ISCTE Business School
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CORPORATE SOCIAL RESPONSIBILITY IN ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

The evolution of the concept of Corporate Social Responsibility has created a lot of debate in the modern world. In the financial world, the engagement in social responsible activities, such as, providing guidelines on sustainability, environmental impact reduction, donations to charitable causes or supporting communities have become a common practice for the vast majority of financial institutions. Islamic Financial Institutions, due to its religious bond, are bound to operate in a system that places social goals at the same level, or even above, of financial goals. Actually, the ethical system and values of Islam, alongside the Shari'ah law, provide a natural framework of social responsibility for Islamic Financial Institutions. Besides the most common characteristics of Corporate Social Responsibility, there are some singular and unique to the Islamic Financial Institutions, for instance, the collection and distribution of Zakat, the establishment of Qard-Hassan and distribution policy (for social reasons) and the management of Waqf properties on behalf of clients. The unique characteristics of these institutions are present in their everyday activities with a strong focus of the prohibition of interest (riba), prohibited (haram) activities and avoidance of uncertainty/speculation (gahrar) and, on the other hand, the offer of products that are Shari'ah compliant, notably, profit-and-loss sharing arrangements.

To understand if the literature concerning Islamic Corporate Social Responsibility matches the actual practices of Islamic Financial Institutions, a study of four published surveys, by renowned authors, was undertaken and the conclusions and implications for the future of Islamic Financial Institutions were drawn.

Key words: Corporate Social Responsibility; Islamic Banking; Shari'ah; Ethical Identity

JEL Classification System: M14; N25

Resumo

A evolução do conceito de Responsabilidade Social das Empresas criou um grande debate no mundo moderno. Na área financeira, o compromisso com actividades de responsabilidade social, como a criação de linhas orientadoras para a sustentabilidade, redução do impacto ambiental, acções filantrópicas ou apoios à comunidade, tornaram-se comuns para a maior parte das instituições financeiras. As instituições financeiras Islâmicas, devido à sua ligação religiosa, estão sujeitas a actuar num sistema que coloca os objectivos sociais no mesmo patamar, ou mesmo acima, dos objectivos financeiros. O sistema ético e valores do Islão, bem como da lei Shari'ah, proporcionam uma delineação natural de responsabilidade social para as instituições financeiras Islâmicas. Além das características mais comuns da responsabilidade social das empresas, existem outras singulares e únicas que são inerentes às instituições financeiras Islâmicas, por exemplo, a recolha e distribuição do zakat, a criação de fundos Qard-Hassan e respectiva política de distribuição e gestão de propriedades Waqf em benefício dos clientes. As características únicas destas instituições estão presentes nas suas actividades diárias com especial atenção na proibição da usura, actividades proibidas (haram) e afastamento de incerteza/especulação (gahrar), bem como a oferta de produtos que respeitam a lei Shari'ah, por exemplo, oportunidades de investimento sob o ideal de partilha de lucros e perdas.

Para perceber se a literatura respeitante à responsabilidade social das empresas Islâmicas vai ao encontro das práticas actuais destas instituições, foi conduzido um estudo de quatro inquéritos de autores de renome, e foram tiradas conclusões e implicações para o futuro destas instituições financeiras.

Palavras-chave: Responsabilidade Social; Banca Islâmica; Shari'ah; Identidade Ética

Sistema de classificação JEL: M14; N25

Executive Summary

A revisão da literatura de Responsabilidade Social (RS) começou com uma descrição da evolução do conceito desde a década de 1950 até aos dias de hoje. Na década de 50, as primeiras publicações de literatura começaram a dar maior ênfase a esta faceta das empresas. Nesta fase ainda havia um sentido bastante básico de obrigação para com a sociedade; com os gestores a serem os responsáveis pela relação com a sociedade. Na década de 1980 assistiu-se ao aparecimento de uma teoria que moldaria o futuro do conceito de RS: Teoria dos Stakeholders. Formulada por Freeman, esta teoria, defendia uma visão mais abrangente de quem eram os agentes afectos e afectados por uma empresa e que impactos sofreriam com a falta de RS desta. Os anos 1990 foram importantíssimos já que foi formulado o conceito de tripple-bottom line: Pessoas, Planeta e Lucros. Ainda hoje é esta a teoria, em conjunto com a Stakeholder que rege os desenvolvimentos de RS.

A revisão da literatura do sistema financeiro Islâmico começou com um enquadramento das implicações da religião no *modus operandi* de qualquer instituição que se caracteriza como Islâmica.

A lei Islâmica, ou Shari’ah, é mais ampla do que uma simples lei e rege toda a actividade humana. A sua concepção e aplicação está mais próxima de um código de conduta e de um conjunto de valores e normas do que uma lei. A Shari’ah é derivada de diversas fontes, umas imutáveis como o Corão, a Sunnah (escritos e ensinamentos do profeta Maomé), a fé (Akhlaq) e os valores éticos (Aqidah) e outras que evoluem com o tempo, como a jurisprudência (Fiqh) e a prática comum (Urf). Para melhor compreender o alcance da religião, conduzi uma breve explicação sobre os princípios éticos presentes no Islão, já que as implicações práticas para o conceito de RS Islâmica são importantes. Há três princípios éticos importantes: a Unidade (Tawhid), a Justiça (Adalah) e Curadoria (Khilafah) dos recursos disponíveis por parte de cada indivíduo.

A perspectiva de RS por parte das Instituições Financeiras Islâmicas (IFIs) está presente sempre, quer seja pelos ensinamentos da religião Islâmica, quer seja por genuína contribuição para com a sociedade. Há vários componentes da RS das IFIs importantes, primeiro os objectivos sociais têm tanta importância como os financeiros; segundo, a obrigatoriedade de serem (e investirem em) instituições que não lidam com actividades proibidas (haram) e por fim, o respeito pelos três componentes éticos e pela Shari’ah que, se cumpridos, contribuem

grandemente para o incremento da RS das IFIs. Assim, os factores de motivação para as IFIs são os mesmos que para as convencionais (pressões de mercados, reguladores, vantagens competitivas, etc.) mas com uma dimensão adicional, a necessidade de cumprir os desígnios religiosos. De seguida é estabelecida uma primeira relação entre a Banca Islâmica e os fundos de Investimento de Responsabilidade Social, em que a principal diferença é o método de selecção das oportunidades de investimento. No caso dos fundos há uma mescla de factores de exclusão e de inclusão enquanto a banca Islâmica se fica pelos negativos.

No capítulo seguinte é realizada uma revisão do propósito da existência dos Bancos Islâmicos, um levantamento das principais diferenças entre este tipo de banca e a convencional e um resumo da evolução histórica da Banca Islâmica. Os bancos Islâmicos foram criados com o objectivo de oferecer à população Muçulmana uma alternativa que cumprisse com a lei Shari'ah, com o sistema ético do Islão e com os objectivos da economia Islâmica (justiça socioeconómica, distribuição da riqueza e retorno justo em depósitos e investimentos). As principais diferenças entre os dois tipos de banca são: o dinheiro é um meio de pagamento e um medidor de riqueza (Islâmica) e não um activo (convencional); o risco é reconhecido mas não cobrado, bem como o custo de oportunidade e os objectivos socioeconómicos são tão importantes como os financeiros, ao contrário da banca convencional. No que respeita a evolução é de referir a criação da primeira destas instituições em 1963, no Egipto, e que em 2008 já contava com 439 que geriam cerca de $750 mil milhões de dólares. A Corporate Governance das IFIs inclui um elemento adicional em relação às convencionais, o Painel de Supervisores Shari'ah que é responsável pela verificação do respeito pela Shari'ah de todas as actividades dos bancos.

Antes de passar aos resultados, há quatro elementos das IFIs que merecem destaque. A proibição de qualquer elemento de juro (riba) nos produtos e actividades do banco; a proibição de actividades e investimentos em produtos/empresas que não cumpram com a Shari'ah; a eliminação de qualquer tipo de incerteza e especulação (gahrar) e a inclusão no portfolio das IFIs de produtos sob o conceito de partilha de lucros e perdas. Estes últimos podem ser de dois tipos: mudarabah (em que há uma partilha de lucros, pré-determinada, mas em caso de perda é suportada na totalidade pelo banco) ou musharakah (onde há uma partilha, pré-determinada, de tanto lucros como perdas, num espírito muito próximo de uma joint venture).

Os resultados dos quatro estudos demonstram que o conceito de RS está presente nas IFIs e nos seus strakeholders. Na Malásia, em 2005, o factor CSR já representava cerca de 18% das razões de escolha de um banco por parte dos clientes. Contudo, há uma discrepância considerável entre a literatura e a RS ideal das IFIs e o que efectivamente acontece no dia-a-dia. Apesar do ideal da RS presente na literatura estar muito próximo do que os stakeholders, em geral, pensam não há uma correspondência adequada nas IFIs. Por exemplo, estudos revelam que 80.9% dos colaboradores das IFIs atribuíam RS às instituições, 60.3% consideraram que os objectivos socioeconómicos eram tão importantes como os financeiros, mas, quanto a resultados práticos, a maioria das IFIs dedicavam apenas entre 0-2% dos seus lucros a causas sociais.

Apesar desta distância, no geral, os resultados podem ser considerados animadores, tendo em conta que esta indústria tem apenas cerca de 50 anos, está em plena expansão e longe de estar consolidada.

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Introduction

The business environment is constantly evolving and one of the most important changes in the last few decades was the introduction of Corporate Social Responsibility (henceforth CSR) in the international scene. From the 1980's until today the development of CSR has gone through dramatic development, especially Freeman's Stakeholder Theory and Elkington's Tripple-Bottom Line. The pressure from the globalization of trade, size and influence of companies, governmental regulation and the recognition of the strategic benefits that a solid and respectable stakeholder relationship, were the main drivers behind the development of CSR. Even though the discussion of CSR is global and has positive impacts on business behaviour towards societies, it has been largely based on the Western value system, disregarding, to some extent, other regions and value sets that could further develop the concept. In Muslim cultures, for instance, there is a unique perspective of what CSR is and how it should be applied. Being a secular religion and second worldwide in terms of followers, Islam CSR (ICSR) has its foundation on the Shari'ah, which is a code of conduct that provide guidance in every aspect of the human life, business included.

Through the first chapter of this thesis, a revision of contemporary CSR literature is conducted, in order to provide an overview and a theoretical ground. In chapter 2 it will be described the aforementioned ethical value system and the Shari'ah concept, with relation to the business world. Chapter 3 will focus on the Islamic CSR perspective, with a description of its characteristics and differences to conventional CSR. On this chapter the motivations and drivers of CSR will be described in detail and with an introduction to two ethical players in the financial markets: Social Responsible Investment funds and Islamic Banks.

The Islamic banking system emerged amidst a peculiar combination of politic, economic and demographical factors. The pan-Islamic movement started in the 1970s with the establishment of the Organization of the Islamic Countries and the Islamic Development Bank. The geo-political scene changed dramatically with the Iranian revolution, also called Islamic revolution and the regional dominance of Saudi Arabia in the Gulf. Economically, there were two key factors for the development of Islamic banks, the 1973 oil price boom and the emergence of the Asian Tigers as a finance powerhouse on their own right. Demographically, and as combination of these factors, the Muslim world assisted to a quick development of an empowered middle class which resulted in a natural increase of purchasing power by households, thus an increase in commerce and trade. At the intersection of all these factors is the Islamic banking system, created to meet the demands of a growing population seeking for

Shari'ah and Islam compliant financial solutions. In 1975 the first modern Islamic Bank was created, the Dubai Islamic Bank. By 1983, there were already three countries with full Islamization of its banking system, Pakistan, Sudan and Iran.
To understand in detail what an Islamic Bank is chapter 4 presents an overview of this financial system, focusing on the purpose of Islamic banks, the differences to the conventional banks and its historical evolution. This thesis places an emphasis on the characteristics of these institutions, in chapter 5, with a look on the corporate governance structure and the religious implications to the whole financial system, highlighting, the prohibition of interest and uncertainty/speculation, the avoidance of engaging in prohibited activities presented in the Shari'ah law and the payment of zakat, the Islamic levy. To what concerns Islamic Financial Institutions and its activities, the reader can find a thorough analysis and description in chapters 6 and 7, with a focus on a cornerstone of the Islamic banking system, the Profit-and-Loss sharing. -

With this in mind, one of the purposes of this thesis is to describe, explain and demonstrate that in Islamic societies there is an established set of values and beliefs that effectively implement a variation of the conventional CSR. Additionally, this thesis serves the purpose of transmitting to the reader an overview of the characteristics, products and the framework where Islamic Financial Institutions operate.

However, the main purpose of this thesis is to find out if the concept of Islamic CSR is present in the minds of managers and in the activities of IFIs and, if it is, to what extent do these institutions engage in social responsible activities. The method chosen to draw such conclusions was a comparison between the published literature (chapter 1 to chapter 7) and three scientific articles and one institutional survey. All of the mentioned articles present a study that relates CSR with IFIs, but doing it from a different angles and perspectives, it enhances my ability to draw better and detailed conclusions.

Chapter 1: Corporate Social Responsibility

In the past century, the concept of social responsibility paved the way for the CSR we recognize today. By the 1930's and 1940's, the discussion around this topic gained some importance and Carroll (1999) identified some literature that emerged in these decades, for instance, "*Chester Barnard's (1938) The Functions of the Executive, J. M. Clark's (1939) Social Control of Business, Theodore Kreps' (1940) Measurement of the Social Performance of Business […] and business executives (the literature called them "businessmen" in those days) were polled by Fortune magazine asking them about their social responsibilities (Fortune, 1946, cited in Bowen, 1953, p. 44)*" (Carroll, 1999: 268).

This review will start in the 1950's, as it was the decade that marked the beginning of the modern era of social responsibility (henceforth SR), supported by formal literature that was most evident in the United States. As time passed by, scholars started to develop their own definitions and literature of CSR, and particularly in recent decades, we have witnessed an ever growing concern not only from the business community, but from governments and notable institutions as well (European Union).

1.1. Concept evolution

1.1.1. 1950's: Modern Era of Social Responsibility Starts

Howard Bowen's book *Social Responsibilities of the Businessman* is considered by Carroll (1999) and Rahman (2011) the cornerstone of the modern era of CSR. In his book, Bowen considers that businesses, as centres of decision and power, touch society and citizens at many points. From this point, Bowen inquires *"What responsibilities to society may businessmen reasonably be expected to assume?"* (Bowen, 1952: 11), setting the ground for further developments of CSR. He defined the Social responsibilities of businessmen the following way: *"It refers to the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society"* (Bowen, 1952: 6)

The concept of CSR remained fairly stable regarding the broadness of CSR, as it can be recognized by Heald's (1957) definition of CSR: *"CSR is recognition on the part of management of an obligation to the society it serves not only for maximum economic performance but for humane and constructive social policies as well."* (Heald, 1957)

From the definitions above it is clear that in the 1950's the CSR concept was still in the beginning, since the broadness was quite limited and the published literature was insufficient. However, it set the tone for the next decade, as businessmen started to reveal concerns with the society well-being.

1.1.2. 1960's: Development in the Relationship Between Corporation and Society

If there was scarcity of literature in the 1950's and before, in the 1960's there was in profusion, attempting to formalize and define the meaning of CSR.

In the beginning of the 1960's, one of the most eminent authors of the decade, Keith Davis, defined social responsibility as "*businessmen's decisions and actions taken for reasons at least partially beyond the firm's direct economic or technical interest*" (Davis, 1960: 70). Davis developed this idea and despite considering SR as a blurry concept, he argued that it should be seen from a managerial perspective, envisioning that SR could bring economic gains in the long-run to the firm, justifying the social responsible outlook (this view became commonly accepted in the late 1970's and 1980's).

Another relevant scholar from the beginning of this decade was William Frederick. He wrote that Social Responsibility "*mean that businessmen should oversee the operation of an economic system that fulfils the expectations of the public. And this means in turn that the economy's means of production should be employed in such a way that production and distribution should enhance total socio-economic welfare. Social responsibility in the final analysis implies a public posture toward society's economic and human resources and a willingness to see that those resources are used for broad social ends and not simply for the narrowly circumscribed interests of private persons and firms.*" (Frederick, 1960: 60)

The foundations for the Corporate Social Responsibility were laid, since both authors are establishing the relation between corporations and societies. However, it was not until 1967 that this gap was finally bridged by a leading thinker of the time: Clarence Walton. In his book, *Corporate Social Responsibility*, Walton develops different models of CSR, emphasizes that the essential characteristic of CSR was voluntarism, rather than coercion. "*In short, the new concept of social responsibility recognizes the intimacy of the relationships between the corporation and society and realizes that such relationships must be kept in mind by top managers as the corporation and the related groups pursue their respective goals.*" (Walton, 1967: 18)

1.1.3. 1970's: The beginning of Stakeholder's Involvement

The 1970's registered an immense debate around CSR definition, purpose, broadness and dimension. In the end, the dimension that prevailed was the concern with all stakeholders of a firm.

Regardless of the outcome, in the beginning of the decade there was a discernible cleavage between scholars. Nobel Prize economist Milton Friedman and Morrell Heald had two distinct approaches to what was CSR. While Heald (1970) developed on the 1960's dimension of firm and society relationship, Friedman expressed CSR from an economic and market driven approach: "*There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud* (Friedman, 1970)".

In 1971, Harold Johnson's *Business in Contemporary Society: Framework and Issues* presented and discussed four views of CSR. The first enunciates that firms are to meet interest from, not only stockholder, but other interest groups as well.

1. "*A socially responsible firm is one whose managerial staff balances a multiplicity of interests. Instead of striving only for larger profits for its stockholders, a responsible enterprise also takes into account employees, suppliers, dealers, local communities, and the nation*" (Johnson, 1971: 50).

The second dimension concerns the profitability that CSR may generate in the long-run.

2. "*Social responsibility states that businesses carry out social programs to add profits to their organization"* (Johnson, 1971: 54).

The third dimension of social responsibility was based on utility maximization. The author claimed that a business prime motivation is utility maximization, and the firm must consider other goals but profit maximization alone.

3. "*A socially responsible entrepreneur or manager is one who has a utility function of the second type, such that he is interested not only in his own well-being but also in that of the other members of the enterprise and that of his fellow citizens*" (Johnson, 1971: 68).

The fourth and final dimension was called "lexicographic view of social responsibility". Johnson explains that "lexicographic utility theory suggests that strongly profit-motivated firms may engage in socially responsible behaviour. Once they attain their profit targets, they act as if social responsibility were an important goal— even though it isn't.

4. *"The goals of the enterprise, like those of the consumer, are ranked in order of importance and that targets are assessed for each goal. These target levels are shaped by a variety of factors, but the most important are the firm's past experience with these goals and the past performance of similar business enterprises; individuals and organizations generally want to do at least as well as others in similar circumstances*" (Johnson, 1971: 73).

By 1974, the discussion of CSR had already expanded to topics like business history, the concept of corporation, ownership and governance. Lead by Eells and Walton, the authors observed: "*In its broadest sense, corporate social responsibility represents a concern with the needs and goals of society which goes beyond the merely economic. Insofar as the business system as it exists today can only survive in an effectively functioning free society, the corporate social responsibility movement represents a broad concern with business's role in supporting and improving that social order*." (Eells & Walton, 1974: 247)"

This decade was notable for the developments in the literature of CSR. Moreover, the concept and especially the scope of CSR went through change. In the end of this decade, Carroll offered a definition that remains timeless: "*The social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time*" (Carroll, 1979: 500).

1.1.4. 1980's: Freeman's Stakeholder Theory

In 1980, Thomas Jones enunciates one of the prominent characteristics of CSR in this decade, the need for voluntariness in CSR, defining it as: "*The notion that corporations have an obligation to constituent groups in society other than stockholders and beyond that prescribed by law and union contract. Two facets of this definition are critical. First, the obligation must be voluntarily adopted; behaviour influenced by the coercive forces of law or union contract is not voluntary. Second, the obligation is a broad one, extending beyond the traditional duty to shareholders to other societal groups such as customers, employees, suppliers, and neighbouring communities*." (Jones, 1980: 59-60)

Carroll (1999) recognizes that one of Jones' major contributions was pointing out CSR as a process, rather than a set of outcomes, as it was very difficult to reach a consensus on what's socially responsible behaviour. Moreover, the already mentioned voluntariness is critical in his work and so is, once again, the reference to other groups apart from shareholders. Regarding the models developed in this decade we can mention Tuzzolino and Armandi (1981) and Dalton and Cosier (1982) approaches to CSR. The first pair of authors developed a framework based on Maslow's need hierarchy. The purpose was to develop a mechanism that could better assess and would facilitate the operationalization of CSR. "*Their organizational need hierarchy suggest that organizations, like individuals, had criteria that needed to be fulfilled or met, just as people do, as portrayed in the Maslow hierarchy"* (Rahman S. , 2011: 169). Dalton & Cosier (1982) developed a model based on a "*2x2 matrix, with "legal" and "illegal" on one axis and "irresponsible" and "responsiveness" on the other. They then posited that there were "four faces" of social responsibility depicted by the four cells. Not surprisingly, they concluded that the "legal-responsible" cell was the appropriate CSR strategy for firms to follow. It may be inferred from this that they think a firm is socially responsible if it is operating "legally" and "responsibly", although this may be difficult to define*" (Carroll, 1999: 285)".

