

The Development of Islamic Finance and Fostering the Influence of Moral Values and Personal Factors in Investment Decision

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Abstract

Since the reform movement of the Muslim World from the mid-nineteenth century, many Islamic Financial institutions have been established. Subsequently, in 2001 the first Islamic banking policy was issued by the State bank of Pakistan and thereafter, Pakistan has faced many commercial, accountability and regulatory challenges in transforming the economy into an Islamic Economy. In this study, we find out whether the development of the Islamic Economy has fostered moral values in investors. This study, hence, aims to discuss the fundamental issues in moral values behind an investment decision while taking in account some personal factors influencing investment decisions. Data has been collected with the help of a questionnaire, where its reliability is confirmed by Cronbach Alpha, followed by correlation and multiple Regression tests. The results show a significant role of certain moral factors in investment decisions.

Key Words

Islamic Economy, Moral Factors, Behavioral Finance, Investment Decision.

Introduction

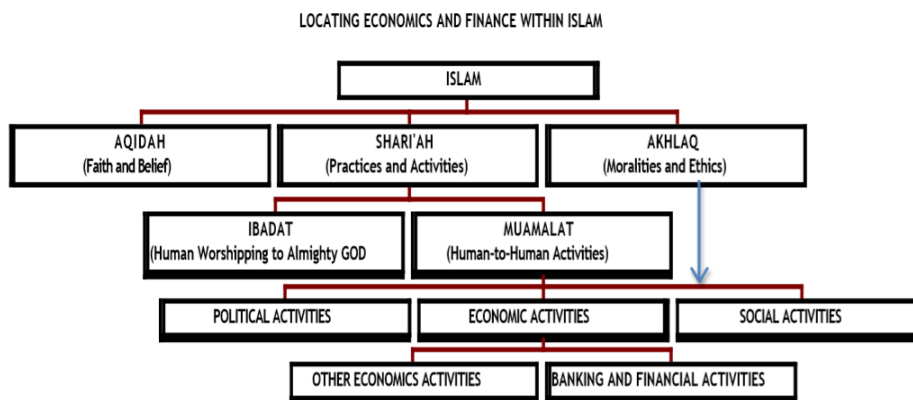
Islamic Banking and Finance aims to fulfill the aspirations of the Islamic Economy by contributing to the development of the society through ethical banking and investment. Islamic economy, as it is defined by Hasanuzzaman (1984, p. 52), is 'the knowledge and application of injunctions and rules of the Shari'ah that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligation to Allah and the society'. It is, however, important to an essentialist Islamic moral economy (IME), which provides the moral values (foundations) of investments to both investors and managers. In general, the term *moral value* directs us towards investor's understanding about a financial security based on its company policy as a proxy formorally responsible manage mentors otherwise. However, In Islamic finance we have a complete set of Shari'ah-based laws which surround moral and ethical practices of investors with the concept of monetary return along with religious benefits.

The investor expects the company to fulfill the moral responsibilities like Shari'ah based laws, transparency of information, in terms of cost on social responsibility and fiduciary duties and being responsible for delivering all the information symmetrically to all the stakeholders i.e. shareholders, investors, customers and society. We have taken moral values in general so that we also consider the applications of Islamic Finance over non-Muslim communities as well, where we have some common pre requisites of doing good and socially responsible.

The prior research has analyzed the attitude of individual investors like according to Qadri (2014) the investor's attitude coming from the personal factors like investor behavior in sense of confidence (oor ver confidence) in his own decision and sensitivity toward risk and return or risk tolerance. Previously researchers have measured the combined effect of both moral factors and personal factors on investor's investment decision. However, two dimensions of moral factors i.e. social responsibility and fiduciary duty have been identified which are concerned with the company that whether the investor is attracted towards the company which is fulfilling these responsibilities or which takes care of moral factors.

