Journal of Banking & Finance 37 (2013) 3529–3547

Contents lists available at SciVerse ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Corporate social responsibility in the banking industry: Motives and financial performance

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ARTICLE INFO

Article history:
Received 21 May 2010
Accepted 13 April 2013
Available online 9 May 2013

JEL classification:
C31
C52
G21
M14

Keywords:
Corporate social responsibility
Strategic motive
Altruistic motive
Extended Heckman two-stage model

ABSTRACT

The current study investigates the association between corporate social responsibility (CSR) and financial performance (FP), and discusses the driving motives of banks to engage in CSR. Three motives, namely, strategic choices, altruism, and greenwashing, suggest that the relationship between CSR and FP is positive, non-negative, and non-existent, respectively. We obtained our sample, which covered 2003–2009, from the Ethical Investment Research Service (EIRIS) databank and Bankscope database. The data consists of 162 banks in 22 countries. We then classified the banks into four types based on their degree of engagement in CSR. This study proposes the use of an extended version of the Heckman two-step regression, in which the first step adopts a multinomial logit model, and the second step estimates the performance equation with the inverse Mills ratio generated by the first step. The empirical results show that CSR positively associates with FP in terms of return on assets, return on equity, net interest income, and non-interest income. In contrast, CSR negatively associates with non-performing loans. Hence, strategic choice is the primary motive of banks to engage in CSR.

1. Introduction

The question of whether adopting corporate social responsibility (CSR) can improve a corporation's financial performance (FP) is an old yet continually and heatedly debated issue.[1] Thus, a better understanding of the link between CSR and FP would be valuable to corporate managers, stockholders, and stakeholders. For example, what resources should managers direct to socially responsible activities? How should stockholders react to resource allocations for a social purpose? How can public policy best promote socially responsible behavior (Simpson and Kohers, 2002)?

A corporation is generally encouraged to adopt CSR because of its perceived benefits to both macro and micro-performances. Macro-performance includes environmental improvement and reduction in social inequality. Micro-performance includes reputation enhancement, potential to charge a premium price for products as well as the enhanced ability to recruit and to retain high-quality workers.[2] The most attractive lure is that firms adopting CSR can gain financial benefits that are greater than the ensuing costs, thereby improving FP in the long run. Accordingly, adopting CSR can be beneficial to both corporate shareholders and stakeholders, which creates a potential win–win situation.

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[1] According to the survey conducted by Griffin and Mahon (1997), explorations on the relationship between CSR and FP date back to the works of Friedman (1962, 1970). His challenge, "a corporation's social responsibility is to make a profit," triggered the debate on proving or disproving the relationship between CSR and FP. Several studies found a negative relationship, including the study by Vance (1975), whereas others found a positive link, such as the study by Fry and Hock (1976), as well as mixed results, such as Coffey and Fryxell (1991).

[2] Rather than using the concept of macro and micro benefits, some studies suggest that a company with strong CSR alleviates potential conflicts of interest. For example, Heal (2005) argues that CSR may reduce two types of conflicts of interest between corporations and society. The first conflict is that a competitive market may not internalize all external costs, which yields discrepancies between private and social cost and benefit. This conflict can be illustrated in the classic example of environmental issues. The Big Oil Company that pollutes the seashore creates huge external cost, making private cost considerably lower than social cost. The second conflict is that of distribution, which argues that the market is efficient but not necessarily fair according to widely held opinions on distributive justice. For example, large international companies pay low wages in poor countries, giving rise to the sweatshop issue. Both government intervention and CSR can mitigate these two conflicts. However, the government is ineffective in solving the actual problem. Thus, the role of CSR is still demanded. Harjoto and Jo (2011) also argue that managers may use CSR as leverage to reduce conflict with various stakeholders when managers pursue their own interests at the expense of society and the financial claimants of the corporation.

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http://dx.doi.org/10.1016/j.jbankfin.2013.04.023

Numerous empirical studies attempt to justify this positive relationship between stock return[3] and accounting performance.[4] However, previous results often offer contradictory conclusions. For example, the review of Margolis and Walsh (2003) of 127 empirical studies, dating from 1972 to 2002, reveals the relationship between CSR and FP. Among those reviewed, 54 studies point toward a positive relationship, 20 show mixed results, and 28 reveal insignificant relationships. Only seven studies show a negative relationship. The meta-analysis by Margolis et al. (2007) on 167 studies over the past 35 years shows that the overall effect is positive yet small. Moreover, they suggest that future studies should be redirected to gain a better understanding of the reasons for companies to pursue CSR, the mechanism connecting prior CSR to subsequent FP, and the methods that companies employ to manage the pursuit of both CSR and FP (see also Shen and Chang, 2009, 2012-a; Garcia-Castro et al., 2010).

The conflicting results may be attributed to the fact that corporations with having different motives in conducting CSR may exhibit different CSR-FP relationships. According to Baron (2001), Dam et al. (2009), and Bénabou and Tirole (2010), an engagement in CSR reflects the different motives of a corporation, which include altruism, strategic choices, and greenwashing. The altruism motive indicates that companies conduct CSR activities for their own sake (Baron, 2001), thereby negatively affecting FP. However, the strategic motive improves FP through CSR engagement. Finally, greenwashing attempts to enhance the corporate image without significantly changing the business (Frankental, 2001).[5] According to Dam et al. (2009), if no clear cost differences are observed between responsible and irresponsible corporations, then these firms are merely greenwashing, hence no effects will become evident in their earnings. Thus, the conflicting conclusions on the relation between CSR and FP may be attributed to the different motives of corporations. Attributing the differences in the results to the different samples, methods, and periods used is plausible as well.