The most notable theory developed in this decade was Freeman's (1984) Stakeholder Theory. "*Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business. It asks managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose*" (Freeman, Wicks, & Parmar, 2004: 364).

This theory was based on the following principles:

1. "*No matter what you stand for, no matter what your ultimate purpose may be, you must take into account the effects of your actions on others, as well as their potential effects on you.*
2. *Doing so means you have to understand stakeholder behaviours, values, and backgrounds/contexts including the societal context. To be successful over time it will be better to have a clear answer to the question "what do we stand for".*

3. *There are some focal points that can serve as answers to the question "what do we stand for" on Enterprise Strategy.*
4. *We need to understand how stakeholder relationships work at three levels of analysis: the Rational or "organization as a whole"; the Process, or standard operating procedures; and the Transactional, or day to day bargaining.*
5. *We can apply these ideas to think through new structures, processes, and business functions, and we can especially rethink how the strategic planning process works to take stakeholders into account.*
6. *Stakeholder interests need to be balanced over time*." (Freeman R. , 2004: 231)

The theory was applied transversely in the business world, on the normative theories of business, to corporate governance and organizational theories, social responsibility and social performance and strategic management.

One of the last notable definition of this decade, built upon Freeman's, was produced by Epstein (1987): "*Corporate social responsibility relates primarily to achieving outcomes from organizational decisions concerning specific issues or problems which (by some normative standard) have beneficial rather than adverse effects on pertinent corporate stakeholders. The normative correctness of the products of corporate action has been the main focus of corporate social responsibility*" (Epstein, 1987: 104). The author further developed alternative themes around CSR. He defined corporate social responsiveness and business ethics and then merged the both concepts into "corporate social policy process".

1.1.5. 1990's: Development of the Triple Bottom-Line Approach

CSR in the 1990's did not went through the evolution of the previous decades, in fact, quite few unique definitions emerged. However, CSR was the point-of-departure for new themes and concepts to emerge, notably, sustainability and its ramifications.

In 1991, Carroll proposed that CSR should constitute a pyramid with four dimensions, economic at the bottom (foundation), then legal, ethical and philanthropic categories above. He also added that firms should not be attempting to fulfil them in sequence, but each category should be fulfilled at all times. "*For CSR to be accepted by the conscientious business person, it should be framed in such a way that the entire range of business responsibilities is embraced. It is suggested here that four kinds of social responsibilities* *constitute total CSR: economic, legal, ethical and philanthropic. Furthermore, these four categories or components of CSR might be depicted as a pyramid. To be sure, all of these kinds of responsibilities have always existed to some extent, but it has only been in recent years that ethical and philanthropic functions have taken a significant place"* (Carroll, 1991: 41).

Without any significant development of the CSR concept, authors and scholars, started to pay attention to other peripheral topics of CSR. One that took the spotlight was sustainability. The concept of sustainable development was defined by the World Commission on Environment and Development, in 1987, the following way: "*development that meets the needs of the present [generation] without compromising the ability of future generations to meet their own needs*" (WCED, 1987). This simple definition, despite vague, set the tone for developments in the area of sustainability. In 1991 a partnership between the World Conservation Unit (IUCN), United Nations Environment Programme (UNEP) and the World Wide Fund for Nature (WWF) helped explain the different concepts that, at the time, were used in connection with sustainability. "*Sustainable development, sustainable growth and sustainable use have been used interchangeably, as if they were the same. They are not. Sustainable growth is a contradiction in terms: nothing physical can grow indefinitely. Sustainable use is only applicable to renewable resources. Sustainable development is used in this strategy to mean: improving the quality of human life whilst living within the carrying capacity of the ecosystem.*" (IUCN; UNEP; WWF, 1991)

The step forward in CSR adoption by corporations was Elkington's Triple Bottom-Line (TBL) concept. Its foundations lie on the stakeholder theory and this Triple Bottom-Line is composed by social, environmental and economic concerns. By 1997 firms were already engaged in CSR initiatives, but the 3 Pillars (people, planet and profit) have made the case for the business community, since Elkington, based on examples, attempted to provide tools for firms who have committed to sustainable principles. Time would prove Elkington's right, as in the private sector the sustainability/CSR reports often include a form of TBL. Moreover, TBL has helped shaped sustainable-related initiatives, such as, the GRI (Global Reporting Initiative) or the Dow Jones Sustainability Index.

A notable CSR definition from the end of the decade was from Khoury et al. (1999). He counterbalanced the stakeholder theory weight in CSR, with the role of employees and the community support, describing CSR as follows: "*Corporate social responsibility is the* *overall relationship of the corporation with all of its stakeholders. These include customers, employees, communities, owners/investors, government, suppliers and competitors. Elements of social responsibility include investment in community outreach, employee relations, creation and maintenance of employment, environmental stewardship and financial performance*. (Khoury, Rostam, & Turnbull, 1999)

CSR definitions took a halt in terms of development and broadness of concepts. This does not mean that authors rejected the concept of CSR, but used it as the basis for expansion of new theories and model, such as, Sustainability and the Triple Bottom-Line, among others.

1.1.6 21st Century: The Emergence of a CSR Industry

In the 2000's, CSR went through a change in terms of definitions and policies developments, with a shift from scholars to international institutions, governments and consultancies. The legitimacy for CSR in this decade arises from the demand that business corporations are to act more responsibly in the use of resources and to consider the impact of its actions on the environment and on the community, or they will respond, or be made to respond by shareholders, stakeholders and in the last instance the law. Moreover, the financial scandals occurred in this decade (Enron, WorldCom, Arthur Andersen) has shook the share and stakeholders' view and demanded firms to be more transparent and have better accountability records. This resulted in a harsher evaluation by all quadrants of society regarding the operation of firms. In fact, the license to operate is not ready to be assumed by any firm, it has to be accountable for its actions and need to engage in socially and environmentally activities (see **Figure 1**).

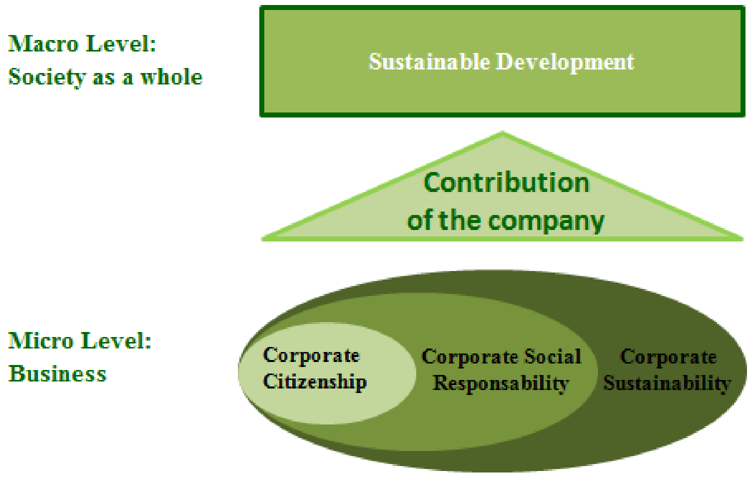
Figure 1 - Areas of Action for CSR

Governance and management systems	**Vision and Strategy**	
	Communication with internal and external stakeholders	
	Environmental management	Management of the social areas of action of CSR
Areas of CSR activity in central	Operational environmental protection	Interests of employees
	Environmental protection in the supply chain	Working conditions and human rights in the supply chain
	Ecological product responsability/integrated product policy	Consumer protection and customer interests
Areas of CSR activity outside central	Involvement in shaping the regulatory framework (including lobbying), combating corruption	Management of the social areas of action of CSR

Source: Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (2006)

The substantial increase in the CSR concept, range and impact in business organizations and its stakeholders in the last six decades have brought CSR to the agenda of every organization. Clarke (2007) defended that "*Corporate social and environmental responsibility (CSR) seems to be rapidly moving from the margins to the mainstream of corporate activity, with greater recognition of a direct and inescapable relationship between corporate governance, corporate responsibility, and sustainable development*" (Clarke, 2007: 268)

Figure 2 - CSR and Sustainable Development



Source: Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (2006)

However, this augmentation in CSR scope and notoriety has brought some difficulties in the definition of the concept, and generated some scepticism. David Vogel (2005) in his book *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* considers that are many reasons for firms to act responsibly even in the absence of legal requirements, such as, strategic, defensive, altruistic or public driven motivations. This is coincident with Lantos (2001) theory of CSR, which states that are three kinds of CSR: ethical, altruistic and strategic. Ethical CSR is the demand for firms to prevent any harm deriving from its activities; Altruistic CSR is related with voluntariness and philanthropic aspects; Strategic CSR is present when a firm engages on CSR-related activities that accomplish some business goals. However, Vogel defends that are important limits to this market: "*CSR is best understood as a niche rather than a generic strategy: it makes business sense for some firms in some areas under some circumstances. Many of the proponents of corporate social responsibility mistakenly assume that because some companies are behaving more responsibly in some areas, some firms can be expected to behave more responsibly in more areas. This assumption is misinformed. There is a place in the market economy for responsible firms. But there is also a large place for their less responsible competitors*"

(Vogel, 2005: 3). Vogel concludes that because CSR is voluntary, companies and stakeholders will only engage in CSR activities to the extent that they see beneficial for its goals. In addition, the author identifies that companies, like individuals, not always display acceptable moral or social behaviour. Vogel theory suggests that exists a cost-benefit in CSR and Hopkins (2004) elaborated a list that relates stakeholders groups with it[1]. This also helps to better understand how CSR is emerging as a full-fledged industry where firms that engage more proficiently in this industry can gain advantages, not only in terms of PR but in overall profitability as well. On other scale, there are other related businesses that are emerging, for instance, consultancy firms, and large corporations that are now hiring in larger numbers specialized executives in CSR. On the non-profit sector, NGO's are effectively watching and controlling the activities of companies, especially those listed in indexes, FTSE Global Islamic Index or DowJones Sustainability Index, and on their own lists, GRI SustainAbility 1000.

Deborah Doane (2005) is particularly sceptical about the drive of market mechanism in delivering social and environmental change. The author identifies four myths in CSR movement:

1. **The market can deliver both short-term financial returns and long-term social benefits**
   The assumption is based on the free-market capitalism, where "*people are rational actors who are motivated to maximize their self-interest. Since wealth, stable societies, and healthy environments are all in individuals' self-interest, individuals will ultimately invest, consume, and build companies in both profitable and socially responsible ways. In other words, the market will ultimately balance itself* (Doane, 2005: 25)". However the author states that are few evidence that the market regulates itself in such ways. Moreover, there is a difficulty in proving that acting in a socially responsible way improve their bottom line.
2. **The ethical consumer will drive change**
   "*Though there is a small market that is proactively rewarding ethical business, for most consumers ethics are a relative thing. In fact, most surveys show that consumers are more concerned about things like price, taste, or sell-by date than ethics* (Doane, 2005: 26)".

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[1] See Annex **1**

3. **There will be a competitive “race to the top” over ethics amongst businesses**
4. **In the global economy, countries will compete to have the best ethical practices**

Clarke (2007) suggest that the acronym “CR” (Corporate Responsibility) would be more prepared to embrace all responsibilities, but sees even more fit the UN’s recent adoption of the acronym ESG (environmental, social and governance) as it may become more influential. As it was already mentioned, the definitions came mainly from institutions or governments and the broadness and the demand level would be the main difference. For instance, the European Commission in 2002 defined “*CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis*” (Commission of the European Communities, 2002). Despite all the development in CSR, especially in the Western World, the Developing Countries do not necessarily follow the same trends. Jamali & Miurshak (2007) debate that while the CSR discussion in the developed countries is important, in the developing countries is not quite the same. In fact, according to the authors, due to the lack of knowledge and know-how in CSR, many corporations disregard their obligation to societies.

In the table below is a resume of the evolution of CSR from the 1950’s to the 21st century,

Table 1 - CSR Dimensions through the last few decades

Decade	Dimension	Characteristics
1950's	Obligation to Society	- Start of literature publication regarding CSR - Accountability of businessmen (management) to the society
1960's	Relationship between corporation and society	- Further development on CSR literature - Broader approach of CSR: society, moral issues (poverty, corruption) and environment
1970's	Stakeholder's Involvement	- Socio-economic goals - Improvement in quality of life - Economic, legal and ethical responsibilities
1980's	Stakeholder's Theory	- Voluntariness - Freeman's Stakeholder Theory - CSR becomes economically profitable - Human rights - Philanthropy
1990's	Triple-Bottom Line	- Environmental Stewardship: people and planet - Profit - Sustainability
21st century	Emerging CSR Industry	- Transparency & accountability of actions - Integration of social and environmental concerns - Economic and quality of life developments - Fight against corruption - Sustainability

Source: Author based on Carrol (2009) and Rahman (2011) presenting the dimensions on which it developed and the characteristics that made each decade unique.

1.2. Legislation and Policy Developments

There has been some divergence of opinions amongst authors whether voluntary engagement in CSR is better than enforcement by law, or if is there a gap in between the two.

Table 2 - Regulation or Burden

Regulation	Prediction by Business	Reality
National minimum wage	Would result in over 1 million U.K. job losses within two years	Unemployment fell by 200.000
EEC introduction of catalytic converters	The cost of the technology would be £ 400 to £ 600 *per* vehicle, with a fuel consumption penalty on top	Real costs of around £ 30 to £ 50 *per* converter; technological innovation led to smaller, cheaper cars
U.S. Clean Air Act	Would cost the U.S. $ 51 to $ 91 billion *per* year and result in anywhere from 20.000 to 4 million job losses	Yearly cost of $ 22 billion to business, but employment in areas affected up by 22 percent; the benefits arising are between $ 120 and $ 193 billion
Montreal Protocol	Opposed by industry on economic cost gounds, but no projected figures	No impact; substitute technologies may have saved costs, according to follow-up studies

Source: Doane (2005)

Doane (2005), in addition to the CSR myths, identified that in some situations CSR implementations ended up on the wrong spectrum of sustainability. "*Often the unintended consequences of good behaviour lead to other secondary negative impacts, too. McDonald's sale of apples, meant to tackle obesity challenges, has actually led to a loss of biodiversity in apple production, as the corporation insists on uniformity and longevity in the type of apple they may buy – hardly a positive outcome for sustainability*" (Doane, 2005: 28). The author goes on and defends the advantage of regulation since it brings with its predictability and in many cases innovation, alongside a more efficient way of enforcing companies to behave in a responsible manner. However, businesses often oppose to the regulations and, as we can see in **Table 2**, sometimes the legislation is in fact an effective driver of change. Legislation can be useful in effectively changing the patterns in consumer behaviour[2]. On the other hand, there are authors that defend that a heavy regulation in CSR would end up the voluntariness aspect and out-of-the-box thinking, by complying with the law and no more than that (lowest common denominator argument).

Grünschloß (2009) is on the opposite side of the table and defends that CSR is to be voluntarily undertaken and recognizes that, for the moment, it is very unlikely that CSR

[2] "Social labelling, for example, has been an extremely effective tool for changing consumer behaviour in Europe. All appliances must be labelled with an energy efficiency rating, and the appliances rated as the most energy efficient now capture over 50 percent of the market. And the standards for the ratings are also continuously improving, through a combination of both research and legislation. (Doane, 2005: 28)".

demands will be consecrated in national laws. The author defends that in some corporations, the simple compliance with environmental laws is already considered CSR. However, "*CSR should go beyond the simple observation of laws and regulations and comprehend concern for the most instrumental interests of the corporation's stakeholders*" (Grünschloß, 2009: 15) and in today's civil society respecting the law alone will not earn corporations with public credit. For Porter & Kramer (2003) the "free-rider[3]" problem is not that relevant and is not, by any means, a deterrent factor for corporations to engage in CSR activities. They argue that, in most cases, it will still generate advantages for the firm that will be recognized as a pioneer and record gains in reputation. This willingness of firms to engage in such activities voluntarily is serving, to a certain extent, as a "riding tide lifting all ships" and leading corporations are dragging others into CSR practices.

Hopkins (2004) and Henriques (2002) are somewhere in between, recognizing both pros and cons in regulating CSR. Adrian Henriques, identifies that the situation in the UK (one of the leading countries in terms of governance and CSR) the situations is already mixed with legislations in areas like the "*the minimum wage, Health & Safety and disclosure to investors, but none covering overall disclosure of environmental impact, little covering supplier relationships and almost nothing on community impact*" (Henriques, 2002: 1). The author argues that if there was business case for CSR in the first place, the legislation would not kill it, it would rather function as a floor, removing the "long tail of underperformers" without jeopardizing the evolution of high achievers. In the end, the author argues, the first law of CSR will be "Disclose" and it would be used to force firms to report what they have been doing (social, environmental and economic performance) and not telling them what to do. Hopkins (2004) has a quite similar view as Henriques, and sums it up in pros and cons, as can be seen in **Table 3**.

[3] "The 'free-rider' problem relates to the fact that companies who do not engage in CSR obviously do not bear the costs of CSR. Yet they still reap the societal benefits accruing from CSR activities of others. With the benefits shared disproportionately, those that do incur CSR costs are at a competitive disadvantage to those that do not. (Tyrrell, 2006)

Table 3 - Pros and Cons of Regulating CSR	
Pluses	**Minuses**
It would help to avoid the excessive exploitation of labour, bribery and corruption	Additional bureaucracy, with rising costs for observance
Companies would know what is expected of them, thereby promoting a level playing field	Costs of operation could rise above those required for continued profitability and sustainability
Many aspects of CSR behaviour are good for business (such as reputation, human resources, branding and making it easier to locate in new communities) and legislation could help to improve profitability, growth and sustainability	Critics already argue that the CSR of companies is simply to make a profit, and legislation would increase the vocalization of these concerns
Some areas, such as downsizing, could help to redress the balance between companies and their employees	Reporting criteria vary so much by company, sector and country, and they are in constant evolution
Rogue companies would find it more difficult to compete through lower standards. The wider community would benefit as companies reach out to the key issue of underdevelopment around the world	

Source: Hopkins (2004)

Despite the doubts that surround the regulation and the voluntary compliance of CSR, the fact is that governments are making an effort to include CSR in national laws. In the year 2000 the UK Modern Company Law Review introduced new policies to include environmental policies and performance on community social, ethical and reputational issues. It is important to emphasize that as a result the duty of directors to promote the success of company[4] includes all the performance indicators mentioned above. In France, the corporate law was reviewed in 2001 to include a mandatory disclosure, for listed companies, in the annual reports on how the companies take the social and environmental impacts of their activities into account.

Motivated by the attention and buzz surrounding CSR in the last few decades, various organizations have proposed international CSR standards, codes of conducts and guidelines. After 2004 there are four main proposals in this area: GRI, AA1000, SA8000 and the UN's Global Compact[5]. By analyzing **Annex 3** it is striking the concentration of such principles in: Brussels, Geneva, London, Paris, New York and Washington DC. The majority of CSR-

[4] Refer to **Annex 2** for the full Clause 156: Duty to Promote the Success of the Company
[5] Reporting Guidelines: www.globalreporting.org; Assurance: www.accountability.org; Standard: http://www.sa-intl.org/; Principles: www.unglobalcompact.org

related standards are, in fact, originated either in Europe or in North America, and are influenced by the cultural values and by the level of development of local businesses and societies. "*This is further reflected by the origin of most of the multinational (MNCs) and transnational corporations (TNCs) in the Western world, for which these principles are mainly developed. Although the characteristics of the principles on CSR appear to be Western oriented, they are significant and useful for the purpose of the welfare of the society"*. (Mohammed, 2007: 14)".