Moreover, Riaz (2012) has identified two dimensions of personal factors as well i.e. overconfidence and risk tolerance. The personal factors are concerned with the individual that if his or her personal factors affect his/her investment decision or not. It is important to analyze how these two factors affect the decision of an investor while going to purchase the stock of a particular

company. Nagy and Obenberger (1994) identified that a study should be done to analyze the internal and external factors which effect the investment decision of an investor while investor is going for investment. The internal factors are related to investor's own personality. Some investors are very much confident about their decision and believe that their decision is always right and better and will result in optimum returns. Another internal factor is risk tolerance. Some investors take high risk to generate high returns and some are not willing to take any risk. The external factor (morality or ethics) are related to company's actions which includes 'fiduciary duties', the investor expects from the company to perform all the fiduciary duties and other one is 'social responsibility



Source: an introduction to Islamic Moral Economy, Asutay M. (2011)

Figure above shows the scope of our research regarding moral values in broad spectrum of Islam and hence its importance to inspect its application in the society.

Source: an introduction to Islamic Moral Economy, Asutay M. (2011)

Among other behavioral Finance notions, we have chosen moral values and personal factors for study. The overall objective of this research is to analyze that since the inception of Islamic finance in Pakistan, to which extent moral values and personality traits have influenced our financial investment decisions? To identify the individual investors' attitude towards investment 380 investors/managers are interviewed from the Peshawar region. This study will help companies to know about moral responsibilities they should fulfill to attract the potential investors towards their company if there is any impact of moral factors on investment decision. Moreover, considering the environmental and social aspects of the firm, this research would suggest that how firms should focus on different aspects of investor's perception towards investment decision. Nevertheless, the academia will observe the gap of educating the society about Islamic Moral economy.

Literature Review

The Idea of behavioral finance was emerged in the early 1990s thus it is a new field to be studied. At that time the center of academic debates moved away from the econometric analysis of time series on values, earnings, dividends to develop the models of individual's psychology as it is related to financial markets. This concept opposes the Efficient Market Hypothesis (EMH) because in Efficient Market Hypothesis we can predict the behavior of an individual as they behave rationally and predictably. In behavioral finance there is psychological process involved regarding any kind of decision making because after all an investor is a human being. Individuals have some specific values and beliefs (in our case religious beliefs) and they make decisions in accordance to them. Values, beliefs and Behavior of investor act as the driving factors to take investment decisions, and they also play an important role in investors' satisfaction from returns.

In Behavioral finance there are cognitive factors and emotional issues that have an impact on the process of decision making of individuals, groups, and organizations (Ricciardi and Simon, 2000). It is not a science because it does not have any specific paradigm (Olsen, 2001). Behavior Finance is built up of two components, one is the 'Cognitive Psychology' and other one is 'limits to arbitrage' (Ritter, 2003). According to Ritter (2003) the former deals with how individual thinks i.e., investor makes systematic errors in thinking or thinking contains so many misconceptions. The later deals with the prediction that in what situations the arbitrage forces will have effect, and

when there will be not. In view of Thaler (1999), to enhance the understanding of financial markets, one can add the flavor of human's element. The most vital commitment of behavioral finance on the hypothesis side is the cautious examination of the part of business sectors in aggregating the variety of behaviors. Sewell (2007) further elaborated that behavioral finance is the impact's investigation of psychology on the conduct of financial specialists and the ensuing effect on markets.

Religious implications on human society foster moral and ethical guidelines for the psychological grooming of human beings, resulting in some good expected behaviors from all market participants. With the religiously responsible behaviors, the concept of Islamic Economy can be achieved (as shown in fig 1.1). However, the scope of this research is limited to some basic level requirements in investment decisions either by investors or by managers. Among the number of traits, here we have discussed moral and personal factors to inspect the implication of Islamic Finance in society. Moral feature is related to the transparency, fiduciary responsibilities, Discretionary responsibilities, Green Investing and Information Symmetry by the corporation. On the other hand, it has its foundation on the base of personal factors which include; Risk tolerance, Over-confidence and desire of wealth maximization that affects investor's investment decision.

Moral Factors

Morality is defined as a system of ethical or moral principles or principles of behavior used by a particular culture or society. According to Cussen, (2015) Morality is the branch of philosophy which deals with norms and values related to human behavior, regarding good and bad of specific activities and their individual thought processes and outcomes. Every individual has his own morality level. Therefore, in this aspect we can say that the morality factors will be affecting investors while they are taking investment decision. An individual's familiarity with moral issues is a critical initial phase in the ethical decision- making procedure (Butterfield, Trevin, & Weaver, 2000). Furthermore, Sparkes & Hunt, (1998) found that 35% of the investors invest ethically, regardless of the amount of return they get.

