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Corporate social responsibility and financial performance in Islamic banks

Christine Mallin[b,*], Hisham Farag[a], Kean Ow-Yong[a]

[a] Birmingham Business School, University of Birmingham, Birmingham B15 2TT, UK
[b] Norwich Business School, University of East Anglia, Norwich NR4 7TJ, UK

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ABSTRACT

This paper examines the relationship between corporate social responsibility (*CSR*) and financial performance in Islamic banks. Using a comprehensive *CSR* index covering ten dimensions, we analyse the *CSR* disclosures in a sample of 90 Islamic banks across 13 countries. The *CSR* disclosure index shows that Islamic banks engage across the range of social activities, both as individual banks and as countries. However Islamic banks seem to show more commitment to the vision and mission, the board and top management, and the financial product/services dimensions, whilst least attention is paid to the environment dimension. Islamic banks also show a considerable awareness of the mandatory disclosure recommendations of the Accounting and Auditing Organisation for Islamic Financial Institutions (*AAOIFI)* however, they pay less attention to the voluntary *CSR* disclosure. Moreover, we find a pronounced emphasis in Islamic banks strategy towards more universal disclosures, suggesting the legitimacy of these banks is reinforced through disclosure to the wider stakeholder community. The empirical analysis highlights a positive association between *CSR* disclosure and financial performance. We also find a positive and highly significant association between the Shari'ah supervisory board (*SSB)* size and *CSR* disclosure index. Finally, the results of the three-stage least squares estimation show that the causality between the two endogenous variables runs from financial performance to *CSR* disclosure. Thus *CSR* disclosure is determined by financial performance.

1. Introduction

Islamic banking has grown unabated since its inception in the mid-1970s. The industry has increasingly carved out a significant slice of the global financial market. According to figures released by the Banker,[1] global Islamic assets held by commercial banks exceeded US $1.8 trillion in 2013. All financial institutions, both conventional and Islamic, play a central role in society. Hence they are expected to be responsive to the different needs of stakeholders. Due to their religious identity, Islamic banks are expected to be more socially responsible than their conventional counterparts whose operations and functions are primarily based on profit maximisation.

Islamic banking, from a theoretical perspective, is based on the principle of profit and loss sharing in place of the interest based deposit/lending found in conventional banks. Two conflicting juristic views have emerged in contemporary Islamic

* Corresponding author. Tel.: +44 01603597240.
E-mail addresses: c.mallin@uea.ac.uk (C. Mallin), h.farag@bham.ac.uk (H. Farag), k.h.ow-yong@bham.ac.uk (K. Ow-Yong).

[1] The Banker, March 2013.

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banking. Progressive Islamic scholars argue that there is no need to reinvent products offered by conventional banks in a globally competitive banking industry. Instead, Islamic banks should adopt the minimal necessary modifications to these conventional products to ensure Shari'ah compliance. This tendency to emphasise '*form over substance*' (Warde, 2013 cited in Belal et al., 2014) is symptomatic of 'big businesses' driven by the profit making maxim. In contrast, those scholars who oppose conventional financial practice feel that the Islamic banking system needs to reconstruct pre-modern contracts by strictly embedding Shari'ah and social responsibility into the banks' business practices (El-Gamal, 2006). According to this view, Islamic banks are expected to perform the role of redistributing wealth (through profit and loss sharing) to selective investments that contribute to the improvement and well-being of society (Farook, 2008). These Islamic banks practice the 'moral economy' philosophy expounded for religious or secular ethical reasons and support the inclusion of social and environmental aims in their investment policies (Belal et al., 2014). Islamic banks, according to this view, should strive to achieve a balance between providing sufficient returns to their shareholders and depositors while at the same time not neglecting their social responsibilities and commitments to their various stakeholders (Ahmad, 2000). Recent studies suggest that Islamic banks have failed to put the profit-loss principle into practice (Dar and Presley, 2000; Chong and Liu, 2009). Thus their findings point to the close similarity between Islamic and conventional banking practices and suggest that the alleged benefits of Islamic banking exist only in theory.

