "Reputational Losses and Operational Risk in Banking", *The European Journal of Finance*, 20(2), (2014), 105-124.

financial crime is committed when the existence of trust thus affects the reputation risk which is translated into the losses to the financial institutions. In addition, this study would be extended to identify the indicators of each element in measuring the impact to the financial performance to better understanding of the relationship of the framework. Furthermore, future study should be conducted for empirical evidence of this framework.

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# TRANSLITERATION TABLE

## CONSONANTS

Ar=Arabic, Pr=Persian, OT=Ottoman Turkish, Ur=Urdu

| | Ar | Pr | OT | UR |
|---|---|---|---|---|
| ء | ’ | ’ | ’ | ’ |
| ب | b | b | b | b |
| پ | – | p | p | p |
| ت | t | t | t | t |
| ٹ | – | – | – | ṭ |
| ث | th | th | th | th |
| ج | j | j | c | j |
| چ | – | ch | çh | ch |
| ح | ḥ | ḥ | ḥ | ḥ |
| خ | kh | kh | kh | kh |
| د | d | d | d | d |
| ڈ | – | – | – | d |
| ذ | dh | dh | dh | dh |
| ر | r | r | r | r |

| | Ar | Pr | OT | UR |
|---|---|---|---|---|
| ز | z | z | z | z |
| ڑ | – | – | – | ṛ |
| ژ | – | zh | j | zh |
| س | s | s | s | s |
| ش | sh | sh | ş | sh |
| ص | ṣ | ṣ | ṣ | ṣ |
| ض | ḍ | ẓ | ż | ż |
| ط | ṭ | ṭ | ṭ | ṭ |
| ظ | ẓ | ẓ | ẓ | ẓ |
| ع | ‘ | ‘ | ‘ | ‘ |
| غ | gh | gh | ğ | gh |
| ف | f | f | f | f |
| ق | q | q | k | q |
| ك | k | k/g | k/ñ | k |

| | Ar | Pr | OT | UR |
|---|---|---|---|---|
| گ | – | g | g | g |
| ل | l | l | l | l |
| م | m | m | m | m |
| ن | n | n | n | n |
| ه | h | h | h[1] | h[1] |
| و | w | v/u | v | v/u |
| ى | y | y | y | y |
| ة | -ah | | | -a[2] |
| ال | al[3] | | | |

[1] – when not final
[2] – at in construct state
[3] – (article) al - or l-

## VOWELS

| | | Arabic and Persian | Urdu | Ottoman Turkish |
|---|---|---|---|---|
| Long | ا | ā | ā | ā |
| | آ | Ā | Ā | – |
| | و | ū | ū | ū |
| | ي | ī | ī | ī |
| Doubled | يّ | iyy (final form ī) | iy (final form ī) | iyy (final form ī) |
| | وّ | uww (final form ū)<br>uvv (for Persian) | uv | uvv |
| Diphthongs | وَ | au or aw | au | ev |
| | ىَ | ai or ay | ay | ey |
| Short | ـَ | a | a | a or e |
| | ـُ | u | u | u or ü<br>o or ö |
| | ـِ | i | i | i |

## URDU ASPIRATED SOUNDS

For aspirated sounds not used in Arabic, Persian, and Turkish add h after the letter and underline both the letters e.g. جھ <u>jh</u> گھ <u>gh</u>

For Ottoman Turkish, modern Turkish orthography may be used.

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