The banking system plays an important role in economic development (Levine, 2005; Shen and Lee, 2005; Beck et al., 1999; 2010) because its safety and soundness create several external benefits to society. Generally, for economic growth, banks serve as financial intermediaries by facilitating cash flow between lenders and borrowers. According to Schumpeter (1912), well-functioning financial institutions, such as banks, enhance technological innovation by supporting entrepreneurs with the best chances of successfully introducing innovative products and production processes. Therefore, a healthy banking system is the key to sustained prosperity (King and Levine, 1993). Banks also play an important role during a credit crisis. For example, when Basel I was implemented in 1989, many banks were compelled to increase capital, to decrease lending, or both. Decrease in lending, or the credit crunch mentioned in the literature review, became one of the factors that caused the US recession in 1991.

Furthermore, by using considerable resources from society, banks are required to provide feedback to the community more often than other industries. For example, bank assets may mainly come from depositors, but not from shareholders. Additionally, when banks are in distress, governments bail them out or take over at the expense of taxpayers. In March 2011, Bank of England Governor Mervyn King accused banks of exploiting gullible or unsuspecting customers for short-term profit. He criticized the culture of short-term profit and bonuses in the banking system, and suggested that traditional manufacturing industries by contrast adhered more to higher "moral" standards when conducting business. According to King, "They care deeply about their workforce, about their customers and, above all, are proud of their products." Therefore, as banks employ public resources paid for by society, they are highly scrutinized by the media, government, and academe regarding their CSR activities. Scholtens (2009) mentions that in member countries of the Organization for Economic Cooperation and Development (OECD), specialized banks offer savings accounts to the public while promising that the money will be used to finance so-called community investments in the environment. Thus, in most countries, banks are involved in economic activities aimed at sustainable development.

Banks are aware of their use of public resources, and this awareness explains why many banks append a CSR section in their annual reports to explain how they give back to society.[6] However, direct studies on the CSR-FP link in the banking industry and the motives for engaging in CSR are considerably scant. Simpson and Kohers (2002) present one of the few studies using bank data but they do not pursue the CSR issue. Other studies on the banking sector engaged in CSR activities focus on a similar issue, but not on the association between CSR and FP. For example, Scholtens and Dam (2007) compare CSR engagements between banks that adopt the Equator Principles and those that do not. Their finding indicates that real cost may be associated with the implementation of the said principles. They observe that banks adopting the Equator Principles have significantly higher CSR policies and lower returns on assets (ROA). Chih et al. (2010) examine the determinants of financial firms that adopt CSR. They observe that financial firms with larger assets and worse ROA adopt CSR. Scholtens (2009) provides a framework for assessing CSR with international banks, but does not examine the concerned relationship. Cuesta-González et al. (2006) focus on social performance but not on the financial performance of top Spanish banks.[7] These studies do not directly address the relationship between CSR and FP, thus drawing a conclusion for the banking sector is difficult. Hence, in contrast to the numerous studies using non-bank data, empirical evidence for the CSR-FP link in the banking industry is rare.

[3] Becchetti and Ciciretti (2009) investigate 372 firms included in the KLD's Domini 400 Social Index during 1990–2003 and find that individual Socially Responsible stocks have on average significantly lower returns and unconditional variance than non-Socially Responsible stocks. Cellier and Chollet (2011) analyze the impact of 1838 Vigeo corporate social rating announcements from 2004 to 2009 on short term stock returns of 739 firms on European markets and find a positive significant influence of the announcement on the stock returns over two days prior to the announcement and two days following. Brammer et al. (2006) examine the relation between corporate social performance and stock returns of all firms in the UK that were constituents of the EIRIS and FTSE All-Share Index as of July 2002, and find that composite social performance indicator are negatively related to stock returns, especially on the CSR dimensions of Environmental and community aspects. Aktas et al. (2011) find that the stock market rewards acquirers who make socially and environmentally responsible investments. Renneboog et al. (2008) conclude that existing studies hint but do not unequivocally demonstrate that socially responsible investors are willing to accept suboptimal financial performance to pursue social or ethical objectives. El Ghoul et al. (2011) find that US firms with better CSR rankings, which are results of their investment in improving responsible employee relations, environmental policies, and product strategies, contribute substantially to reducing the cost of equity of firms. The factors affecting stock price are complicated, and CSR may not be influential in this regard. For example, there is no significant difference in the returns of socially responsible and conventional funds (see Bauer et al., 2005; Bello, 2005; Statman, 2005; Galema et al., 2008).

[4] For example, using Taiwanese data, Shen and Chang (2009, 2011a) suggest that CSR firms exhibit a positive relation to CSR activities and earnings. Garcia-Castro et al. (2010) use KLD data and find that positive relationship found in most of the previous research on the link between SP and FP becomes a non-significant or even a negative relationship when endogeneity is properly taken into account.

[5] Greenwashing refers to the disingenuous act of companies to spin their products and policies as environment-friendly, such as presenting cost cuts as reductions in resource use.

[6] For example, the HSBC annual report states that the corporation's CSR is related to charitable donations, environment, and society as well as to decision-making that maintains the right balance between the environment, society, and the business of the bank.

[7] Their social performance includes codes of ethics governing bribery, corruption, and policy with stakeholders, employees, customers, suppliers, the community, human rights, and so on.