Boatright (2015) has explained the moral values as **a)** fiduciary duties and **b)** social responsibility. **a) Fiduciary Duty** is a legal duty to act completely in someone else interest, the highest standard of care at either equity or law. A fiduciary responsibility is expected to be extremely loyal to the person to whom representative owes the duty. Such that there must be no conflict of duties between fiduciary and principal (to whom he owes the duty), and the fiduciary must not profit from its position as a fiduciary. Hence, managers have a fiduciary duty to shareholders to run the company to their interest. Apart from managers' fiduciary duties, Individual investors must also think of benefit to the society. As opposed 0 cognitive and emotional elements on the investors decisions making is depicted in the market price and return. According to Bondt & Thaler, (1985), 'investors tend to overestimate the likelihood of accuracy of the information they have, their successes and abilities'. As to Shiller, (1997) "overconfidence is connected with individuals in their own judgments, these people underestimate the error margins to be performed". As Wang, (2001), stated that the under-confidence or negativity can't survive, however a moderate level of overconfidence or an optimistic approach can survive and even can be dominated, especially when the basic risk is greater.

However, as pointed in prior literature both personal and moral factors affect the investment decision of individuals. Hence this study is an attempt to verify the influence of these factors after a successful implication of Islamic Finance in the society under study. We drew following hypotheses:

H1₀: There is no effect of personal factors on investment decision

H1: There is effect of personal factors on investment decision.

H2₀: There is no effect of moral factors on investment decision.

H2: There is effect of moral factors on investment decision.

Methodology and Data

In this research paper the effect of moral and personal factors on investment decision have been studied. For studying this issue, the population of interest in the study is mutual funds' Investors, individual security investors, business graduates and managers of different organizations primarily involved in investment decision. By using a convenient sampling technique the data was collected from individual investors of Peshawar only. However, questionnaire was distributed among individual investors in institutions, banks, companies and mutual funds. Some of the respondents were unreachable; therefore, questionnaire was developed in Google forms to get their responses online, but it was made sure in the online responses that all respondents are residing in Peshawar permanently and involve in any type of investment decision. However, limited responses were gathered online but their results were included in overall analysis. A total number of 450 questionnaires were distributed; out of which 384 were received. Out of which we considered 380 because of missing answers. The respondents were asked to mark their gender

and age, however mentioning of their names was optional and asked to mark rest of the entire questionnaire. The number of male respondents was 304 and Female respondents were 80.

The research questionnaire was prepared while taking into consideration two dimensions of moral factors and two dimensions of personal factors. All the independent variables and one dependent variable were measured using five Likert scale i.e Strongly Agree, Agree, Neutral, Disagree and Strongly Disagree. In the questionnaire, from question 1 to question 5 are questions about 'overconfidence', from 6 to 9 are questions about 'risk tolerance', question 10 to 13 are linked to 'investment decision', question 14 to 16 are related to 'fiduciary duty' and question 17 to 20 are about 'social responsibility'.

For analysis the collected data was entered in Statistical Package for Social Sciences (SPSS). The data has been analyzed with the help of Regression analysis & Correlation in SPSS. The correlation has been run to find out the relationship among dimensions of moral & personal factors, then regression analysis was done to find out the impact of moral factors (fiduciary duty & social responsibility) and personal factors (risk tolerance & overconfidence) on investment decision. The questionnaire reliability has been checked with the help Cronbach alpha test. The test result has showed whether the questionnaire is highly reliable and further analysis can be done or not. If value for Cronbach alpha is equal to or greater than 0.7 then it means questionnaire is highly reliable and further analysis can be done to check the impact of personal factors and moral factors on investment decision.

Analysis

The analysis has been started with reliability tests for the questionnaire, followed by descriptive statistics and correlation matrices. The Cronbach's alpha is 0.719 which means that there is good level of internal consistency between the questions of the questionnaire.