To bridge this gap between the Western World and the Islamic Financial Institutions (from now on IFIs) there have been a growing number of institutions making efforts to develop standards, codes of conduct and studies on areas such as Governance and CSR. The leading institutions, besides governments and central banks, are:

- **Accounting and Auditing Organization for Islamic Financial Institutions**
  AAOIFI "*is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and the industry"* (AAOIFI website). Its contributions for the development of IFIs are not limited to auditing and accounting issues, in fact, it also releases standards and codes of conduct of CSR practices. In 2010, the AAOIFI has released a set of Government Standards in which were included the following mandatory conducts and disclosure for good CSR practices[6]: Policy for screening and for responsible dealing with clients; Policy for earnings and expenditure prohibited by Shari'ah; Policy for employee welfare; Policy for Zakat (AAOIFI, 2010). The standards also include a number of recommended conduct and voluntary disclosure.
- **The Islamic Financial Services Board (IFSB)**
  "*Is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders*" (IFSB website). The results of IFSB have led to the publication of a corporate

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[6] See **Annex 4**

governance standard and the preparation of two more standards on Supervisory Review Process and Transparency and Market Discipline.

- **International Islamic Financial Market (IIFM)**
  "*International Islamic Financial Market (IIFM) is the global standardization body for the Islamic Capital & Money Market segment of the IFSI. Its primary focus lies in the standardization of Islamic financial products, documentation and related processes".* (IIFM website).
- **Hawkamah, the Institute for Corporate Governance**
  Establishing its range of influence mainly in the MENA[7] countries the "*Hawkamah was created to bridge the governance gap by assisting the region's countries and businesses in developing and implementing sound, well integrated corporate governance frameworks"* (Hawkamah website). It is responsible for elaborating regular studies of corporate governance in the region, finding trends and creating standards for good corporate governance.

Outside Islamic Countries:

- **The Financial Services Authority (FSA)**
  "*We are the independent body that regulates the financial services industry in the UK. We have been given a wide range of rule-making, investigatory and enforcement powers in order to meet our four statutory objectives. In meeting these, we are also obliged to have regard to the Principles of Good Regulation".* (FSA website)
- **Dow Jones Islamic Market Index and FTSE Shari'ah Global Equity Index Series**

  While not providing guidelines, merely by screening if the corporations, that aim to have their stocks integrate these indexes, are complying with the rules and the standards set out in the published methodology are, in fact, serving as an enforcer of policies.

[7] MENA is the acronym for Middle East and North Africa, ranging from Morocco to Iran, thus, representing an important share of the IFI's markets.

Chapter 2: Islam Ethical System in Islam

2.1 Shari'ah and Islamic Religious Values and Beliefs

The ethical system in Islam is derived by two main sources of doctrine: the Qur'an (first) and Sunnah (second). Qur'an is the holly book that Muslims believe to have been revealed by God, through angel Gabriel, to the prophet Muhammad. It is composed by 114 chapters, containing 6236 ayat (verses)[8] where God provides divine guidance and direction to humanity. Sunnah is a set of practices taught to Muslims by the Prophet. Even today there are clear evidence of the teachings, for instance, the praying ceremony is performed the same way, regardless the location, the pilgrimage (Hajh) to Mecca and Medina is still practiced in the way Muhammad taught Muslims centuries ago. Hadith, while similar to Sunnah in form is not in content. Much like Sunnah, Hadith also communicates the actions and teaching of the Prophet, however, in Hadith the teachings were not taught directly by the prophet Muhammad. It is, in fact, a reported tradition or "*a narration of the words or acts of the Prophet, as perceived and transmitted by one or more persons who heard or saw the Prophet saying or performing these acts*". (Hassan, 2003). Hence, it is not regarded as highly valuable doctrine as the Qur'an and Sunnah.

Shari'ah is often defined as Islamic law and even though it is correct (to a certain extent) it is much ampler than that. It can be considered as a code of conduct and a set of norms and values and is not static, it changes as societies and mentalities change. The variable sources and components of Shari'ah shape it to the needs and challenges of times. Moreover, there is not one thing that can be identified as Shari'ah, since there are numerous Muslims communities and schools of thought that understands Shari'ah differently[9]. Shari'ah is much more concerned with the individual religious orientation, like prayer and fasting, than with national laws (Rice, 1999; Bakker et al., 2009; Duss, 2011).

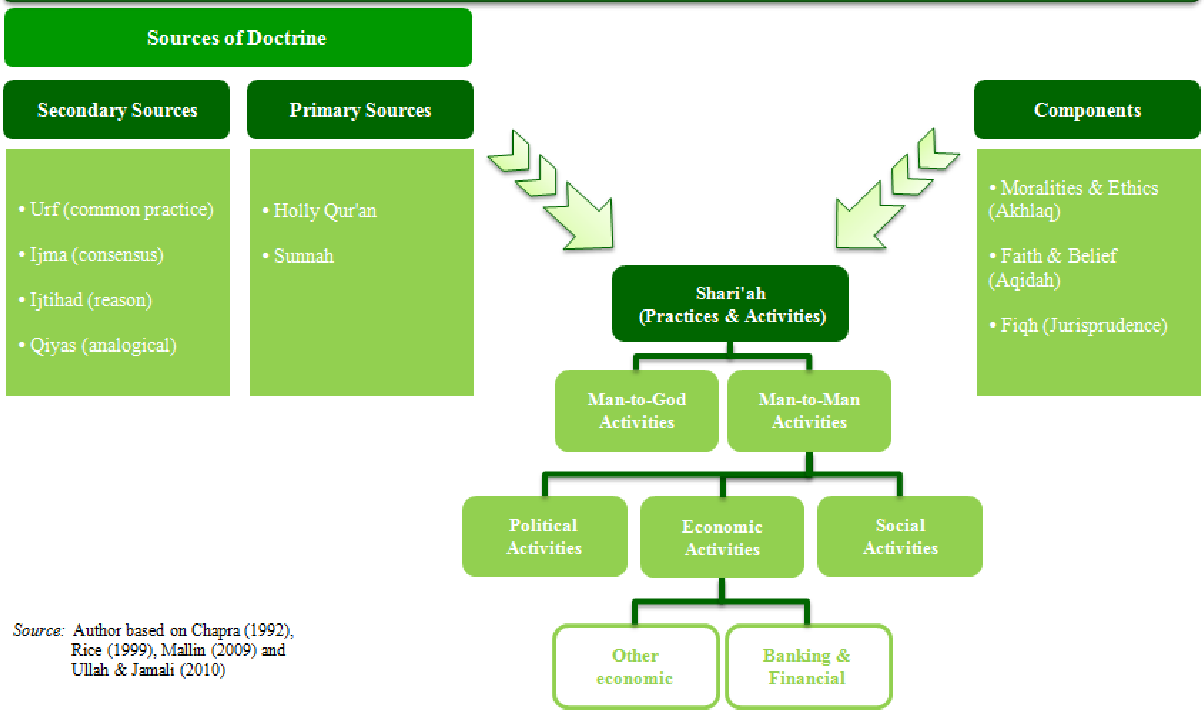
There are, however, values beliefs and purposes that are unchangeable and represent the core of Shari'ah everywhere in the world. On the characteristics of Shari'ah, identifies in **Figure 3**, Akhlaq and Aqidah are the anchor, while Fiqh is, on the other hand, changeable and adaptable to each society. To better understand Shari'ah and its implications in the life of Muslims, it is

[8] According to Wikipedia, "The actual number of ayat has been a controversial issue among Muslim scholars since Islam's inception, some recognizing 6,000, some 6,204, some 6,219, and some 6,236, although the words in all cases are the same. The most popular edition of the Quran, which is based on the Kufa school tradition, contains 6,236 *ayat*. (Wikipedia)"

[9] The three that gather the largest number of followers are, by descending order, Sunni, Shi'a (or Xiit) and Salafi.

important to sub-divide it into "Ethical Principles", related with Akhlaq and Aqidah, and "Business Implications"[10] related with Fiqh.

Figure 3 - Framework for Shari'ah Law



Source: Author based on Chapra (1992), Rice (1999), Mallin (2009) and Ullah & Jamali (2010)

2.2 Islam Ethical Principles

There are four main principles that are commonly accepted by authors: Unity, Justice and Trusteeship (Rice, 1999; Ullah & Jamali, 2008; Beekun & Badawi, 2005; Dusuki, 2008; Wilson, 2006; Uddin, 2003; Chapra, 1992; Okte, 2010). These principles are embedded in any Muslim society and frame, not only the Shari'ah concept, but the whole economic system of Islam. In the table below, Ullah & Jamali (2008) resumed the most relevant characteristics of each principle, citing other authors and the Qu'ran. The ethical principles play the role of "moral filter" (Rice, 1999 & Chapra, 1992) which alongside price serve the purpose of a mechanism to efficiently distribute scarce resources. In Islam, the ethical system ensures that socio-economic goal can be achieved effectively.

[10] See section **5.2**

Table 4 - Islamic Ethical Principles

Unity	Justice	Trusteeship
- Belief in One God	- Erradication of inequity, injustice, exploitation and oppression (Rice, 1999)	- People believed as trustees of God on earth
- The whole life is based on this unity	- No bearer of burdens can bear the burdens of another;…man can have nothing but what he strives for…" (Qura'n, 53: 38-9)	- Resources are for the benefits of all and should be acquired and consumed in the righteous way and the well-being of all should be taken into account in the disposition of resources
- Unity of ideas and actions	- No cheating, uphold promises and fulfill contracts	
- Relationship of brotherhood and equality	- Constant circulation of wealth	- All economic activities are regarded as worship conducted in the right way
- All people are equal partners	- Basic needs of the poor to be taken care of	

Source: Ullah & Jamali (2008)

2.2.1 Unity (Tawhid)

This is the very foundation of Islamic faith, the belief in one and only God. The unity with God is what emanates everything, from the creation of the universe to the purposefulness of every action taken. It presupposes a vertical relation between God and Humans and Muslims believe that their actions today will later determine their after-life fate, as they are accountable to God. This belief impacts the way Muslims relate with each other, with the society as a whole and the environment, so the unity principle presupposes a relationship of brotherhood and equality. "*In this sense, unity is a coin with two faces: one implies that God is the sole creator of the universe and the other implies that people are equal partners or that each person is a brother or sister to the other. As far as business is concerned, this means cooperation and equality of effort and opportunity*". (Rice, 1999: 347)

2.2.2 Trusteeship (Khilafah)

"*The human being is His khalifah or vicegerent on earth and has been endowed with all the spiritual and mental characteristics, as well as material resources, to enable him to live up to his mission effectively*" (Chapra, 1992: 202). Every individual is free to reason, to make his own judgment and to choose the resources he sees fit to his needs. However, since there are millions of other khalifahs, the use of resources must be balanced, efficient and equitable, in order to respect and ensure the unity of a universal brotherhood. According to Chapra, there are four implications of the khalifah concept.

1. **Universal Brotherhood** – Islam recognizes that each human being is a khalifah and every individual is regarded as an equal, despite the race, group or country. The way to be a worthy khalifah is, for instance, by cooperating with society, endeavouring to fulfil the basic needs of all and enrich the human life.

2. **Resources are a Trust** – Resources were created by God and made available to humans by God. Therefore, khalifahs are not their primary owner and can't dispose of resources as they please. Firstly, the resources are to be used to ensure the well-being of all, by using them equitably. Secondly, the resources must be acquired respecting the Qur'an and Sunnah. Thirdly, even by acquiring resources in a compliant way, they ought to be used to benefit not only him and his family but the society as well. Fourthly, to no khalifah is permitted the waste or destruction of resources.
3. **Humble Lifestyle** – The humble lifestyle is the only that fits a khalifah of God. Arrogance, pomp, extravagancies are unnecessary and lead to the destruction of the brotherhood and equality feelings.
4. **Human Freedom** – One of Prophet Muhammad's objectives was to bring freedom to humanity. However, khalifahs are to be subservient to God and only him, thus they have to abide by Shari'ah in order to attain the well-being and social responsibility demanded by God.

2.2.3 Justice (Adalah)

Justice has always been considered an indispensable principle and in Islam, there is an unambiguous objective to eliminate any hint of injustice, oppression, inequity and exploitation. According to Chapra (1992) there are four particular aspects of Justice that are especially important in Shari'ah:

1. **Need fulfilment** – The resources entrusted by God to humans are to be used to satisfy human needs of all individuals and ensure a fair standard of living.
2. **Respectable source of earning** – Jurists have emphasized the obligation of every Muslim to support himself and his family through an honest income. Opportunities for Muslims to be employed must exist, so that they meet their obligations. It can be deduced that society has a collective obligation to ensure everyone equal opportunities to earn an honest living. In business, this principle is present under the form of Zakat[11] (mandatory Islamic tax) and voluntary contributions.
3. **Equitable distribution of income and wealth** – Inequalities can be admitted in Muslim societies, but only if they are in (relative) proportion to skill, initiative, effort and risk. However, an extreme inequality is condemned as it is a driver of disaggregation of the brotherhood feeling.

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[11] Refer to section **5.2.3** for further details.

4. **Growth and stability** – This is the corollary of the other three aspects of Justice. Without economic growth and stability, it might not be possible the generation of jobs and the need fulfilment is endangered. Moreover, if these conditions are inexistent, it is much harder to attain a respectable source of earning and it is harder for firms and individuals to pay the zakat and make the voluntary donations.

Chapter 3: Islamic Financial Institutions and Islamic Corporate Social Responsibility

3.1 CSR from an Islamic Perspective

The relation of commercial activity and the civil society is regarded as natural in Islamic societies, as the rules of operation are embedded in the values described above. With IFIs it is no different, as the philosophy that rules their activities is enshrined in the Shari'ah precepts that require IFIs to operate in morally, ethically and in a socially responsible way. CSR as defined before is, therefore, a natural commitment of IFIs.

In Islam there are always two goals to be met that, while inseparable, are sometimes contradictory: financial and social goals. Any for-profit organization that meets just the first is a failing one. It is important to stress that IFIs are not to be considered as charitable organizations, but it is wrong for managers of these institutions to seek for profit maximisation only while neglecting social obligations. It is necessary to reach equilibrium (Al'adl) between the two and, in Islam, justice (adalah) strive exactly for this. In Islamic Banking these two concept are side by side and is considered unjust if the banks fail to deliver sufficient returns to the depositors and investors and in a more extreme scenario, IFIs are "*prohibited to make excessive profits at the expense of their customers or at the local community at large* (Dusuki & Dar, 2005: 396)".

Regarding the above topics the International Association of Islamic Banks (IAIB) produced in 1990 a statement that even today sets the standards of performance for Islamic Banks (will be also referred to as IBs).

"*The Islamic Banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or development activities, the Islamic bank takes into prime consideration the social implications* *that may be brought about any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.* (IAIB 1990 as quoted by (Dusuki & Dar, 2005: 396))"

The above quote is the confirmation that CSR is not, by any means, an unknown concept to the Islamic Banking system and is, in fact, deeply rooted in the Shari'ah and in its ethical system. Being that Shari'ah is the foundation for understanding CSR in Islam, the goals of CSR differ from their conventional counterparts, as the intense commitment to brotherhood (trusteeship), justice (adalah) and the well-being of human being (both physically and spiritually) lead to a rejection of maximisations of outputs as the sole measure of performance. Any firm that claims to be run under the Shari'ah principles is supposed to naturally practice CSR and this should be a key issue to have in mind by managers as this is a way to fulfil the customers' needs. Beekun & Badawi (2005) identify[12] the relationship between firms to its key stakeholders and identifies the ethical issues that should be addressed to be in tune with the Islamic notion of CSR. Ullah & Jamali (2010) defend that Islamic CSR is quite in line with Freeman's stakeholder theory but the main difference is that in Islam each stakeholder is not treated equally but in relation to its stake in the company. The purpose of this differentiation arises from the fact that is considered unjust to treat stakeholders the same because they are affected differently in case of failure. They can be divided into three main categories:

1. "Those who are directly affected by the success and failure of the business e.g. owners and employees;
2. Those who are sufficiently affected by the success and failure of the business and its activities e.g. suppliers, customers and government;
3. Those who are subject to the externalities of the business e.g. environment and community (Ullah & Jamali, 2010: 623)"

The authors also relate the rights and duties of each stakeholder to the Islamic ethical principles described above, establishing a connection between the different stakeholders in the

[12] See **Annex 5**

Islamic CSR vision[13]. This is important to understand how religion impacts stakeholder in Muslim societies. In the case of CSR, religion acts as a regulator on its own, because the "*ethical principles of Islam do influence the decision making process in a business situation where such decisions may not be in conformity with decisions made in the economic interests of the firm* (Uddin, 2003)". So religion acts as a "moral filter" to relinquish superfluous usage of resources and held responsible each individual if violates the prescribed principles. The responsibility is not bound to one's private life but also to the investment choices made. This means if an investor has stock of a company which goes beyond the principles of Islam, he/she will be held responsible for the activities of that company. Similarly and despite the "fictious" character of a company it does not diminish in any way the responsibility of its owners and managers for its actions.

If a company profits from haram activities, these revenues are not to be taken by Muslim investor, nor by the IFI. This is the reason why AAOIFI established in its CSR standards a "Policy for earnings and expenditure prohibited by Shari'ah"[14]. In such case, the ethical/Islamic shareholders have two options: either forces the company to align its activities to meet the demands of both stakeholder and Shari'ah; or sell the shares of this non-compliant company and invest in companies that act in a more ethical fashion and meet the Islamic screening criteria. Moreover, IFIs are not entitled to invest in companies that damage or explore the natural environment and do not provide any kind of compensation to the involving societies, for instance, educational, medical development, employment opportunities and quality products at affordable prices. The role of an IFI in develop ICSR is to make sure that they invest only in companies that comply with Shari'ah or meet the screening criteria. Thus, IFIs are building a portfolio of Shari'ah compliant companies and by doing so ultimately is being social responsible in a broader sense. Undoubtedly, the IFIs are also responsible for developing their own CSR-related activities and really make a long-term difference and catalyzing the CSR agenda in the Muslim countries and in the financial sector as whole.

3.2 Drivers for CSR development

The development of CSR concept and applications has turned it into an industry, especially in Western countries. Nowadays there are consulting firms specialized in this topic, the large professional services firms also incorporated CSR into their consulting portfolio and,

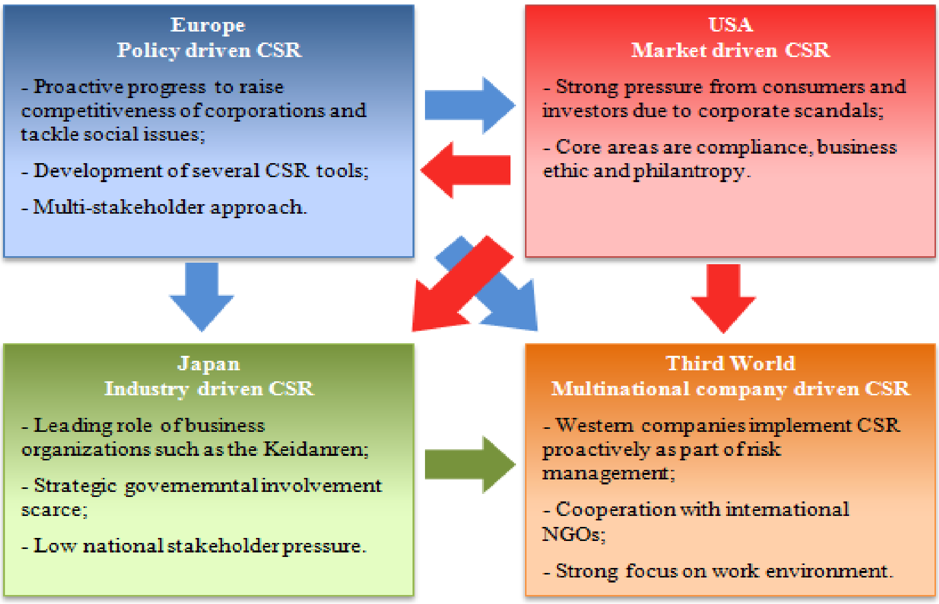
[13] See **Annex 6**

[14] **See Annex 4** (third bullet point)

according to The Economist (2005), larger multinational have a senior executive with the dedicated responsibility of developing and coordinating the CSR function. Dusuki (2008) identifies that in the last decade there have been four main driving forces for the growing trend of CSR initiatives on Western countries.