Concerning their social role, Islamic banks are expected to bring about economic and social benefits to their stakeholders; and to fulfil their Corporate Social Responsibility (*CSR*) including its disclosure. Farook (2008) argues that disclosure provides evidence of the Islamic banks involvement in social activities and hence earns legitimacy for their existence.

Islamic Financial Institutions (*IFIs*) may not be disclosing their social responsibility publicly, even though they are carrying out these activities. Therefore, to encourage disclosure, the international regulatory authorities such as the Accounting and Auditing Organisation for Islamic Financial Institutions (*AAOIFI*) developed reporting standards for Islamic banks. In particular, it issued Standard No.7 on Governance Standards for Islamic banks in relation to Corporate Social Responsibility (*CSR*) conduct and disclosure in 2010.[2] In the Standard, *CSR* for (*IFIs*) is defined as '*all activities carried out by an IFI to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions.*' Therefore, in complying with these standards, Islamic banks report aspects of their business activities and results differently from those of their conventional bank counterparts.[3]

The existing body of the literature on *CSR* in Islamic banks can be grouped into two broad strands. The first strand uses content analysis to explore the disclosure of *CSR* as described in the Islamic banks' annual reports (Maali et al., 2006; Haniffa and Hudaib, 2007; Abdul Rahman et al., 2010; Hassan and Harahap, 2010; Aribi and Gao, 2012). The second strand investigates the determinants of *CSR* disclosure (e.g., Farook et al., 2011). This second strand is in the early research stage as – to the best of our knowledge – there is only one empirical study namely Farook et al. (2011). However, other possible determinants of *CSR* like financial performance (*FP*) have not yet been investigated empirically in Islamic banks.

Our paper is motivated to bridge a perceived gap between the two broad strands on *CSR* disclosure. We integrate Maali et al. (2006) and Haniffa and Hudaib (2007) benchmark *CSR* indices with *AAOIFI* Standard No.7 recommendations on mandatory and voluntary *CSR* disclosure to produce a more comprehensive index covering ten dimensions to identify the type and the extent of *CSR* disclosure for a sample of Islamic banks over the period 2010–2011. Furthermore, motivated by the study of Belal et al. (2014), we split the CSR index into two strands namely; 'Particular' reporting practices relating to Shari'ah compliance issues and 'Universal' reporting practices which are more relevant to conventional banks and the wider stakeholder groups such as community, employees and customers. Secondly, we investigate the impact of financial performance on *CSR* disclosure in Islamic banks which has not been empirically researched before; and finally, the paper investigates the direction of causality between financial performance and the *CSR* disclosure. Our data set covers a large sample of Islamic banks (90 Islamic banks[4]) and the *CSR* disclosure data is collected not only from the annual reports but also from the information posted on the Islamic banks' websites.[5]

This paper makes two incremental contributions to the literature on *CSR* and Islamic banks. First, although there have been a few empirical studies investigating the link between *CSR* and financial performance in the banking sector, as far as we are aware, this is the first study to empirically investigate this relationship in Islamic banks using a more comprehensive *CSR* disclosure index which distinguishes between mandatory and voluntary disclosures as recommended in *AAOIFI* Standard No.7. Secondly, we also classify the CSR index items into two main categories. The first includes items expected to be found in Islamic banks and the second category includes those expected to be found in banks in general.

The paper is structured as follows. Section 2 discusses the literature review and hypotheses development. The sample selection and research methodology are presented in Sections 3 and 4 respectively. Section 5 presents the results and discussion of the findings, whilst section 6 summarises and concludes.

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[2] This Standard provides both mandatory and recommended guidelines on *CSR* disclosure by Islamic banks. AAOIFI standards are compulsory for IBs operating in Bahrain and Qatar but voluntarily applied to IBs in other countries.

[3] For example, Islamic banks might be expected to include within their annual reports or within a separate report of the SSB, a section about the role and function of their *Shari'ah* Supervisory Board (SSB), the sources and uses of zakah and charity funds and the unrestricted investment accounts held. Disclosing these activities will reveal the extent to which Islamic banks fulfil their socio-economic objectives for the benefit of the Islamic community.

[4] Maali et al. (2006) and Farook et al. (2011) pointed out that further research with a larger sample of Islamic banks may be worthwhile.

[5] Previous studies covered a much smaller sample and collected data only from annual reports.