Table 1. Descriptive Statistics

| | N | Min | Max | Mean | Std. Dev | Skewness | Kurtosis | | |
|---------------------|-----------|-------|-------|---------|----------|----------|------------|------------|------|
| | Statistic | | | | | | Std. Error | Std. Error | |
| Gender | 380 | 1.00 | 2.00 | 1.1782 | .38460 | 1.707 | .240 | .932 | .476 |
| Age | 380 | 22.00 | 80.00 | 31.1782 | 7.75422 | 3.054 | .240 | 15.10 | .476 |
| Moral Factors | 380 | 1.00 | 3.00 | 2.1188 | .58800 | -.025 | .240 | -.135 | .476 |
| Personal Factors | 380 | 2.00 | 4.00 | 2.7030 | .55758 | .021 | .240 | -.546 | .476 |
| Investment Decision | 380 | 1.00 | 4.00 | 2.6238 | .70500 | .334 | .240 | -.469 | .476 |
| Valid N (list wise) | 380 | | | | | | | | |

Table 2. Correlation of the Two Major independent and one dependent variables

| | | Moral Factors | Personal Factors | Investment Decision |
|---------------------|---------------------|---------------|------------------|---------------------|
| Moral Factors | Pearson Correlation | 1 | .261** | .109 |
| | Sig. (2-tailed) | | .008 | .278 |
| Personal Factors | Pearson Correlation | .261** | 1 | .400** |
| | Sig. (2-tailed) | .008 | | .000 |
| Investment Decision | Pearson Correlation | .109 | .400** | 1 |
| | Sig. (2-tailed) | .278 | .000 | |

** Correlation is significant at the 0.01 level (2-tailed).

From the table 2 the relationship among moral factors, personal factors and investment decision can be drawn. The p-value obtained for personal factors in relation to moral factors is 0.008 which is less than 0.05. Moreover, the p-value obtained for investment decision is insignificant in relation to moral factors and this requires more investigation. However, the p-value obtained for investment decision in relation to personal factors is 0.00 which

is less than 0.05 so we accept alternative hypothesis and therefore conclude that there is relationship between personal factors and investment decision.

The regression analysis is carried as follows;

Investment decision = f (moral factors, personal factors)

Table 3 is showing is the regression of the model and its validity with ANOVA. The value of Adjusted R-Square is 0.143 which is 14.3% and this indicates the contribution of independent variables in dependent variable. Moreover, the personal and moral factors' contribution in investment decision is found to be 14.3% and the rest is error term. The ANOVA table tells us whether overall model is significant or not as the P-value for ANOVA table is 0.00 which is less than 0.05, so we reject null hypothesis and accept alternative hypothesis and conclude that the model is significant.

Table 3. Regression Analysis and ANOVA

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | | |
|--------------------------|-------------------|----------------|-------------------|----------------------------|-------|-------------------|
| 1 | .400 ^a | .160 | .143 | .65278 | | |
| ANOVA^b | | | | | | |
| | | Sum of Squares | Df | Mean Square | F | Sig. |
| 1 | Regression | 7.943 | 2 | 3.971 | 9.320 | .000 ^a |
| | Residual | 41.760 | 98 | .426 | | |
| | Total | 49.703 | 100 | | | |

a. Predictors: (Constant), Personal Factors, Moral Factors

b. Dependent Variable: Investment Decision

The P-value obtained for moral factors shown in table 4 is insignificant and concludes that there is no effect of moral factors on investment decision of investors. However, the P-value obtained for personal factors in regression model for investment decision is 0.000 which is less than 0.05 so we accept alternative hypothesis and conclude that there is effect of personal factors on investment decision.

Table 4. Coefficients^a of independent variables

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|------------------|-----------------------------|------------|---------------------------|-------|------|
| | B | Std. Error | Beta | | |
| (Constant) | 1.250 | .360 | | 3.475 | .001 |
| 1 Moral Factors | .006 | .115 | .005 | .050 | .960 |
| Personal Factors | .504 | .121 | .398 | 4.154 | .000 |

a. Dependent Variable: Investment Decision

Furthermore, the Positive value of beta in personal factors indicates that change in personal factors will bring positive change in investment decision. The relationship of Investment Decision is significant with Personal Factors and insignificant with Moral Factors. So, in order to check the noise in Moral Factors relationship with investment decision we have done regression analysis separately for the sub variables of Moral factors i.e., Social Responsibility and Fiduciary Duty only.