1. **Market pressure** – Firms stakeholders, such as, customers, employees, suppliers, shareholders are driving enterprises to act more responsibly towards the society by developing CSR initiatives and policies. Moreover, the market itself plays it role, as firms are forced to keep up with the competition and are starting to recognize performance improvements due to CSR practices. On listed companies there is an additional pressure source from capital markets, and capital markets disclosure policies exert firms to produce documents regarding CSR.
2. **Regulatory pressure** – Governments regulations, reporting and disclosure requirements have been a driving force behind CSR development. This pressure mechanism was very important in the beginning, so that firms, markets and even people started to recognize CSR importance.
3. **Communication power** – With the development of new communication technologies (particularly internet) people are able to scrutinize a firm's activities more effectively.
4. **Competitive advantages** – Firms are investing heavier in CSR and communicating it, in order to gain competitive advantages and generate profits. By investing in CSR, firms are strengthening their brand(s), corporate reputation with stakeholders and attract and retain skilled labour.

Figure 4: International drivers of CSR



Source: Grünschloß (2009)

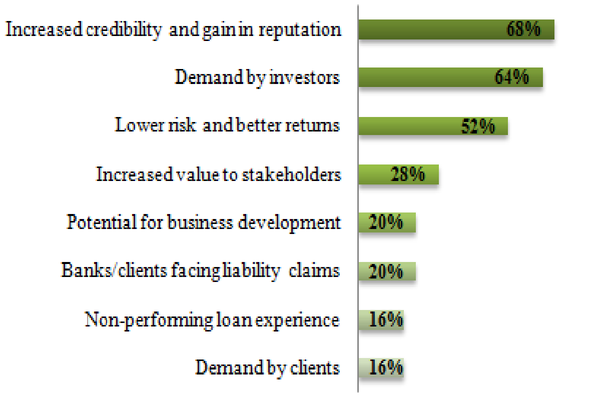
In the table above, Grünschloß (2009) sums the above information and adds some more regarding the CSR drivers in Japan, Europe, USA and in the Third World.

In 2005, IFC conducted a survey on Sustainability of Financial Institutions (IFC, 2007) to identify trends among 120 financial institutions in 43 emergent markets. The results, shown in **Graph 1**, suggest that sustainability drivers are similar to CSR drivers 1 and 4, described before. The benefits arising from such initiatives (**Graph 2**) were also addressed in the same survey, with the results being common to those found by Hopkins (**Annex 1**).

Graph 2 - Benefits of considering Social and environmental Issues (percent of commercial banks)

Source: IFC Sustainability Survey of Financial Institutions (2007)
Note: The figure shows the percentage of commercial banks that responded to the survey that cited a certain type of benefit as a benefit to their bank

Graph 1 - Key Reasons why Banks consider Sustainability Issues (percent of respondents)



Source: IFC Sustainability Survey of Financial Institutions (2007)

In IFIs the drivers are very similar to those already mentioned, with an added dimension, religion. A survey conducted in Saudi Arabia (National Commercial Bank, 2009) shows that the most important CSR themes are "societal improvement or reformation" and "one's religious obligation of serving the impoverished and underprivileged". The top 5 CSR activities identified in this study were a direct consequence of the drivers, thus, the identified in Saudi Arabia are creating job opportunities for the unemployed (49%), encouraging entrepreneurship (47%), conducting or supporting anti-smoking campaigns (46%), supporting charitable organizations (41%) and providing training and job opportunities to the physically challenged (41%). The benefits identified in the study, reveal not only an alignment with the CSR drivers in IFIs but, with those present in IFC's survey as well.

3.3 Seizing Opportunities

In the most recent economic turmoil, Social Responsible Investment and Islamic Finance have been receiving greater attention, not only from investors but from the media as well. The main question in debate is whether these sectors can help prevent such a financial crisis to happen again. According to Gassner (2009) "*the majority of studies came to the conclusion* *that sustainability does not incur costs for financial performance. The additional value identified is the long-term risk management associated with business sectors, which are operating with high social and environmental risks*" (Gassner, 2009: 5). It seems that while these solutions are not able to prevent such crisis from happening again, due to their still small size in the finance world, they offer a lower risk profile and some evidence suggest an outperformance of these funds in the stock market when compared to regular ones (Gassner, 2009).

3.3.1 Social Responsible Investment (SRI) and Islamic Finance

"*Sustainable index investment is a broad topic that can take a number of different forms. Traditional sustainable indices combine positive and negative environmental, social and governance (ESG) criteria, and are aimed primarily at investors that want to match their investments with their values*." (Social Investment Forum)

This sector has been under tremendous growth, and in the US alone, by 2010 it already represented 12.2% of market share of all professional managed assets, corresponding to USD $3.02 trillion. More importantly, in the 2007-2010 economic slump, these funds outperformed the rest of S&P 500, growing 12% against just 1%. (Social Investment Forum Foundation, 2010)

Islamic Finance comprises financial services that comply with Shari'ah[15]. In terms of portfolio and screening criteria, SRI uses a combination of both positive and negative criteria, as it emphasizes economic, social and environmental topics, good practices but also applies financial ratios and rejects harmful firms to the society. It adopts an overall negative and restrictive approach, excluding from its investment portfolio firms that operate in non Shari'ah advisable industries, like pork-related products, alcoholic beverages, weapons and defence, conventional financial services, etc (Dow Jones Islamic Market Indexes). Moreover, it screens firms' financial ratios to determine if they are Shari'ah compliant, being that:

1. "Total debt divided by trailing 12-month average market capitalization cannot be 33% or more.
2. Cash plus interest-bearing securities divided by trailing 12-month average market capitalization cannot be 33% or more.

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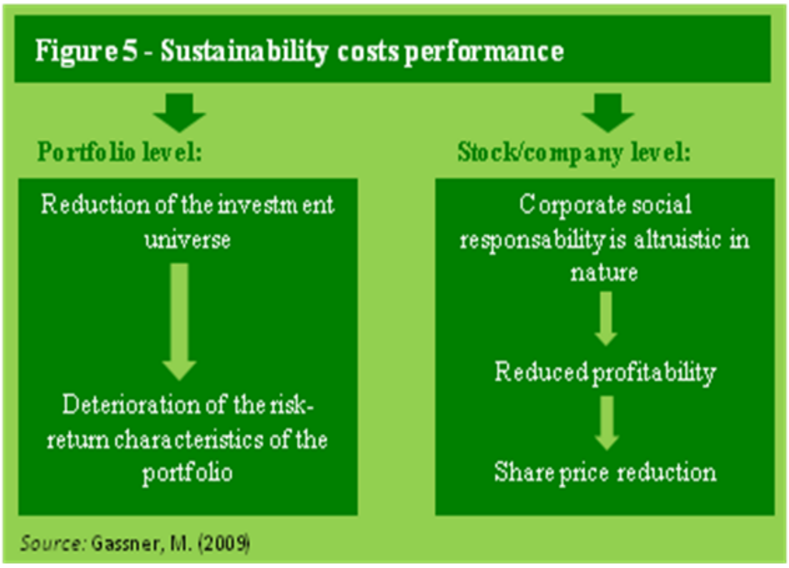
[15] Discussed further on this paper in sections **6.2**, **6.4** and **7.1**

3. Accounts receivable divided by 12-month average market capitalizations cannot be 33% or more. (Gassner, 2009: 4)”



The argument that sustainability criteria is harmful to firm’s financial performance (due to portfolio reduction and share price reduction, through costly CSR initiatives) is being widely dismissed as untrue (**Figure 5**). Regarding the portfolio management, the reduction of the investment universe is becoming irrelevant, as sustainability can even include shares that otherwise would be dismissed for reasons such as low market capitalization. In fact, the diversification value (in Islamic finance) is superior due to the influence of factors other than market size and interest rate (Gassner, 2009). When it comes to the share price reduction, there are numerous studies that point in the opposite direction. For instance, “*CSR performance appears to be valued by markets. […] CSR indicators (notably diversity, employee relations, and environment) positively contribute to a firm’s market value*.” (Gregory, Whittaker, & Yan, 2010: 22).

Chapter 4: Islamic Banking Overview

4.1 Purpose of Islamic Banks

“*An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a Mudarabah or Wakalah (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank which are guaranteed. On the assets side, it advances funds on a profit-and–loss sharing or a debt-creating basis, in accordance with the principles of the Shari’ah. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net* *earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank*." (AIMS, 2011)

Islamic banks were created with the purpose of offering Muslims an alternative to the conventional banking system. They took under its responsibility to operate within the limits and rulings of Shari'ah, respecting the ethical system and to comply as best as it can with the goals of Islamic Economics: 1) Large-scale economic well-being with full employment and optimum rate of economic growth; 2) Stability in the value of money to enable a reliable measure for trade; 3) Just return is guaranteed by investments and project development; 4) Socio-economic justice and equitable distribution of income and wealth.

It is now easier to understand how the Islamic Economic is tightly linked with the ethical system and Shari'ah concepts. Islam banking has been proving along the years that the ideal model for Islamic societies and it's not only proved by the exponential growth but by market share (Iman & Kpodar, 2010). In addition, governments have recognized this sector has important and have taken the lead in supervising Islamic Banks and encouraging growth of the system. Islamic Banks' target clients are, traditionally, composed by two types: Islamic and Economic clients. Islamic clients invest in Islamic banks primarily for religious reasons but also for economic reasons; it is composed by pious Muslims (including high net worth individuals), Islamic firms and sovereign states. Islamic individual investors seek for companies that are Shari'ah compliant and social responsible, as well as, having their money invested in halal businesses. The economic clients invest in Islamic banks for purely economic reasons; is mainly composed by non-Muslim investors (individual and firms) and multinational corporations. For instance, in Malaysia 70% of the country's Islamic banking clients are non-Muslim (Ghazal, 2006).

4.2 Islamic Banks vs. Conventional Banks

Islamic banks are quite similar to conventional banks in terms of legal modalities, structures, objectives and financial activities. Moreover, there are principles that both types of banks share: the factors of production are the same (land, labour, capital and entrepreneurship); there is a concern with equitable distribution of wealth and the developing concern with socio-economic issues (though in Islam its present in the very core of the ethical system and in conventional banking is based on initiative and is undergoing development). Resembling any private-sector financing institution, Islamic banks have the objective of making as much profit as they can, but the means to attain this objective are different to any conventional bank.

Lawal (2010) defends that in Islam, money is not a commodity but merely a medium of exchange and a measure of wealth. While Islam does not discourage the accumulation of wealth, it encourages entrepreneurship via trade or investment in real assets. Therefore, we can conclude that Islamic banking principles are locked within Asset finance and Profit based returns, while conventional banks are oriented towards a money financing approach with an interest based returns. As a result of these different approaches, the risk and opportunity cost evaluation differ in both types of banking systems. In Islamic banks, the Profit-and-Loss sharing[16] approach enables entrepreneurs and banks to engage in a fully fledged business venture, thus sharing the risk, as well as profits and losses, among themselves. In

Table 5 - Major Differences between Islamic and Banking System

Conventional System	Islamic System
Money is a product besides medium of exchange and store of value.	Real Asset is a product. Money is just a medium of exchange.
Time value is the basis for charging interest on capital.	Profit on exchange of goods & services is the basis for earning profit.
Interest is charged even in case, the organization suffers losses. Thus no concept of sharing loss.	Loss is shared when the organization suffers loss.
Due to non existence of goods & services behind the money while disbursing funds, the expansion of money takes place, which creates inflation.	Due to existence of goods & services no expansion of money takes place and thus no inflation is created.
Due to inflation the entrepreneur increases prices of his goods & services, due to incorporating inflationary effect into cost of product.	Due to control over inflation, no extra price is charged by the entrepreneur.
Government very easily obtains loans from Central Bank through Money Market Operations without initiating capital development expenditure.	Government cannot obtain loans from the Monetary Agency without making sure the delivery of goods to National Investment fund.
The expanded money in the money market without backing the real assets, results deficit financing.	Balance budget is the outcome of no expansion of money.
Real growth of wealth does not take place, as the money remains in few hands.	Real growth in the wealth of the people of the society takes place, due to multiplier effect and real wealth goes into the ownership of lot of hands.
Due to failure of the projects the loan is written off as it becomes non performing loan.	Due to failure of the project, the management of the organization can be taken over to hand over to a better management.
Due to decrease in the real GDP, the net exports amount becomes negative. This invites further foreign debts and the local-currency becomes weaker.	Due to increase in the real GDP, the net exports amount becomes positive, this reduces foreign debts burden and local-currency becomes stronger.

Source: AIMS (2011)

[16] See chapter **7** for an in-depth analysis.

conventional banks, however, often the bank serves merely as the provider of funds, thus the risk is considered as a decisive factor and depending on the project's or client's level of risk the interest charged is higher or lower. This makes Islamic banks much more prone to accept projects that may be regarded as not attractive.

4.3 Historical Evolution of Islamic Banking

The first Islamic Banking was created in Egypt, in the town of Mit Ghamr, in 1963. It was created and envisaged as a savings bank and was modelled under the concept of "profit-loss sharing" – the cornerstone of Islamic Banking (that will be discussed in detail further on this paper). Though it was, in the very beginning, an experiment by 1967 there were already nine banks similar to Mit Ghamr Saving operating in Egypt.

Despite a rather slow start, the 1970's geo-political situation created the conditions for the Islamic Banking development in the 80's and 90's. It experienced a tremendous boom and by 1996 it already boasted an impressive $137,131 million in total assets (Zaman & Movassaghi, 2001).

Table 6 - Islamic Banks and Financial Institutions at year-end 1996 (in $ million)

Region	# of Banks	Capital	Total Assets	Total Deposits	Net Profit	Capital to Asset in %	Net Profit as % of Total Assets
South Asia	50	962	45.201	27.042	350	2,1%	0,8%
Africa	35	213	1.951	603	39	10,9%	2,0%
Southeast Asia	30	136	3.801	1.572	184	3,6%	4,8%
Middle East[1]	24	4.060	67.142	54.288	373	6,0%	0,6%
GCC[2]	19	1.340	18.084	16.494	686	7,4%	3,8%
Europe & America	8	559	952	1.164	54	58,7%	5,7%
Total	**166**	**7.270**	**137.131**	**101.163**	**1.686**	**5,3%**	**1,2%**

1 -Middle East includes Egypt, Iran, Iraq, Jordan, Lebanon, Turkey, and Yemen.

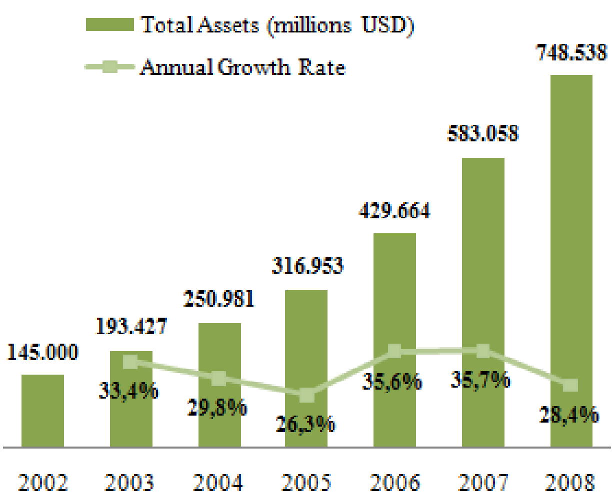
2- GCC stands for Gulf Cooperation Council, consisting of Bahrain, Kuwait, Qatar, Saudi Arabia, and United Arab Emirate (UAE).

Source: Zaman & Movassaghi (2001) quoting Timewell (1998)

From the 80's onwards the Islamic Banking was acknowledged and became fully integrated in the global financial system. In fact, by 2009 there were already 91 conventional banks that had an Islamic window (CIBAFI, 2009). "*Some of the largest and western groups have already embraced this particular type of banking, whether through subsidiaries (Citigroup's Citi Islamic Investment Bank and UBS's Noriba Bank); special divisions (HSBC Amanah); and Islamic windows – that serve as a powerful sign of differentiation – includes Barclays Capital, Deutsche Bank, BNP Paribas, Calyon, Royal Bank of Scotland, JP Morgan/Chase,* *Goldman Sachs, ABN Amro, American Express Bank, ANZ Grindlays and Lloyds TSB*" (Siddiqi, 2006).

The business portfolio of IFIs has undergone serious developments and is now both sophisticated and competitive in the global market. Despite the similarities with the conventional banking portfolios, the Shari'ah compliancy keeps the IFIs product range differentiated, as it will be explained in chapters **6** and **7** of this paper.

Graph 3 - Global IFI's Assets



Source: CIBAFI (2009)

Despite the evolution of the Islamic Finance, there is still room for expansion. According to the General Council for Islamic Banks and Financial Institutions, in 2009 there was 439 IFIs (180 of them are IB) serving 39 countries. In terms of Total Assets, there was also a tremendous growth, from USD $137 billion in 1996 to USD $748.5 billion in 2008, which represents a 446% growth rate. In recent years, the growth rates are still impressive remaining at an average of 31.5%, between 2003 and 2008 (CIBAFI, 2009).

The general interest of the economic and business entities in IFIs has been attracting the attentions of several renowned entities. According to Nasser "*some of the largest financial consultants, law firms and research and publishing institutions that frequently issue reports on the developments taking place in the industry. These include McKinsey & Company's report on competition in Islamic banking, reports by Moody's and Standard & Poor's, which are amongst the most reputable credit rating institutions in the world as well as analyses by Bloomberg and the Financial Times.*" (Nasser, 2008). Besides those already mentioned, there has been some recent developments, for instance, the establishment of the Dow Jones Islamic Market Index, that besides all the market data that composes these indexes, also includes specific Islamic characteristics, such as, Screens for Shari'ah compliance and has a Shari'ah supervisory board of its own.

Regarding regulatory, transparency and standardized practices, there has also been developments and efforts made to unify and consolidate the Islamic Financial System. The main regulatory institutions are the Shari'ah Supervisory Board (SSB) and the Islamic

Financial Services Board (IFSB). Both these supervising bodies work together with the IFIs to promote the adherence to corporate governance requirements and best practices. By 2004 the "*AAOIFI has issued 56 standards including 24 financial accounting standards and statements, five auditing standards, four governance standards, 21 Shari'ah Standards and a code of ethics for accountants and auditors of IFIs. It has also produced a statement on the purpose and calculation of the capital adequacy ratios for Islamic banks*." (Alexakis & Tsikouras, 2009: 93)

However, there is still room for improvement and there have been a considerable number of personalities alerting for the need of further regulation, in order to prevent a financial collapse in the Islamic Finance. As the former International Monetary Fund executive director, Dr. Abbas Mirakhor stated: "*We may have more regulatory standards but there is no implementation of the standards in a unified manner, and there is no organization that supervises the instruments. [...]Our problem is that every jurisdiction has its own regulation, and some may not even have their own regulation. That gives an opportunity for regulatory arbitrage, which means people may issue Islamic instruments that are sub-par in jurisdictions that have very weak or no regulation on that particular instrument, therefore creating risk for the system*" (Koon, 2009).

Table 7 - Development of Islamic Economics and Finance in Modern History

Time Period	Development
Pre-1950s	Barclays Bank opens its Cairo branch to process financial transactions related to construction of the Suez Canal in the 1890s. Islamic scholars challenge the operations of the bank, criticizing it for charging interest. This criticism spreads to other Arab regions and to the Indian subcontinent, where there is a sizable Muslim community. The majority of Shariah scholars declare that interest in all its forms amounts to the prohibited element of riba.
1950s-60s	Initial theoretical work in Islamic economics begins. By 1953, Islamic economists offer the first description of an interest-free bank based on either two-tier mudarabah (profit- and loss-sharing contract) or wakalah (unrestricted investment account in which the Islamic bank earns a flat fee). Mitghamr Bank in Egypt and Pilgrimage Fund in Malaysia start operations.
1970s	The first Islamic commercial bank, Dubai Islamic Bank, opens in 1974. The Islamic Development Bank (IDB) is established in 1975. The accumulation of oil revenues and petrodollars increases the demand for Shariah-compliant products.
1980s	The Islamic Research and Training Institute is established by the IDB in 1981. Banking systems are converted to an interest-free banking system in the Islamic Republic of Iran, Pakistan, and Sudan. Increased demand attracts Western intermediation and institutions. Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
1990s	Attention is paid to the need for accounting standards and a regulatory framework. A self-regulating agency, the Accounting and Auditing Organization of Islamic Financial Institutions, is established in Bahrain. Islamic insurance (takaful) is introduced. Islamic equity funds are established. The Dow Jones Islamic Index and the FTSE Index of Shariah-compatible stocks are developed.
2000 - the present	The Islamic Financial Services Board is established to deal with regulatory, supervisory, and corporate governance issues of the Islamic financial industry. Sukuk (Islamic bonds) are launched. Islamic mortgages are offered in the United States and United Kingdom.

Source: Khan (1996); IDB (2005); Greuning & Iqbal (2008)

Chapter 5: Characteristics of Islamic Banking

5.1 Corporate Governance in IFIs

OECD defines Corporate Governance as "*the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.*" (OECD, 1999)

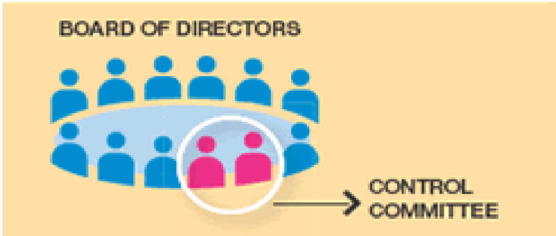
The attention that Corporate Governance (from now on CG) in Islamic Financial System has been receiving in the last few years is a natural development of a fast growing market that is been increasingly in the spotlight. The growth in this financial sector has, naturally, attracted investors from all over the world and from different business sectors. This growth of investors drives the attention and the development of CG policies forward and in IFIs this is no different with pension and mutual funds, insurance companies and high profile levered firms. Besides this reason, there are other drivers for IFIs development in CG policies. The pressure placed on IFIs by leading institutions and publicly held companies, notably in the United Kingdom and in the United States, are forcing IFIs to develop faster, better and more efficiently, as the criticism and concerns expressed have been seriously harsh. Another driver was explained in detail already, is the steady shift from the "shareholder value" to favour a broader approach envisioned in a stakeholder approach (Greuning & Iqbal, 2008).

In conventional banking, the corporate governance structure is, traditionally, either a one-tier system, most commonly found in Anglo-Saxon countries, or a two-tier system, most commonly found in Germany and continental Europe. In the former structure, directors (executive functions) and non-executive directors (supervisory functions) operate as a single organizational layer, while the latter, presents two distinct layers, where the upper is the supervising board and the lower the executive board. (Maassen, 2002; Arnaboldi & Casu, 2011). The first, to the fact that distinctiveness it presents is manifested on some interesting features like risk and Profit-and-Loss sharing arrangements, equity participation or interest prohibition, just to name a few. These financial arrangements and features imply a different stakeholder relationship and, in the end, a different governance structure. The governance structure must be able to respond to depositors that have a direct financial stake in the bank's investment and equity participations (through the aforementioned PLS arrangement), and second to the Shari'ah-compliance demand by investors. As a consequence, IFIs have an additional layer of supervision in the Shari'ah Supervisory Board, as depicted in **Figure 6**.

Figure 6 - Corporate Governance System

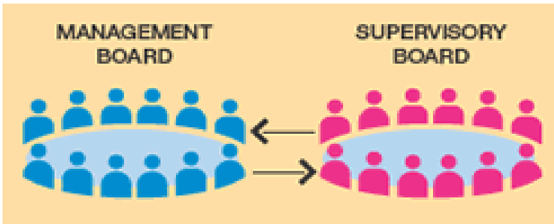
One-Tier system

Typical of the English-speaking country tradition, where management is assigned to a single board, the Board of Directors, among whose member a control committee is appointed



Two-Tier system

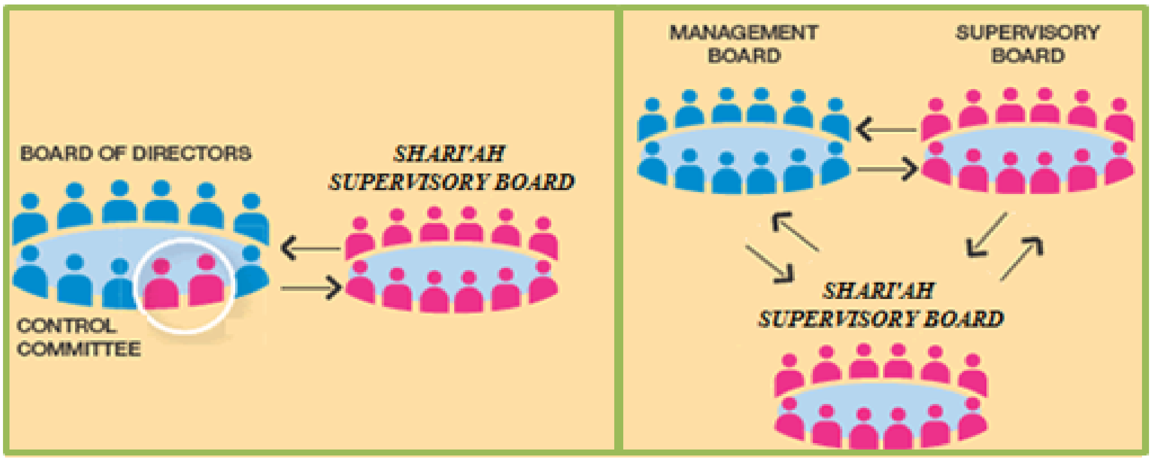
Typical of the German tradition and later adopted by other European countries such as France, the Netherlands, and Finalnd. It entails that the company's administration is divided into two different bodies: the management board and the supervisory board



Islamic Banking Corporate Governance

Whether it is based on the one-tier or two-tier model, the Islamic Banking Governance structure has always an additional layer, the Sharia'ah Supervisory Board, that serves both as supervisory (check the Shari'ah compliancy of IBs) and as a consultive (provides guidelines and emits opinions - fatwas - to the BoD and management) entity.

So, IBs Corporate Governance system can be organized as follows:



Source: Author; Gruppo Hera (2008)

The Shari'ah Supervisory Board (SSB), or religious board, is a monitoring mechanism that guarantees investors of the banks' compliance with the Islamic laws and principles. It comprises a two-fold function of being a supervisory and consultative board and Farook and Lanis (2005) stress that in most cases, SSBs authority is equal to those of external auditors. The SSB role is to provide formal legal opinions (fatwa) according to Shari'ah; review and approve/vet new financial products, transactions, dealings, etc; hold meeting to consult enquiries by the bank's management; prepare contracts (to avoid gahrar); carrying technical reviews and ensure that the Shari'ah control is being applied by the bank and in all its affiliated companies (Rammal, 2009). SSBs are composed by at least three Shari'ah scholars and are appointed by the shareholders at the General Assembly. Due to divergences in the way Qur'an is interpreted by the different schools of thought, SSB member tend to be selected in accordance to the country's dominant sect which reflects on the rulings of every IFI transaction, as well as, perils a standardization of principles on the Islamic Banking sector. (Nathan & Pierce, 2009) CSR monitoring and assessment are also in the scope of action of SSBs. It is this board responsibility to provide an independent review of the IFI CSR policy and present its conclusions to the shareholders.

Besides IFIs own corporate governance regulations, there are institutions that provide guidelines and a corporate government framework to IFIs. On a national level, each government is responsible for establishing specific laws and codes to rule the banking sector and the stock exchanges where IFIs maybe listed. Internationally, there are the worldwide institutions that develop guidelines and best practices codes, such as, the OECD and the Basel Committee and dedicated Islamic institutions, for instance, the IFSB, AAOIFI and Hawkamah. The importance of all the stakeholders mentioned above is resumed in **Table 8**, where in addition to the importance in policy level and operational level, there is an additional dimension the responsibility for risk management (critical area of Corporate Governance).

Table 8 - Importance of Key Stakeholders in the Islamic Finance Industry			
Key players	**Responsability for risk management**	**Importance**	
		Policy level	**Operational level**
Systemic			
Legal and regulatory authorities	Optimize	Critical	n.a.
Bank supervisors	Monitor	Indirect (monitoring)	Indirect
Institutional			
Shareholders	Appoint key players	Indirect	Indirect
Board of directors	Set policy	Critical	Indirect
Executive management	Implement policy	Critical (implementation)	Critical
Audit committee, internal audit	Test compliance with board policies and provide assurance regarding corporate governance, control systems and risk management processes	Indirect (compliance)	Critical
External auditors	Evaluate and express opinion	Indirect (evaluation)	n.a.
Shariah boards	Protect rights and interests of stakeholders in light of *Shariah* principles	Critical	Critical
Consumer	Be accountable for own actions	n.a.	Indirect
Outside stakeholders, public	Act responsibly	n.a.	Indirect

Note: n.a. = Not applicable

Source: Source: Khan (1996); IDB (2005); Greuning & Iqbal (2008)

Regarding the stakeholder relationship, Abu-Tapanjeh (2007) develops a comparison based on Islamic Banks Governance Principles (AAOIFI, 2003) and OECD's[17] (OECD, 2004). By analysing the **Table 9** it becomes easier to understand that there is a religious dimension that is not present in the conventional banking system. That dimension is not only imposed by the SSB or other regulators, but principally by the stakeholders that invest their money in Shari'ah compliant products as a mean to follow religious beliefs.

[17] See **Annex 7** for a detailed description of OECD's six principles.

Table 9 - Comparison of Islamic Corporate Governance Principles with OECD principles

Principle number	OECD principles and annotation	Islamic principles
	Insuring the basis for na effective corporate governance framework	
1	Promotion of transparent and efficient markets with rule of law and division of responsabilities	Promotion of business within ethical framework of *Shariah*
		Believes in profit and loss
		Primacy of Justice and social welfare with social and spiritual obligations
		Prohibition of interest
	The rights of shareholders and key ownership functions	
2	Basic shareholder rights	Property as trust from God
	Participation in Decision-making at the general meetings	Sole Authority is God
	Structures and arrangements markets for corporate control	Society as stakeholders
	Ownership rights by all shareholders including institutional shareholders	Accountability not only to stakeholders but also to God, the ultime owner
	Consultative process between shareholders and institutional shareholders	
	The equitable treatment of shareholders	
3	Protection to minority and foreign shareholders	Just and fairness of value
		Equitable distribution of wealth to all stakeholders and disadvantages members in the form of *Zakat* and *Sadqa*
		Social and individual welfare with both spiritual and moral obligation
		Sensation of Equality
	The role of stakeholders in corporate governance	
4	In creating wealth, jobs and sustainability of financially sound enterprises	Islamic accountability to *Falah* and social welfare orientation
		Haram/Halal dichotomy in transaction
		Social & indivual welfare from both spiritual and material
		Consideration to whole community
	Disclosure and transparency	
5	Matters regarding corporation	Accountability with *Shariah* compliance
	Financial situation	Socio-economic objectives related to firms' control and accountability to all its stakeholders
	Performance, ownership and governance	Justice, equality, truthfulness transparency
		Wider accountability with written as well as oral disclosure
	The responsabilities of the board	
6	Strategic guidance	Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success
	Monitoring of management	Holistic and integrative guidance
		Negotiation and co-operation
	Accountability to company and stakeholders	Consultation and consensus seeking for each decision with related stakeholders

Source: Abu-Tapanjeh (2007)

5.2 Religious Aspects and Implications for Business Practices (Principles)

The foundations of the financial system remain largely unchanged. In fact, "*Islam is a religion that guides every aspect of life including spirituality, business and social justice by encompassing an entire socio-economic system*" (Ullah & Jamali, 2010: 622).

Islamic Financial Institutions have a collective religious obligation (fard kifayah) and must abide by a set of rules, guidelines and principles. First of all, and as it was already said, each and every IFI is enshrined within the Shari'ah. "*The primary objective of Shari'ah, which dictates the moral code of conduct in Islam, is to establish justice, as without justice there can be no peace or freedom*" (Mohammed, 2007: 60).

Based on the Shari'ah there are four principles that that strictly rule the investment behaviour and financial sourcing of these institutions.

5.2.1 *Riba* (interest)

Riba is prohibited under Shari'ah and includes all interest, payable or receivable, in any transaction. This ban impacts not just the borrowing/lending of capital, but all other products and financial instruments that are managed by the Islamic bank. In fact, this prohibition is the cornerstone of the Islamic Banking system itself. Since it ruptures to what was the norm (interest-based banking system) the IB system had to create new ways of conducting business.

The ethical values of Islam are very important to better understand this prohibition. According to the Qu'ran, the ban of interest is a mean to achieve and establish a just and fair society. The abolition of *riba* arises from the Islamic belief that the demand of the capital owner to be rewarded must be measured against the risk associated with the project in which the money is being lent to. "*Hence, what is forbidden is the predetermined fixed charge in financing a loan, an investment, or a commodity exchange*." (Samad, Gardner & Cook, 2005: 73). This was, in fact, the first step to establish the profit-an-loss sharing system, as it forces the lender (usually the bank) to share the losses as well as the profits of any investment.

There is a simple test to determine whether a transaction can be considered as riba. According to Abdulkader Thomas a transaction is considered riba if: "*1) Either a product or a service must be delivered (money does not count as either); 2) It is only legitimate to accept a profit if you are willing to accept a risk of loss; 3) There must be a verbal or written contract; 4) No party should conceal information or try to defraud the other party; 5) Neither party may profit from haram (forbidden) activities, as discussed above*" (Thomas, 2006: 133)

5.2.2 *Gahrar* (uncertainty)

There are a number of dimensions where *gahrar* concept is present; this happens due to the broadness of the concept itself, which can mean: deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss. *Gahrar* concept is used to prohibit any games of chance or gambling (*Qimar*), to write unambiguous contracts (*gahrar*-free) and even to prevent economic transactions involving speculation (*Maysir*).

Islam recognises that there is no such thing as a complete contract – it, therefore, emphasises on unambiguous contracts that minimise the occurrence of disputes and conflicts within organisations. The first step towards managing an Islamic enterprise is writing a gahrar-free contract. Gambling is strictly forbidden by the Qu'ran, due to the antagonism and hostility that it generates. However, the question lies in whether gahrar is permitted (*halal*) or prohibited (*haram*) in business. Islam does not condemn commerce and therefore the transactions that are designed to maximize profits are not prohibited, as long as not conducted through any dishonest appropriation of other people's property or at the expense of society.

According to Samad, et al. speculation in business can be defined as "*the practice of (a) using available information to (b) anticipate future price movements of securities so that (c) [the] action of buying and selling securities may be taken with a view to (d) buying and selling securities in order to (e) realize capital gains and/or maximize the capitalized value of security-holdings*" (Samad, Gardner & Cook, 2005: 73).

5.2.3 *Zakat* (Islamic levy)

Zakat refers to a compulsory religious tax that serves the purpose of redistributing the wealth, to ensure that every Muslim can enjoy a fair standard of living (*nisab*). "*Generally, the accepted amount of the zakat is one fortieth (2.5 per cent) of a Muslim's annual income in cash or kind from all forms of assessed wealth exceeding nisab*" (Mohammed, 2007: 161).

The Islamic Banks, however, are taxed in a different way. They have to establish a *Zakat* fund that becomes responsible for collecting and distributing it to those that most need it, either directly or through religious institutions. This tax is independent of the regular business income tax and is calculated taking into consideration the bank's initial capital, profits and reserves. The recipients of the *Zakat* are the poor (*faqir*), the needy (*miskin*), the *zakat* collectors (*amil*), those who reconciled to Islam (*al-mua'lafah gulubahum*), the captives and slaves (*riqab*), debtors (*gharim*), those serving the cause of God (*fi-sabilillah*) and the travellers (*ibn-al-sabil*) (El-Ashker, 1987).

5.2.4. *Haram* (Prohibited)

Since the Islamic banking operates respecting the Shari'ah law and under an ethical investment concept, there are some activities, businesses and trades that are excluded from the business portfolio of Islamic banks. Under the Islam is prohibited (*haram*) to finance/invest, for example, interest-based activities, pornography, alcohol, tobacco, gambling, pork or human rights violations. Furthermore, IFIs are not allowed to invest in companies that harm the environments and do not provide any compensation. Besides those discussed, Mohammed (2007) identifies other tenets that define the conduct of business practices. The author included not only the Haram practices but the Halal as well.

Table 10 - Islamic Tenets of Business Transactions

Halal Business Transactions	Haram Business Transactions
Keaness to earn legitimate (Halal) earning	Interest (Riba)
Trade through mutual consent	Dealing in Prohibited (Haram) items
Truthfulness	Sale of Al-Gharar (uncertainty, risks, speculation)
Generosity and Leniency	Arbitrarily fixing the price
Trustworthiness	Hoarding of foodstuff
Honouring and fulfilling obligations (Uqud)	Exploitation of one's ignorance of market conditions
Fair treatment of workers	Cheating and fraud

Source: Mohammed, J. (2007)

Chapter 6: Profit-Loss Sharing

6.1 The concept

The concept of profit and loss sharing arises from the need to create distinctive products that operate in an interest-free and under a Shari'ah-based financial system. Banks were expected to create and offer Shari'ah compliant products that adhere to that principal, while making possible that their clients are able to earn a return on their money, solely by committing to the risk of profit and loss sharing.

"*Profit and Loss Sharing (PLS) is the method utilized in Islamic banking to comply with the prohibition of interest. The Islamic solution, commonly referred to as Profit & Loss Sharing (PLS), suggests an equitable sharing of risks and profits between the parties involved in a financial transaction. In the banking business, there are three parties - the entrepreneur or the actual user of capital, the bank which serves as a partial user of capital funds and as a financial intermediary, and the depositors in the bank who are the suppliers of savings or capital funds. Under this proposal, financial institutions will not receive a fixed rate of* *interest on their outstanding loans; rather, they share in profits or in losses of the business owner to whom they have provided the funds. Similarly, those individuals who deposit their funds in a bank will share in the profit/loss of the financial institution*". (VentureLine)

There is some controversy among authors to determine whether PLS is better, in terms of risk, than conventional banks. Al-Zoubi & Maghyereh (2007) identify why PLS mechanism is preferable, in terms of risk, over conventional banks. The authors defend that "*the PLS mechanism will be superior to the western type finance in terms of risk*" (Al-Zoubi & Maghyereh, 2007: 236) and that, potentially, shareholders would prefer an Islamic firm due to the less volatile payoffs. The Islamic firms when experiencing profits, while under PLS financing contracts, would provide lower contingent payoffs, for the reason that "*when the firm experiences a profit, the financier will share the profit with the firm. The profit sharing rate in which profits are distributed is ex-ante and provides higher returns for the financier than interest rates*" (Al-Zoubi & Maghyereh, 2007:236). On the other hand, when a firm experiences a loss, the contingent payoff would be higher, due to the fact that it the financier will be accounted a percentage of the losses, allowing the firm to pay higher contingent payoffs. The PLS system envisages a relationship between the borrower and the lender that has to be unusually close. Leiss (2007) and Rahman (2007) defends that this full disclosure policy presents an "informational disincentive" to engage in PLS arrangements. This occurs due to 1) the necessity of the banks (lender) to guarantee that they are receiving the right share of the profits, and 2) to the obligation of entrepreneurs (borrowers) to provide banks with accurate financial statements, being that, "*entrepreneurs in developing countries, including many of the countries where Islamic banking is prevalent, frequently falsify their financial records in order to evade taxes* (Leiss, 2007: 5)". This disincentive of IBs has its reflection of the clients' knowledge as evidence from Khattak & Rehman's (2010) study conducted in 2008 shows. The evidence shows that in 10 Pakistani banks, both full-fledged IBs and conventional banks IBs branches, despite the majority of the population being aware of the fundamental of IBs, they are, in fact, unaware of specific products, including the profit-and-loss arrangements, as depicted in **Table 11**.

The authors disagree when it comes to project selection. According to Al-Zoubi & Maghyereh (2007) the PLS system "*will provide the entrepreneur with funds only if the project has low level of risk since it shares the loss*" (Al-Zoubi & Maghyereh, 2007: 237), and while conventional banks may seek financing for lower quality projects, Islamic banks through PLS is able to reduce the overinvestment problem by more demanding selection criteria and by

Table 11 - Customer awareness level towards Islamic Banking						
Product	Not aware of it		Aware but do not use it		Aware and use it	
	Frequency	%	Frequency	%	Frequency	%
Current account	21	13.5	31	19.9	104	66.7
Time deposit A/C	29	18.6	37	23.7	90	57.7
Mudarabah	54	34.6	62	39.7	40	25.6
Musharakah	74	47.4	60	38.5	22	14.1
Ijara financing	68	43.6	58	37.2	30	19.2
Traveler's cheques	4	26.9	65	41.7	49	31.4
Overdraft	39	25	81	51.9	36	23.1
Letter of credit	49	31.4	73	46.8	34	21.8
Murabaha financing	71	45.5	73	46.8	34	21.8

Source: Khattak & Rehman (2010)

monitoring and even co-managing a project (in case of Musharaka). Leiss (2007), on the other hand, suggest that there is a first selection criteria are the entrepreneurs themselves. Conventional banks offer "cheaper money" than their Islamic counterparts, since they do not share as many risks. The author identifies the possibility of "*creditworthy entrepreneurs, then, may turn to conventional banks for capital, leaving Islamic banks a sub-prime pool of borrowers in whom to invest*" (Leiss, 2007: 6).