Investment decision = f (Social Responsibility, Fiduciary Duty)

Table 5. Coefficients^a

| Model | Unstandardized Coefficients | | Standardize Coefficients | t | Sig. |
|-------------------------|-----------------------------|------------|--------------------------|-------|------|
| | B | Std. Error | Beta | | |
| (Constant) | 1.996 | .309 | | 6.468 | .000 |
| 1 Fiduciary Duty | -.017 | .111 | -.016 | -.150 | .881 |
| Social Responsibilities | .286 | .123 | .243 | 2.330 | .022 |

a. Dependent Variable: Investment Decision

The Fiduciary Duty is insignificant with Investment Decision while Social Responsibility has significant relationship with Investment Decision. The positive relation of social responsibility is robust with Friedman, (2007).

Conclusion

In the current study it is concluded that the personal factors do have an impact on investment decisions which is robust with Riaz (2007). However, there is no relation between collective moral factors and investment decision where two dimensions of moral factors were considered in the study i.e. Fiduciary duty and social responsibility. To further explore which dimension of moral factor is affecting or not affecting investment decision, multiple regressions was run. The results show that fiduciary duty has no effect on investment decision and social responsibility somehow shows effect on investment decision. The absence of fiduciary duties from the society challenges the academia for the need of further planning and awareness campaigns to better imply Islamic Economy in Pakistan. Our results support the evidence of moral values and risk sharing phenomenon but still improvement is required to foster complete moral values in investors.

A future study can be conducted to find out the investment attitudes of people in other cities or countries. Other moral factors like 'information symmetry', 'discretionary responsibilities' can be considered while studying investment decision. Ethical and Social factors can be taken into account while studying investment decision.

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APPENDIX

| | | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|----|--|----------------|-------|---------|----------|-------------------|
| 1 | I believe that I can predict the development in the stock market better than what is actually possible. | 1 | 2 | 3 | 4 | 5 |
| 2 | I regard my own competence to be superior to what it actually is. | 1 | 2 | 3 | 4 | 5 |
| 3 | I consider my own decision base to be better than it actually is. | 1 | 2 | 3 | 4 | 5 |
| 4 | Most of the time I overestimate my ability to make good investments. | 1 | 2 | 3 | 4 | 5 |
| 5 | I always confused about true competence and the influence of chance. | 1 | 2 | 3 | 4 | 5 |
| 6 | I can take substantial financial risks expecting to earn substantial returns. | 1 | 2 | 3 | 4 | 5 |
| 7 | I can take above average financial risks expecting to earn above average returns. | 1 | 2 | 3 | 4 | 5 |
| 8 | I can take average financial risks expecting to earn average returns. | 1 | 2 | 3 | 4 | 5 |
| 9 | I am not willing to take any financial risks. | 1 | 2 | 3 | 4 | 5 |
| 10 | The investment policy statement defines monitoring criteria for investment options and service vendors | 1 | 2 | | 4 | 5 |
| 11 | The investment policy statement defines appropriately structured socially responsible investment strategies (when applicable) | 1 | 2 | 3 | 4 | 5 |
| 12 | Periodic reports compare investment performance against an appropriate index, peer group, and IPS(Investment Policy Statement) objectives | 1 | 2 | 3 | 4 | 3 |
| 13 | Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting | 1 | 2 | 3 | 4 | 5 |
| 14 | When making investment decisions, financial return is most important to me | 1 | 2 | 3 | 4 | 5 |
| 15 | When making investment decisions what is most important to me is ensuring that my investment decisions reflect my personal values about social and environmental impacts | 1 | 2 | 3 | 4 | 5 |
| 16 | I am willing to have some portion of my investment portfolio dedicated to investments that may result in lower returns but that can do some good in this world | 1 | 2 | 3 | 4 | 5 |
| 17 | The company should not use unethical business practices (i.e. bribery and corruption) | 1 | 2 | 3 | 4 | 5 |
| 18 | By investing in SRI (Socially Responsible Investment) every investor can have a positive effect on the environment. | 1 | 2 | 3 | 4 | 5 |
| 19 | Every person has power to influence social problems by investing in responsible companies | 1 | 2 | 3 | 4 | 5 |
| 20 | It does not matter if I invest my money in SRI mutual funds since one person acting alone cannot make a difference | 1 | 2 | 3 | 4 | 5 |