6.2 Sources of Fund

Mohammed (2007) defends that, in general, there are two main sources of funds, besides, of course, their own capital and equity, for Islamic banks to rely on – demand deposits and investment deposits. Demand deposits, includes current and saving accounts, are placed under Amanat (for safekeeping), have no return on the capital, are risk free and banks must apply a 100% reserve requirement. In contrast, investment deposits do carry the risk of capital loss (and because of that a zero reserve requirement), as they are used in risk-bearing ventures with knowledge and approval of the depositors.

6.2.1 Current Account

In addition to the Amanat, current accounts hold another importance principle, al-wadiah, which guarantees the full repayment of depositor's funds. As it was already mentioned, these accounts hold no return on the capital, since the capital will not be used by the bank to fund PLS ventures. In fact, the capital can only be used to face liquidity needs of the banks and for very short-term transactions on the bank's responsibility.

6.2.2. Savings Account

Savings accounts are also under the al-wadiah principle; however, it distinguishes itself from current deposits given that the depositors may earn a premium (hiba), paid by the bank at its own discretion and depending on the bank's results.

6.2.3 Investment Accounts and Special Investment Accounts

Unlike the deposits accounts already described, an investment account has a different underlying principle, Mudaraba al-mutlaqa, in which "*the Mudarib (active partner) must have absolute freedom in the management of the investment of the subscribed capital*" (Mohammed, 2007: 166). The most important characteristic, the risk of capital loss due to its use in risk-bearing activities, is not the only condition that differentiates investment form saving accounts. Investment accounts also require a higher minimum amount and a longer duration of deposits. The differences to the regular investment accounts are on the target clients and on the project selection. These dedicated accounts are oriented to larger wealth individuals and/or corporations; this is so because the investment to be made "*is related to a specific project, and the investor has the choice to invest directly in a preferred project carried out by the bank*." (Mohammed, 2007: 166).

6.3 Uses of Funds

To better understand the financial products and activities of IFIs, it is easier to breakdown into three categories: Financing activities, Investment activities, and others (**Figure 7**), providing some examples of possible products /services on each category.

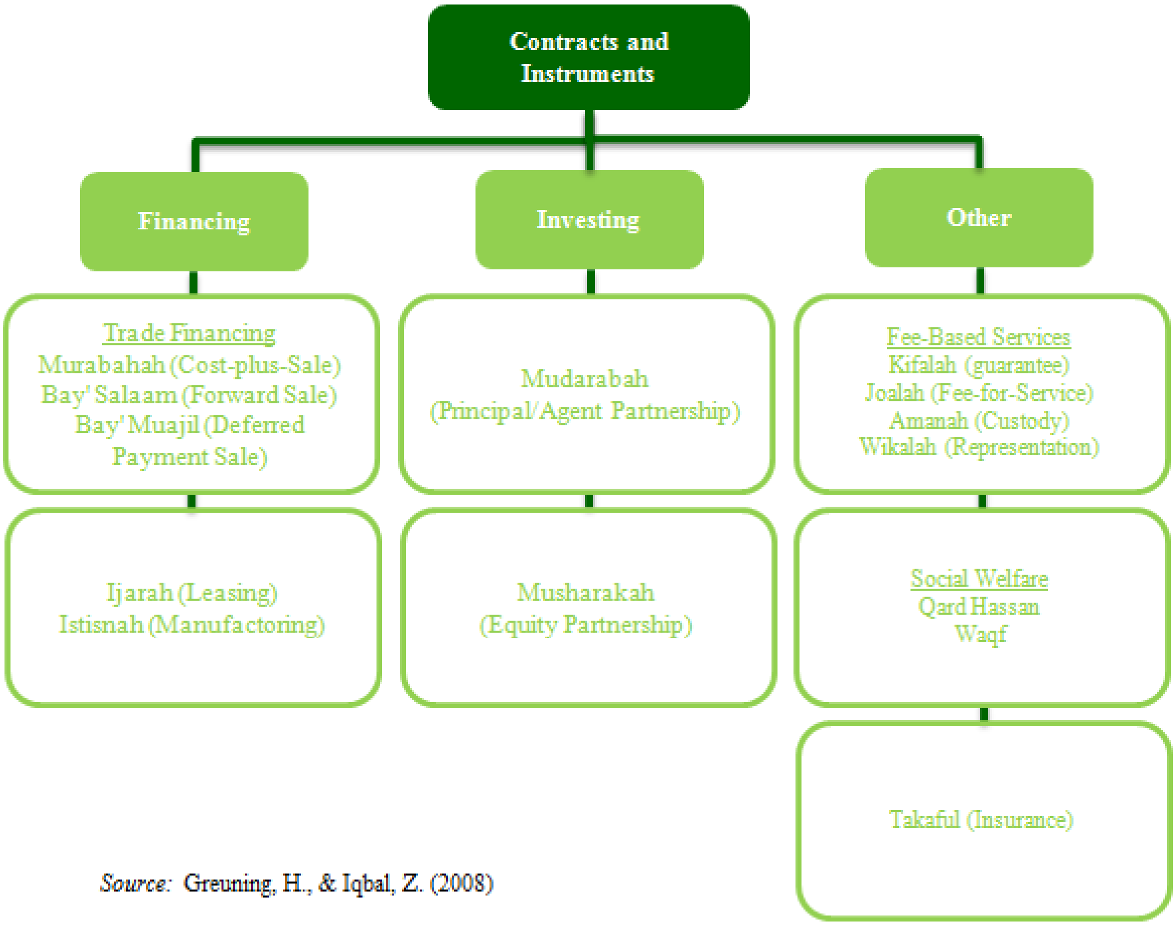
Table 12 - Repartition of IFI's and conventional institutions with Islamic financial services

	Islamic Banks	Financing and Investment Companies	Banks Islamic Windows	Takaful Companies	Insurance Islamic Windows	**Total**	**%**
Bahrain	27	5	10	10	0	**52**	**21%**
Saudi Arabia	6	21	8	28	2	**65**	**26%**
Kuwait	5	54	2	12	1	**74**	**30%**
Qatar	6	5	5	4	2	**22**	**9%**
UAE	8	10	7	10	0	**35**	**14%**
Total	**52**	**95**	**32**	**64**	**5**	**248**	-
%	**21%**	**38%**	**13%**	**26%**	**2%**	-	**100%**

Source: CIBAFI (2010)

Islamic banks have the knowledge and the resources to embrace all three activities. However, there is room and market for specialized firm to coexist with banks. As we can see in **Table 12**, in the GCC region in 2009, Islamic banks and the conventional banks' Islamic windows, represented 34% of the market, while dedicated investment and financing 38% and Takaful 28%.

Figure 7 - Contracts and Instruments



Source: Greuning, H., & Iqbal, Z. (2008)

World asset composition of IFIs, by 2008, was mainly divided between Financing (40.1%) and Investment (27.2%) activities. In 2008, Murabaha, clearly dominated representing 64.7% of all investment activities, while Ijara represented 13.8% and Mutajara 12.8%. Regarding Investment activities, 37.2% was applied in securities (sukuk), investment in companies (12.1%) and real estate/properties (6.1%). Overall, Murabaha is the primary choice of Islamic banks and Investment companies, representing a total of 25.9% (CIBAFI, 2009).

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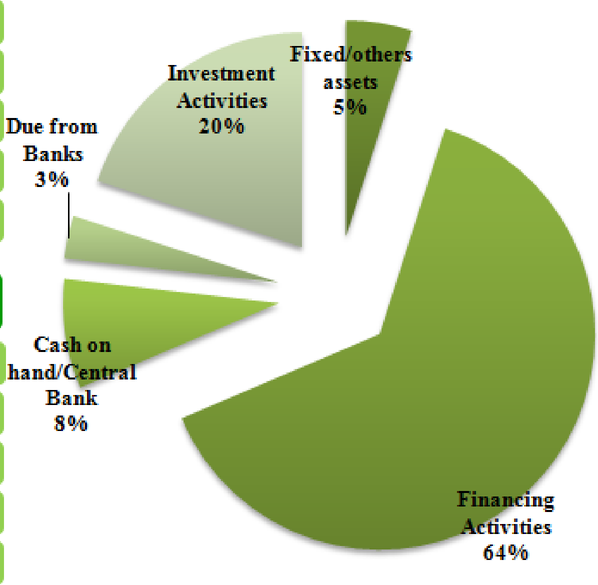
The GCC region asset composition, in 2009, is similar in form but not in size. Financial activities in the region (second larger in the world, only after Iran) are much more important (63.7%) than investment activities, that account for only 20%. It is also important to refer that the most notorious PLS arrangement, Mudarabah and Musharakah, represent 15.6% of overall investment activities (see graph below).

Graph 4 - IFI's Assets Composition

Financing Activities Composition	
Murabaha	57.6%
Istisna	3.2%
Ijara (Leasing)	18.4%
Mutajara	14.4%
Other receivables	6.4%
Salam	0.0%

Investment Activities Composition	
Musharaka	7.7%
Mudaraba	7.9%
Investments in companies	17.4%
Sukuk	28.1%
Restricted inv.	0.1%
Real estate/Properties	20.5%
Other	18.2%



Source: CIBAFI (2010)

It is important to reinforce that all financial activities undertaken by any IFI must be Shari'ah-compliant[18]. Any institution that offers Islamic products or services is required to have their own Shari'ah Supervisory Board (SSB), where a panel of scholars regularly meets to approve/vet investment decisions, new products and services (Siddiqi, 2006). Recently have been emerging Shari'ah advisory firms offering the same services as the SSBs. However, there have been critics among scholars regarding the independence, impartiality and conflicts of interests of these firms.

[18] Besides the financial products that will be discussed in further detail in the following sections, there are, naturally, other products. A list of basic products can be found on **Annex 8.**

6.4 Financing Activities

6.4.1 Murabaha (cost-plus finance)

Created in the 9th century, Murabaha is one of the oldest transaction methods in Islam, but even so, there is still some controversy surrounding it. In its essence, Murabaha is a resale contract where the bank purchases a good or an asset and then sells it immediately to his client adding a mark-up (profit margin), agreed by both parties. The payment is usually done through instalments and the pricing is determined by clients' credit-rates, transaction size and type of goods.

The controversy arises from the mark-up charged that is considered by some authors and scholars as a transaction that bears a fixed interest (which is illegal due to the riba prohibition). Leiss and Cobham are both critics of this type of financial product. David Cobham (Professor of Economics at Heriot-Watt University, Edinburgh), in a letter response to Jeremy Harding's article "The Money that Prays", states that "*Islamic banks focus on short-term lending of the murabaha (working capital loans) […] type, which Western economists and many Muslims immediately recognize as covert forms of fixed interest transaction*" (Harding, 2009). "*This mark-up is effectively an interest payment, and often corresponds to the prevalent interest rate [LIBOR or US treasury Bills rates]. However, by breaking down the sale into two transactions in which the good changes hands twice (once to the bank and once to the borrower), the sale is technically interest free*" (Leiss, 2007: 6 and 7). This type of transactions is considered legitimate if charges (mark-up and service charges) are for services provided and not for deferred payments. To quote a fatwa (opinion) by Shari'ah scholars "*Murabaha is conducted in the form of exchange, real goods for money. The specific feature of Murabaha, as compared to Riba-based loans, is that even if the mark-up amount is predetermined the seller's profit will be influenced by the market price of the relevant real good. Therefore, ant profits in Murabaha are expressed as a function of supply and demand in the real goods market rather than the monetary market*." (Nagaoka, 2009).

The justification for the service charges arises from the bank's acceptance of the risk of "*unforeseeable damage to goods from the time of purchasing and selling to the buyer*" (Siddiqi, 2006: 41). Understandably, banks keep this period as short as possible, being this type of arrangement a short-term option.

6.4.2 Ijara (Leasing) and Ijara Wa-Ikitina (hire purchase)

Ijara is a long-term leasing contract that differs from the conventional lease in that, the lessor (Islamic bank) owns , monitors the use of asset (haram-free activities), maintains and insure the physical good. The lessee (end-user) is to pay a fixed-rental for a certain period of time, with no buying option. Ijara Wa-Ikitina, is a bit more complex, but similar to the previous one. In this case, the financier acquires a physical good, an asset or an entire project with the exclusive purpose of renting it to clients. The agreed rental is, in this case, accompanied by fixed payments to an Islamic investment account (with the acceptance of the client, which will lead to the acquisition of the good from the lessor. The rent is also pre-agreed to avoid gahrar and the goods must be put to halal activities. In the mass market, this is the method use to purchase cars or home mortgage schemes (also called "diminishing musharakah").

6.4.3 Istisna (manufacturing)

This contract is a pre-delivery financing and leasing mode. It is an important source of large scale projects financing, since the bank funds the manufacture of plants, equipments, construction workers wages, etc. and then "*takes title upon completion and sells to a third party*" (Siddiqi, 2006: 42).

6.4.4 Bal' Salam (prepaid purchase)

This transaction is the complete opposite of Murabaha. In this case, the bank pays for the commodity first and receives it later in the future. It can only be used to products where quantity and quality can be predetermined and fully specified. Therefore this instrument is used, preferably, in agriculture or manufactured products. The rate of return does not depend on the time dimension, but rather on cash transaction.

6.4.5 Qard-Hassan (benevolent loan)

A zero-return loan made available for welfare and religious reasons. The Qu'ran instils Muslims to make it available for those who need it the most. The borrower is to repay the loan (the principal amount) over a specific span of time that is determined by the capability of the borrower to repay. To these loans is added a margin that represent the service/administrative charges, that is not to be determined either by the maturity or by the amount.

Chapter 7: Investment Activities

7.1 PLS Arrangements

Being PLS one of the most distinct characteristics of the whole Islamic banking, it is somehow surprising that these are not one the preferred investment methods (only 15.6% in the GCC region in 2009). While the reasons are not entirely clear, the results might suggest that Leiss (2007) opinion, discussed previously, might be the one closer to the reality.

7.1.1 Mudarabah (trust-financing) and Two Tiered-Mudarabah

Chong & Liu define this equity-based investment product the following way: "*Mudarabah contracts are profit-sharing agreements, in which a bank provides the entire capital needed to finance a project, and the customer provides the expertise, management and labour. The profits from the project are shared by both parties on a pre-agreed (fixed ratio) basis, but in the cases of losses, the total loss is borne by the bank*" (Chong & Liu, 2009: 129).

Consequently, the bank has the right to receive the principal loan capital at the end of the contract, but only if the entrepreneur's business present profits. If the books show a net loss, it will not be considered default, and "*until the investment yields a profit the bank is able to pay a salary to the entrepreneur based on the ruling market salary*" (Suleiman, 2009).However, in the case of losses are proven to be caused by mismanagement or negligence of the entrepreneur, these are to be assumed entirely by the entrepreneur. Additionally, Islamic banks can't require any guarantees on the investment (to insure the capital in case of losses), for instance securities or collateral, from the entrepreneur. There are a few other characteristics that make Mudarabah a unique instrument. First of all, it is necessary a good balance between the financier (sahib al-mal) and the entrepreneur (Mudarib). The bank (lender) has the right to determine the kind of activities, to ensure they are halal and profitable, where the capital can be used, the duration and the location of the projects and monitor the whole process (from set up to accountancy and book keeping). However, the bank cannot interfere in the management of the investment, nor can the conditions afore mentioned be devised to harm the performance of the entrepreneur. Two-tier Mudarabah is an expansion of the original concept to include a third party, the investors as financiers. When this instrument is used, the funds will be provided by a pool of investors (investment accounts, government, waqf[19], etc.), the bank will act as Mudarib (on the savings side) and as sahib al-mal (on the investment portfolio side), and the final entrepreneur. "*Islamic fund management is based on the concept of "two-tier Mudarabah", whereby the bank mobilizes investors' savings into mutual funds, managed by portfolio management. Most operate as either close or open-ended funds, with tradable units*." (Siddiqi, 2006: 42)

7.1.3 Musharakah (participatory financing)

The Musharakah principle is present in the equity structure of Islamic banks and it is, in fact, quite similar to what can be found in convention banks as joint stock ownership. Unlike Mudarabah, where the bank is the sole financier, in Musharakah the bank and the entrepreneur provide working capital for a joint venture project. The proportion of capital contribution of each partner, determines the ratio on which losses are to be distributed. The profits, however, are to be distributed on a predetermined ratio. When it comes to managing the venture, more often, the entrepreneur assumes that responsibility. However, both parties have the right, but not the obligation, to manage or exercise executive power in the venture. Moreover certain structural decisions that may affect the business structure can be subject to bank's consent. Even if the PLS arrangements are not the primary instrument choice in Islamic banking, due to the high costs that are usually associated with them, there is an acknowledgment among authors that these two products represent what the purpose of Islamic Banking creation. "*Mudarabah and Musharakah constitute, at least in principle if not always in practice, the twin pillars of Islamic Banking. The two methods conform fully to Islamic principles, in that under both arrangements lenders share in the profits and losses of the enterprises for which funds are provided and shirkah (partnership) is involved*". (Mohammed, 2007: 164)

7.2 Sukuk (Islamic securities)

The sukuk is sometimes defined as Islamic bonds or Islamic tradable bonds, but in fact, its concept is closer to securities than bonds. **"***Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed income, interest bearing bonds are not permissible in Islam, hence Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Sukuk is*

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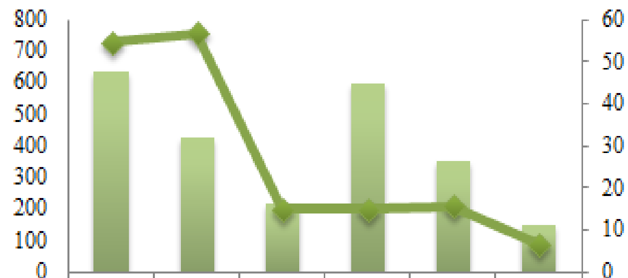
[19] Waqf refers to "the gift of money, property or other items to charity. Today, Islamic Relief organizes Waqf to cater for long-term projects. Donations are pooled and invested according to the principles of Islamic Shari'ah, and the income is then used to help the poor. The Waqf is comparable to Western concepts of charitable trusts or endowments" (Islamic Relief).

a certificate of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or investment activity" (Ernst&Young). Sukuk grant investors a share of an asset along with profit and risks resulting from such ownership. It carries maturity dates, coupons, yields and can be structured using various modes ("virtually undistinguishable from a non-Islamic bond" as defined by the IMF). Although AAOIFI provides for 14 eligible classes, only 7 are being used: ijara, musharakah, mudarabah, murabahah, salam (trade-based instrument) and manfa'a (usufruct rights). Moreover, at least 51% of the assets must be leased-back as tangible assets, not debt instruments.

Graph 5- Sukuk Issuances (2005-2010)



	2010	2009	2008	2007	2006	2005
Amount $US bn	47,78	31,92	16,23	44,76	26,14	11,2
No. Of sukuk	730	758	199	198	208	87

Source: Islamic Finance Information Service (2010)

Sukuk market is growing at a staggering pace. As it can be seen from **Graph 5**, from 2005 to 2010, the sukuk global market grew $US 36,58bn to $US 47,78bn and the issue count increased by 643 issuances to 730[20]. In the first half of 2010 the undisputed leader in the sukuk market was Malaysia, 60.5%, followed by Indonesia and Saudi Arabia, 14.1% (IFIS, 2010). In Europe, the first issue of sukuk was of $US 10m, in 2010, by International Innovative Technologies, a maker of industrial milling machines from the United Kingdom. Albeit, the impressive growth, there has been criticism and intervention was necessary on the sukuk market by the AAOIFI[21]. After the 2007 sukuk boom, Sheikh Muhammad Taqi Usmani, chairman of the AAOIFI board of scholars, stated that around 85% of sukuk violated the risk-and-profit sharing (Reuters, 2007). Sukuk were being issued with a repurchase undertaking, which is no more than a promise that the borrower will pay back the face value at maturity. This promise is illegal under Shari'ah, because risk is not shared and reward is not shared according to the actual profit-sharing venture proceeds. The sukuk market has reformed itself to become

[20] The 2007 value were sparked by a boom in Dubai's sukuk emissions (tightly linked with appreciation in real estate's value). In that year alone, Dubai issued almost 70% of all sukuk emissions in the GCC region, surpassing for the first time Malaysia, until then the undisputed market leader.
[21] See **Annex 9** for full detail of AAOIFI's sukuk standards

Shari'ah compliant, and that resulted in a shift from a debt-based instrument to an equity-based.

7.3 Takaful (Islamic Insurance)

Takaful, or Islamic insurance, is in fact the Islamic counterpart of conventional cooperative insurances, where participants contribute to a fund together to insure one another. This industry was created to satisfy the need to have a Shari'ah compliant insurance mechanism. Mutual Guarantee is the basis of Takaful, where members contribute with money into a pooling system in order to guarantee each other against loss or damage. Thus, policyholders are both insurers and insured. The underlying principles of Takaful are: "*1) Policyholders co-operate among themselves for their common good; 2) Every policyholder pays a part of the contribution as a donation to help those that need assistance; 3) Losses are divided and liabilities spread according to the community pooling system; 4) Uncertainty is eliminated in respect of subscription and compensation; 5) It does not seek to derive advantage at the cost of others*". (Institute of Islamic Banking and Insurance). Following these precepts, Takaful companies offer a product range that comprises life, health and general insurances, as well as, pension funds.

Chapter 8: Findings

8.1. "Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports"

This study was conducted by Roszaini Haniffa and Mohammed Hudaib (both scholars in Bradford University School of Management, UK) and was published in the Journal of Business Ethics in its November edition of 2007.

The premise for the study is that Islamic banks have "ethical identity". According to the authors the Islamic banks are inserted in a new wave of corporations that place social goals in the same level of importance (if not above) as profit-making. Additionally, Islamic banks have their ethical identity improved due to their foundation being so closely knit with religion. The purpose of this study was to find out if there were discrepancies between the communicated (via Annual report) and the ideal (based on the Islamic ethical business framework) ethical identities of Islamic banks and to measure it using what they called an Ethical Identity Index (EII). They used a period of three years, from 2002 to 2004 where the authors computed a mean average of seven Islamic Banks under 8 categories.

The paper starts by identifying the current status quo of the Islamic Banking system. The Islamic Banking has been receiving increased attention due to the impressive growth it has registered, especially since the 1970's and due to "*the increasing concern regarding the relationship between religion and economic activities among Muslims* (Haniffa & Hudaib, 2007: 99)". The authors argue that the growing acceptance of Islamic bank is still surrounded with controversy regarding the "purity" of their financial products and the "sincerity" of the managers running the banks. According to the authors IBs are seen as too complacent, since they do believe that they have a natural and solid market in the Muslim communities that will recur to these banks on religious grounds alone, while losing important potential non-Muslims clients, interested in investing in these banks due to the banks' ethical facet. IBs have also been criticized for being overly anxious to "*tap funds from the Muslim masses that they opt for pragmatism over purity in the products offered* (Haniffa & Hudaib, 2007:99)", thus jeopardizing the confidence of the Muslims clients. Succinctly, IBs as value-oriented corporations need, according to the authors, to evaluate the corporate identity and corporate branding processes, since their current status is deemed as controversial.

Following this introduction, the authors discuss what they consider to be the benchmark of ideal ethical identity. They identified five distinct features that distinguish IBs from conventional banks (competitors): "*a) underlying philosophy and values; (b) provision of interest-free products and services; (c) restriction to "Islamically" acceptable deals; (d) focus on developmental and social goals; and (e) subjection to additional reviews by the Shari'ah Supervisory Board (SSB)*. (Haniffa & Hudaib, 2007: 99)". Thus IBs must exhibit all of these five features, derived from Shari'ah and business ethics, in their activities. They do, indeed, compose the ideal ethical identity mentioned previously. The authors describe in detail each of the five features identifying what are the most relevant components and expectations of bank's disclosure. To compare and find out if there were any disparities between the ideal and the communicated ethical identities, the authors expressed the results in an index that they called "Ethical Identity Index" (EII) as:

$$EIIj = \frac{\sum_{t=1}^{n_j} X_{ij}}{n_j}$$

Each bank was then ranked according to its EII, where the higher the EII the less difference (or variation) exists between the communicated and the ideal ethical identities. The authors defend that “*a high EII suggests that the corporation has adopted a communication strategy that fits its religious ethical identity while a low EII suggests the need to improve its communication strategy to enhance its ethical image and reputation and to gain competitive advantage* (Haniffa & Hudaib, 2007: 104)”.

Analysis and discussion of results

The results are expressed in **Annex 10** and the overall EII ranking of the seven IBs is present in the bottom three rows, for each of the three-years and the three year mean. The authors proceeded to explain the mains findings and driving forces behind each category.

1. **Vision and mission statement** – DIB was the lowest score in this category, not reporting any information in 2002 and 2003 but doing so in 2004. The authors argue that one possible explanation for this was a desire to increase its competitiveness. They also found that BIB expressed the same desire. IBs tend to emphasize that they operate in Shari’ah compliant environment. However, ARB and DIB did not, and authors suggest that they are sending two signals: the management knows that the bank’s operations are not entirely Shari’ah compliant or that management did not foresee the need to do so due to the reputation and years in activity (ARB and DIB were created in 1975 and 1987, respectively).
2. **BoD’s and top management** – The authors find the inconsistencies through the 3 year period to be puzzling since they can’t find an explanation to the anomaly. As can be deduced by the results, none of the banks communicate in great detail the expected information.
3. **Product and services** – Authors consider that banks need to be transparent and give complete information regarding their services and products. KHF experienced an increase from 2003 to 2004 that can be justified by the close monitoring by the Kuwait central bank. KHF in 2002 disclosed that its financing activities contained a combination of conventional and Islamic financing, raising questions on the claim to be Shari-ah compliant. In the same note, only two banks stated clearly no involvement haram activities.
4. **Zakat, charity and benevolent loans –** In Saudi Arabia, Kuwait and UAE the responsibility to pay the zakat is shareholders’ rather than the IBs. ARB seems to consider zakat a burden rather than a duty to fulfil a pillar of Islam faith. Only BIB and DIB has reports from the SSB confirming that the payment of zakat was according

the Islam principles. Regarding qard-hassan, four IBs reports the source and uses of such funds, but according to the authors some of the applications are questionable.

5. **Commitment toward employees** – Four IBs declared to provide training for their staff to increase their knowledge on Shari'ah related topics. Only ARB, in 2002, communicated to have provided to their employees medical benefits.
6. **Commitment toward debtors** – ADIB, ABB, ARB and SIB did not disclose the amount of debt written off. ADIB and SIB did not disclose any information concerning their debt policy while ARB was the only IB that did not disclose the type of lending activities.
7. **Commitment toward community and society** – "*Despite corporate social responsibility forming an integral part of Islamic business ethics, it is surprising to find IBs not communicating much on this important aspect in their corporate annual reports* (Haniffa & Hudaib, 2007: 109)". The low results on the EII for each bank represents exactly this and is indeed the dimension were the discrepancy is higher. Authors recognize that in a region where gender segregation is common, three IBs had a dedicated woman branch. Also four banks disclosed information on donations for such things as marriages, refurbishments, community development programmes, etc.
8. **Shari'ah Supervisory Board (SSB)** – The driving force behind the relatively good disclosure - ranked 2nd - of SSB information (except in the case of ARB) is the adoption of AAOIFI's ruling in Bahrain. All IBs, except ARB, disclosed the names of the SSB members, while only BIB the remuneration.

Summary and concluding remarks

The survey showed that the highest ranked bank was Bahrain Islamic Bank (BIB) with the three year mean EII was 0.65 while the lowest was Al-Rajhi Bank (ARB) with 0.16. This result shows that in the case of BIB 65% of the ideal ethical identity was met while in the case of ARB only 16%. The remaining five banks' results were under the range of 0.28 and 0.48 "*suggesting that a large disparity between the communicated and ideal ethical identities* (Haniffa & Hudaib, 2007: 111)". The authors also found that across the three year period, the index of each bank varied, suggesting that the communication is not fixed and often minimal. A possible reason for this may be attributed to the lack of pressure/indifference from stakeholders and also the prevailing secretive culture of the region (Haniffa & Hudaib, 2007). The study also showed that largest incongruence is on the social commitment (18%), followed by the vision & mission statement (35%), and BoD and top management and Zakat, charity &

benevolent loans (39%). The authors consider the results a surprise because "*IBs, as social and economic institutions, are expected to communicate more on those dimensions to reflect accountability and justice not only to society, but also ultimately to God* (Haniffa & Hudaib, 2007: 111)".

The authors suggest that managers "*may need to reflect on their communication management strategy as well as their image and reputation, not only from an ethical point of view but more importantly, from the perspective of religion (…) and need to communicate more effectively and avoid ambiguous styles of communication, as these have important religious implications as well as implications for corporate image and reputation* (Haniffa & Hudaib, 2007 :111)".

8.2 "Stakeholders' Perception of Corporate Social of Islamic Banks: Evidence from Malaysian Economy"

Developed by Asyraf Dusuki, who was at the time, lecturer in the International Islamic University of Malaysia, and Humayon Dar, Vice President, at the time of publication, of the Dar Al Istithmar Institute, UK this paper is divided in two parts: Review of CSR and the study the opinion of different stakeholder groups about CSR of IBs in Malaysia.

The first part is quite in line with what was already written in this thesis, but it adds a review of the patronage studies already made in the field of Islamic Banking. The studies selected by the authors are largely focused in a combination of factors such as, religion, reputation, commercial, staff, convenience, etc.. Much of the published literature exhort the differentiation factors of Islamic Banking system to be closely tied to its religious grounds, particularly those concerning the ethical and social norms, but there seems to be a small number of studies focusing in CSR alone.

Purpose of the study

As portrayed in **Annex 11**, there is no direct CSR factor and this is the reason why the authors developed such study. "*The main purpose of the study is to poll the opinion of different stakeholder groups of Islamic banks in Malaysia regarding CSR of Islamic banks. In particular, the study sets out to provide answers whether CSR criteria constitute part of the patronage factors influencing selection decision by the stakeholders of Islamic banks* (Dusuki & Dar, 2005: 399)".

Factor Analysis: Support for CSR across Stakeholder Groups

“*Scholars have demonstrated that people identify themselves with organisations when they perceive an overlap between organisational attributes and their personal attributes. As stakeholders perceive that key organisational features are in harmony with their self-identity, they are likely to patronise the organization* (Dusuki & Dar, 2005: 403)”. With this in mind, authors assumed that stakeholders of IBs share the same norms, beliefs and values, so they expected that the practice of CSR would have a positive impact on the organization. The authors argue that since Shar’ah principles support stakeholder’s norms, the behavioural expectations should be shared with the majority of IBs stakeholders, especially the Muslims. Subsequently a variety of stakeholder groups should endorse and even expect CSR practices of IBs.

As a result the authors elaborated the following null hypothesis:

Ho: Stakeholders in Malaysia apply equal importance to the CSR factors along with other banking selection criteria when making a judgement about patronising Islamic banks. (Dusuki & Dar, 2005: 403)

“*To test this hypothesis, an exploratory factor analysis was conducted. Factor analysis with separate varimax rotation was run on twelve variables representing various attributes of banking selection criteria* (Dusuki & Dar, 2005: 403)”. In **Annex 12** are identified the twelve variables, which have been used extensively in published literature, that are used in this study to better depict the stakeholder perception of CSR in Malaysian IB system. The authors used the aforementioned variable for two purposes: to determine if CSR constitutes relevant criteria in bank selection and to discover which of the factors constitute the strongest motivation.

“*Factor analysis was conducted using principal component analysis (PCA) and varimax rotation with Kaiser Normalisation. The resulting varimax rotated factors are given in Table 5 along with communality values of each variable; eigenvalues and percentage of explained variance*” (Dusuki & Dar, 2005: 403).

The results in **Table 13** we can see that the 12 factors could in fact be clustered into three categories, that explain 57.73% of the variance, meaning that explains 57.73% of the selection criteria of Islamic banks by stakeholders. Of the twelve factors, six of them are inputs in the “Reputation/service delivery” criteria, while the other two – CSR of Islamic Banks and Convenience/product price – have three each. The first criteria exhibit a cluster of relationships between these factors: " '*knowledgeable and competent personnel*'(**X_6**), '*Islamic reputation and image*'(**X_{10}**), '*friendly personnel*'(**X_5**), '*Islamic working environment*'(**X_7**), '*service quality (fast and efficient service)*' (**X_2**) and '*economic and financial reputation*'(**X_8**), (Dusuki & Dar, 2005)". The Reputation/service delivery criteria explains around 27% of the reasons for selecting Islamic banks (and is the most important criteria because it presents the highest variance and eigenvalue), while CSR of Islamic Banks and Convenience/service delivery explain around 18% and 13% of the reasons, respectively.

Table 13 - Rotated Component Matrix[a] on Banking Selection Criteria

Variable	Factor 1 Reputation / service delivery	Factor 2 CSR of Islamic bank	Factor 3 Convenience / product price	Communality of Each variable
X_6	**.766**			.633
X_{10}	**.742**			.642
X_5	**.670**			.579
X_7	**.655**			.545
X_8	**.624**			.511
X_2	**.616**		.434	.571
X_{12}		**.790**		.649
X_{11}		**.715**		.583
X_9	.416	**.631**		.589
X_4			**.721**	.646
X_1			**.586**	.432
X_3			**.571**	.548
Eigenvalue	3.191	2.148	1.589	
% of Variance	26.590	17.897	13.245	
Cumulative %	26.590	44.487	57.732	

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser

[a] Rotation converged in 6 iterations

Source: Dusuki & Dar (2005)

The authors conclude that the main reason behind selection of IBs is a combination of Islamic and financial reputation and the quality of the service provided by the bank to clients. This finding is consistent with other patronage studies identified in **Annex 11**[22]. Dusuki & Dar also found interesting the impact of CSR factors in the overall choice criteria. In fact, it explains about 18% of stakeholders' decision-making process and if combined with the Reputation/service delivery explains almost 45% of banking selection criteria. Accordingly,

[22] Erol and El-Bdour (1989), Erol, Kaynak et al. (1990), Haron, Ahmad et al. (1994), Gerrard and Cunningham (1997) and Abbas, Hamid et al. (2003).

the authors suggest that IBs should promote CSR practices and also consider CSR as a strategic instrument to market the organisation to every stakeholder. The third and final selection criteria of this study, Convenience/product price, is the least important of the three explaining about 13% of the reason why stakeholder's choose between Islamic Banks. This result is, nonetheless, interesting since it goes against what some patronage studies (**Annex 11**) indicate[23]. Overall, the study shows that the null hypothesis can be rejected, since it was demonstrated that do not apply equal importance to CSR factor when choosing a bank. However, the study also shows that it was indeed one of the most important factors when it comes to stakeholder patronizing a bank. The authors expected that the proportion of stakeholders influenced by the CSR factor. This was indeed true as it was confirmed by the information on **Table 14**, where the high percentage in "important" and "very important" degrees of influence accumulated: 93.7% in X_9, 90.2% in X_{11} and 82.9% in X_{12}.

Table 14 - Frequency Distribution: Factor 2 Variables - Degree of influence on Stakeholders' Judgement on Islamic Bank

Degree of influence	Value	Environmental practise (X_{12}) (%)	Involvement in community (X_{11}) (%)	Respect for human rights (X_9) (%)
Not important at all	1	.7	.3	.3
Not important	2	8.4	4.8	2.2
Cumulative %		9.1	5.1	2.4
Important	4	58.3	56.6	53.0
Very important	5	24.6	33.6	40.7
Cumulative %		82.9	90.2	93.7
Neutral	3	8.0	4.7	3.9
Mean Value		3.9789	4.1823	4.3164
Median Value		4	4	4
Mode Value		4	4	4

Source: Dusuki & Dar (2005)

Kruskall-Wallis Test: Comparing Stakeholder Groups' Perceptions

The authors proceed with the study, but the focus now shifted to better comprehend if "*there is any significant difference in the perception of multiple stakeholder groups towards CSR as one of the banking selection criteria for Islamic banks* (Dusuki & Dar, 2005: 407)". The null hypothesis for the Kruskall-Wallis ensues:

[23] "Almossawi (2001) and Gerrard and Cunningham (2001) found that convenience factors were of paramount importance in banking selection criteria compared to other factors based on their survey conducted on conventional banking customers in Bahrain and Singapore respectively (Dusuki & Dar, 2005)".

Ho: There is no significant difference in the various stakeholder groups' opinions when considering CSR as an important patronage criterion of Islamic banks. (Dusuki & Dar, 2005: 407)

Table 15 - K-W Test Results Comparing the Mean Ranks of Banking Selection Criteria variable amongst the Stakeholder groups

Variable	Subgroup	N	Mean Rank	χ^2	Asymp. Sig. (p)
			K-W Test:		
Reputation and Service Delivery Factor (V_1)	Employees	328	756.25	χ^2 = 19.183	0.004
	Customers	349	727.21		
	Managers	96	723.01		
	Depositors	352	722.26		
	Local Communities	266	645.81		
	Shari'ah Advisors	9	605.06		
	Regulators	24	495.02		
			K-W Test:		
CSR Factor (V_2)	Depositors	363	817.23	χ^2 = 61.322	0.000
	Customers	358	786.71		
	Local Communities	271	701.42		
	Employees	330	656.29		
	Shari'ah Advisors	9	611.39		
	Managers	98	562.68		
	Regulators	25	487.30		
			K-W Test:		
Convenience and Product Price Factor (V_3)	Employees	323	771.91	χ^2 = 10.439	0.107
	Customers	347	723.20		
	Shari'ah Advisors	10	719.70		
	Depositors	360	697.33		
	Managers	99	696.40		
	Local Communities	268	683.28		
	Regulators	25	618.10		

Source: Dusuki & Dar (2005)

The authors identified that were strong disagreement among stakeholder in the first two variables, as justified by the values of the observed significance level – which is below than 0.05 confidence level - but not so much in the third (higher than the confidence level). In addition to the significance level, the chi-square value also shows the same result, in the first two variables (V_1 and V_2) the χ^2 is above the tabulated value ($\chi2$ = 12.59) for a 0.05 confidence interval and, once again, the third variable is below that value.

The conclusion is to reject the null hypothesis, since the findings clearly show that the various stakeholder groups award different importance to the 'CSR of Islamic Banks' variable and to 'reputation and service delivery' when choosing an IB based on the selection criteria.

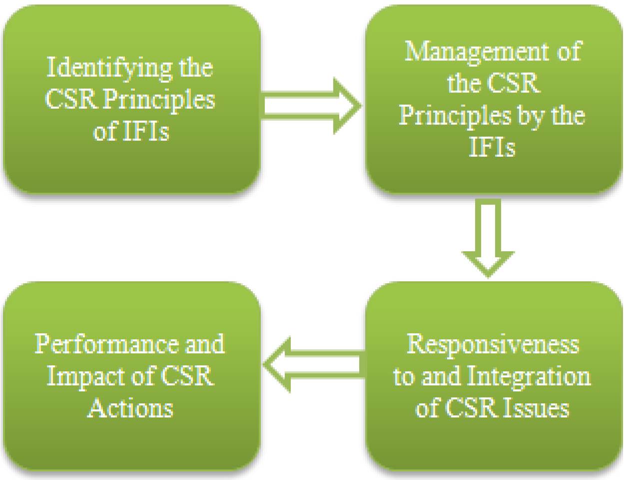
The results of the CSR factor is indeed quite interesting, as it show that the highest mean rank is depositors (817.23), followed by customers (786.71) and the lowest is the regulator (Bank Negara) with 487.30. Two possible explanations for the low score of regulators is offered by the authors: "*Firstly, even though the commitment towards social responsibility is encouraged, there is no specific requirement by law or any official guideline or standards made available by the Central Bank (Bank Negara), especially for the regulators in overseeing CSR practices of Islamic banking operation. Secondly, it can be deduced from the results presented in [**Table 15]**, regulators are more concerned with the commercial aspects of Islamic banks particularly on the latter's ability and viability to compete and sustain in the dual banking system*. (Dusuki & Dar, 2005: 409)". The authors do not find this a surprise, since Malaysia operates in a dual-banking system, and argue that is not that the regulator is not concern with CSR but is may be much more interested in ensuring the competitiveness of IBs than in monitoring and forcing CSR practices.

The authors, as a final remark, conclude that CSR is not a foreign topic in Islamic Banking, and it resides in the very foundation of the Shari'ah law applied in the banks. Not only banks, but the stakeholder as well are aware and have positive views of CSR. In fact, CSR was revealed as one of the most important stakeholders' selection criteria of banks. Despite the structural and fundamental differences between both banking systems, Islamic and conventional, CSR is a common theme and concern for banks. The authors argue that CSR should be embedded in IBs due to the Shari'ah breadth in society. Therefore "*Islamic banking should endeavour to be the epicentre in the financial galaxy of promoting good CSR practises. In this respect, an assimilation of CSR and other Islamic ideals in fulfilling stakeholders' expectations deserve utmost consideration as it represents a fundamental difference between Islamic and conventional banking, and has the potential to propel Islamic banking to greater heights in securing stakeholders' recognition and acceptance* (Dusuki & Dar, 2005:410)".

8.3 "Evaluating the 'Social Responsibility' of Islamic Finance: Learning from the Experiences of Socially Responsible Investment Funds"

The author of this study is Beebee Salma Sairally, who as at the time a PhD candidate in the Loughborough University, UK. This publication was submitted in partial fulfilment of the requirements for the award of Doctor of Philosophy of Loughborough University and was made public in 2006. The author identifies that the motivation for this study was the problem generated by the apparent divergence of Islamic Finance in practice and the initial purpose of enhancing the overall human wellbeing. To address this problem the author attempted to determine how 'social responsible' are IFIs in their practice, but first, the author reviews four topics (already discussed in this thesis): CSR, CSP, IFIs and SRI. The author used Wood's model to measure CSP as basis to assess the CSR of IFIs, and so the results of the study are presented in the following order, as depicted in **Figure 8**.

Figure 8 - Model of CSP measurement



Source: Sairally (2006)

Stage 1: Identifying the CSR Principles Endorsed by IFIs

The author defined the following questions as key to comprehend the CSR issues endorsed by IFIs: "*1) What do financial practitioners understand by the terms 'corporate social responsibility' or 'to be socially responsible'?; 2) How do financial practitioners define Islamic finance? Is their view of Islamic finance comprehensive enough to cover CSR issues which impact on the community and the environment?; 3) Do financial practitioners assign a social responsibility function to financial institutions?; 4) Do they believe that IFIs should emulate the objectives of western SRI funds?; 5) What CSR issues are stipulated to be the concern of the IFI?* (Sairally, 2006: 429)". The results are expressed in **Table 16**, where it's possible to comprehend that the 41.7% of respondents related social responsibility with "pro community", using key words, such as, "responsive to social need" or "social obligation to the public and themselves". The second largest group, 27.8%, associated it with "social justice" against financial exploitation.

Table 16- Key words to describe social responsability		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Ethical	5	10,4%	13,9%	13,9%
	Pro Community	15	31,3%	41,7%	55,6%
	Divine based or Shariah compliant	2	4,2%	5,6%	61,1%
	Not only profit geared	1	2,1%	2,8%	63,9%
	Social justice	10	20,8%	27,8%	91,7%
	Not socially irresponsible	1	2,1%	2,8%	94,4%
	Sustainable development	2	4,2%	5,6%	100,0%
	Total	**36**	**75,0%**	**100,0%**	
Missing	System	12	25,0%		
Total		48	100,0%		

Source: Sairally (2006)

On top of these results, 70.8% of the respondent that defined Islamic Finance (**table 17**) equalled it to all the possible options: "prohibition of *riba*, trade without interest, a socially acceptable just financial system, and a human-oriented environmentally-friendly financial system". However, the respondents from the UK (62.5%) and Turkey (80%) had a more restrictive view and considered mainly two topics "trading without interest" and "a socially acceptable just financial system". The authors find this not surprising due to the characteristics of these markets, which follow mainly trade financing activities. Using a cross tabulation the author queried "*whether they [practitioners] would attribute a socio-economic purpose, in addition to financial and legal responsibilities, to IFIs* (Sairally, 2006: 433)". The study showed that 80.9% of practitioners agreed/strongly agreed to the above statement.

Table 17 - What Islamic finance is Equal to?		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Only Prohibition of Riba	1	2,1%	2,1%	2,1%
	Trade without interest	6	12,5%	12,5%	14,6%
	Socially acceptable just Financial System	5	10,4%	10,4%	25,0%
	Human oriented, environmental friendly financial system	2	4,2%	4,2%	29,2%
	All the above	34	70,8%	70,8%	100,0%
	Total	**48**	**100,0%**	**100,0%**	

Source: Sairally (2006)

The author proceeds the study with the evaluation of the Screening Criteria for Investments used in IFIs. The most relevant results was the confirmation that the common "*attitude of Muslims to primarily define Islam, and by extension Islamic finance, with what 'we should not* *do' as compared to being positive and proactive* (Sairally, 2006: 434)". This is coincidental to the beginning of SRI, which focused on negative screening, rather than in the positive screening criteria. Sairally argues that this might be a reflection of the state that Islamic Finance is which seem to be supported by 55.3% of positive answers to "Investing in companies that contribute positively to society" screening criteria. The results concerning environmental practices are not the brightest despite the prohibition of exploitations and waste of natural resources prescribed in Shari'ah. "*About 52.6% would not be concerned about investments in environmentally polluting economic activities and about 60.5% would not take initiatives for investing in environmentally friendly activities* (Sairally, 2006: 434)".

Stage 2: Assessing the Management of CSR Issues by IFIs

Based on the above result that IFIs are to have a social responsibility function (80.9%), the author queried whether there were any conflicts between profitability and the social objectives of the institution. The results show that 63.8% said they were equally important, and of these 82.7% considered that an IFI should be socially oriented. About 27.7% viewed financial gains as more important (and paradoxically, 77% of these respondents agreed that IFIs should more social oriented), 6.4% as less and 2.1% not important at all. The author concluded that there is indeed a conflict and the author questioned if respondents preferred "*that 'social organizations' rather than 'financial institutions' be made responsible for undertaking morally-motivated economic and financial activities which have a socio-economic purpose* (Sairally, 2006: 435)". The results showed that 48% agreed/strongly agreed to the statement, while 20% remained neutral and 32% strongly disagreed.

"*With a view to further evaluate how IFIs manage CSR issues the question "whether financial practitioners believe that acting in a socially responsible manner can create value for their organization" was posed. 29.8% strongly agreed and 66.0% agreed. (...)In the light of this highly positive belief that there is a business case for CSR, the results were cross-tabulated with the earlier question "should IFIs adopt the SEE objectives of SRI funds". It was noticed that 65.1% approved that IFIs should assume such objectives. Still the results show that a significant 25.5% was neutral to this question. This could imply that a number of financial practitioners do not perceive a link between SRI funds and IFIs and therefore would not suggest the sharing of objectives by the institutions* (Sairally, 2006: 435)".

Stage 3: Evaluating IFIs' Corporate Responsiveness to CSR Issues

The author started this point by querying if the practitioners considered their IFIs social responsible and 78.3% agreed/strongly agreed while only 6.5% disagreed. Even though most of them deemed that the IFIs where they worked was social responsible, the author investigated what was the predisposition to be social responsible. The results show that 30.6% of the respondents found their IFI to be accommodative towards CSR, i.e. meeting their economic, legal and ethical responsibilities; while 41.7% was classified as defensive, only meeting their economic and legal responsibilities. Still, 27.8% observed that their IFI was proactive towards CSR, "*highlighting their roles in uplifting socio-economic development and fulfilling the needs of low-income communities* (Sairally, 2006: 437)".

Stage 4: Measuring the Outcomes of CSR Actions for IFIs

The aim was this part of the study was to assess what percentage of the profits was spent in CSR activities and what kind of activities would IFIs be involved in.

The first part of the study can be seen in **Table 18**, where 44.2% stated that their IFIs spent between 0-2% of the annual profits on community enhancing projects, 33.3% spent between 2-5%, 11.1% spend 5-7% and 8.3% on the 7-10% range. Regarding the ranking of activities in which IFIs would get involved, the top 5 is composed by: 1) Staff welfare; 2) donations to charities; 3) Abstaining from false advertising; 4) Promoting ethical values among staff and 5) Donations to community causes. Once again the concerns with environment rank low, and from the total of 20 types of activities, it ranks 17th (taking initiatives to protect the environment) and 20th (Lobbying for a particular social, ethical or environmental cause).

Table 18 - Percentage of profits spent on community enhancing activities * Whether IFI is socially responsible? Crosstabulation

Count		Whether IFI is soccially responsable?				Total
		Strongly agree	Agree	Neutral	Disagree	
Percentage of profits spent on community enhancing activities	0-2%	6	7	3	1	**17**
	2-5%	1	9	2		**12**
	5-7%		3	1		**4**
	7-10%	1	2			**3**
Total		**8**	**21**	**6**	**1**	**36**

Source: Sairally (2006)

Comparing the Theory and Practice of Islamic Banking and Finance and Conclusions

"*To reiterate, the aim of the study was to assess the internalization of socially responsible practices by IFIs based on the contention of academicians that the social commitment emphasised by the Islamic economics literature is being neglected within the practice of*

Islamic finance which appears to focus more on the efficiency/profit aspects and less on equity/social aspects (Sairally, 2006: 438)". Based on this the author compares IFIs with SRI funds and draws conclusions about the findings.

According to the data, there is a contradiction with the premise, since the practitioners do indeed place great emphasis on the social responsible facet of their IFIs, which is consistent to the Islamic economics literature. Theoretically, the majority of practitioners believes and considered important the social aspect of IFIs. Indeed most respondents place equal importance to the social and profitability goals and, in fact, considered that acting in a social responsible way was strongly perceived as creating value for IFIs. However, despite this consideration and after analyzing the results of the survey, the evidence suggests that this idea is not consistent with the actual practice. Actually, a number of respondents saw the profitability and social concerns as conflictive and preferred social organizations to undertake morally motivated economic and financial activities.

From a screening criteria point of view, the information disclosed by IFIs was focused in negative criteria while SRI's were based on positive. This resulted in ethical concerns, such as sustainability and environment, to be of little concern to IFIs. The report also shown that there was little commitment to ethical employment policies and community involvement, except for charitable donations, community and staff causes. A clear sign of this lack of engagement is present in the 0-2% of profits being channelled into social responsible initiatives.

Another concerning indicator was the responsiveness of IFIs, an analysis of the mission and statement by the authors revealed that lacked a proactive culture of CSR, which is consistent with the already mentioned in "Stage 3". The author argues that due to the foundation values on which Islamic Banking lays, the results should be more relevant in terms of the proactivity of IFIs regarding CSR.

The author considers that IFIs and SRI funds target a niche market, in particular those that seek investment options that comply with their ethical or religious beliefs. In this sense, the author argues that IFIs could usefully emulate SRI funds in terms of the ethical and socially responsible values and, by doing so, making the approach to financing easily accessible to prospective clients. In what concerns the recognition by practitioners of the benefits that CSR commitment brings positive impacts to the institution (95.8%), the author defends that IFIs should indeed follow more closely this belief held by the practitioners. At the same time, one can argue that "*the lack of transparency in data reporting, especially regarding funds spent on community causes, could be the cause for the lower reported profits spent on community enhancing activities* (Sairally, 2006: 441)". According to the author, this can mean that IFIs could consider best to keep the charitable donations undisclosed, if this is indeed the case it would extent the support for the claim that CSR is only a peripheral practice of CSR. The author concludes that in line with the modern disclosure policy of CSR activities, IFIs could opt for enhancing the transparency of their social activities, in order to gain the trust and recognition of their clients and the public at large.

The final assertion made by the author is regarding the measurement of the social responsibility performance of IFIs, in line with it already happens with SRI funds. Islamic finance has been experiencing developments in financial performance indexes, like the Dow Jones Islamic Index and the FTSE Global Islamic Index. However, there is still not index to measure the social performance of companies that claim to be Shari'ah compliant. The author deems that it would be useful to have such index to benchmark the responsible business practices of IFIs. As a final remark, the author acknowledges that more time is necessary for a firmer establishment of Islamic finance industry so that these changes and improvements could effectively happen.

8.4 "Social Responsibility Trends at Islamic Financial Institutions"

This was the first study endorsed by reputable institution in the area of CSR in Islamic finance and is in its own right a milestone in this key component of any IFI. The purpose of this study was to analyse the results of a survey conducted[24] in 2009 and to "*assess the level and extent to which Islamic financial institutions (IFIs) undertake socially responsible activities* (Farook & Shikoh, 2010: 6)". The study was endorsed by the Dinar Standard, Dar Al Istithmar[25] and supported by the AAOIFI; it was authored by Dr. Sayd Farook (Senior consultant of Dar Al Istithmar) and Rafi-uddin Shikoh (Managing Partner at Dinar Standard).

Screening and Dealing responsibly with clients

100% of IFIs answered that they have an active screening policy for prospective client, while 97% answered that their organization have an active policy to responsibly dealing with clients. The authors identified that IFIs placed a great deal of importance in service (79%), screening (97%) and responsibly dealing with customers (76%) among the socially responsible activities. "*This suggests that banks are conducting themselves in a risk mitigation and value enhancing manner, which while being in line with Islamic social*

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[24] See **Annex 13** for the questions that composed the survey and **Annex 14** for the distribution by country and IFI type

[25] Dinar Standard is a consultancy firm and focus on market intelligence and growth strategy of IFIs. Dar Al Istithmar is a glob al Shari'ah advisory firm based in the UK

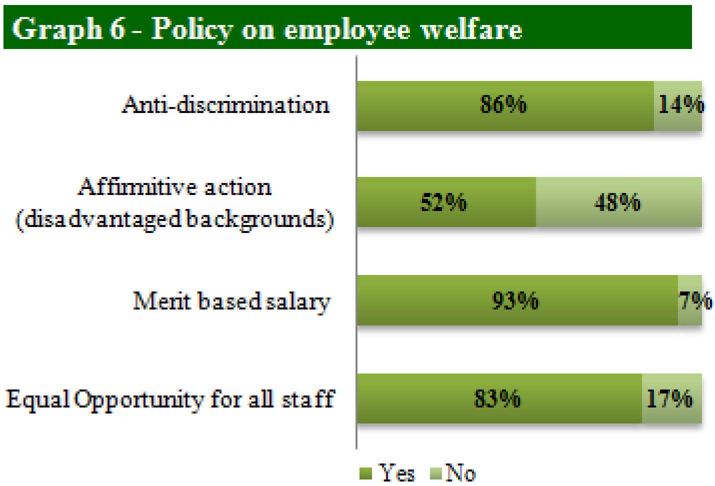
responsible norms, are also driven by bottom line concerns about retaining and increasing value from customers. This is in and of itself a good indicator, but not enough to suggest that IFIs do conduct themselves in a socially responsible manner outside of their vested interest (Farook & Shikoh, 2010: 19)".

Earning and Expenditure prohibited by Shari'ah

In this topic, 76% of IFIs answered positively to have a policy which deals with earning & expenditures prohibited by Shari'ah, while 14% responded negatively and the remaining 10% ticked the N/A box. "*These responses indicate that more the mature the organizations, then there is more tendency to adhere to such a policy whilst new organizations in the field of Islamic finance tend to overlook such a policy* (Farook & Shikoh, 2010: 9)".

Employee Welfare

As it can be seen by the results expressed in **Graph 6** there was a good rate of agreement among IFIs on having "equal opportunity for all staff", "merit based salary" and "anti-discrimination" policies. However, in the "affirmative action (disadvantages backgrounds) there was a significant disagreement with 52% claiming that indeed they have such policy but the remaining 48% claimed otherwise.



Source: Farook & Shikoh (2010)

The authors identify two main issues regarding this topic: 1) There is still a need to move to what the authors consider a second generation employee welfare, which is given by a positive and affirmative action for prospective and existing employees with disadvantaged backgrounds (only 52%); 2) The protection that the other three components can't just be analyzed from a quantitative (have/don't have) point of view but from a qualitative and comprehensive read through the IFIs written policies.

Zakat

There was a mixed response in what concerns the existence of a policy to collect and distribute the Zakat reserves on behalf of clients, customers or shareholders, with 31% answering positively, 55% negatively and 14% N/A. The authors' analysis identified this as a missed business opportunity to be considered by IFIs.

Qard Hassan

The question was whether IFIs had a policy to deal with Qard Hassan distribution for social reasons, and the answers were, once again, mixed. Of the total of IFIs 59% answered yes and 34% no, which lead to the authors analyze that despite being fairly well practiced, they would expect to be practiced fairly universally with a special focus on the impact, reach and effectiveness of this measure.

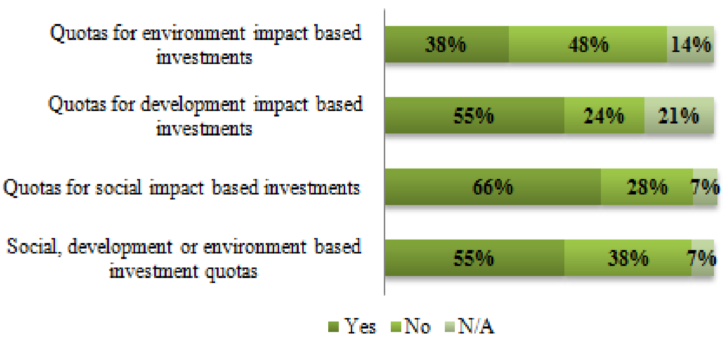
Reduction of Impact on Environment

Regarding the proactive environmental policies that IFIs may have, only 52% claimed that they had such policies and 38% responded negatively. This is a surprise to the authors since both Islam and contemporary CSR recommends the protection and sustainability of the environment. The authors identified that the environment in Islam is not the priority, but the social and basic human requirements (clothing, shelter, food). They consider that IFIs are more concerned with preserving the environment than investing in its improvement, and add that in this case, the Islamic windows of conventional banks, for instance, HSBC Amanah can be useful in setting a benchmark.

Social, Development and Environmental Based Investment Quotas

Regarding the environment quotas, given the above result, it is not surprise that the results present a negative outlook, with 48% of IFIs stating that they do not have, against 38% that do, a quota for environment impact based investment meaning that investment decision making of IFIs is not so

Graph 7 - Policy on social, development and environment investments



Source: Farook & Shikoh (2010)

influenced by it. These results were not a surprise to the authors, since in the OIC[26] countries, development and social investments take higher priority, thus the 55% and 66% of positive answers, respectively.

Par Excellence Customer Service

The development policy for excellent customer service is a clear concern of IFIs - 79% of positive answers – since the natural growth and development of this market pushes IFIs to engage in investment and training in this particular area.

Small Business and Social Savings

The response to this topic was quite balanced, with “assistance to micro and small businesses/social savings and investment” totalling 62% of positive answers, “social savings for marriages, education, community based programs” posing 52% and “family savings and investments”, 59%.

Charitable Activities

This topic had three dimensions to be addressed. In the first “support for charitable activities”, 76% of IFIs affirmed that they had a policy to deal with this, while only 17% stated otherwise. In terms of “fund raising drives” the results were opposite, with only 34% of IFIs answering yes and 55% answering no to the question posed. The final dimension, “Targeting groups” was mixed, with 52% answering that they indeed had a policy to distribute charity to specific groups, while 31% responded that they didn’t have. The answers spurred the following analysis from the authors: “*However, only approximately half of the IFIs (52%) surveyed actually target specific groups, communities or institutions that require assistance, which suggests that many IFIs do not have a pro-active role in scoping out needy causes. This traditional approach to charitable activities is also evident from the fact that the IFI do not utilise their infrastructure, which is conducive to mobilizing funds, to administer fund raising charity drives for emergency or recommended causes, such as orphanages and natural disasters* (Farook & Shikoh, 2010: 16)”.

[26] Organization of the Islamic Conference

Management of Waqf Properties

In terms of IFIs having a policy to deal with Waqf properties on behalf of their clients, 55% indicated that they had not while 34% said it was no relevant to their organization. Only 10% identifies that they did have such policy. This suggested the same answer as Zakat management from authors.

Overarching Recommendations and Conclusion

The overall conclusion is that IFIs, despite of all the subtleties, have a good start in terms of the social responsibility topics identified by the AAOIFI. Even though the authors acknowledge that they could not asses entirely the real extent and level of implementation of such policies, they consider that there is room to improvement and that the majority of IFIs "*have yet to embrace the concept of financial institution utility to enhance their social responsibilities* (Farook & Shikoh, 2010: 20)".

The authors recommend three methods of ensuring an equitable distribution of resource and efficiently channel funds from the capital rich to the capital deficient.

1. Maintaining policy targets for SMEs and micro-finance entrepreneurs in the developing world. "*Micro-finance and SME finance has continuously proven to be a sustainable revenue stream, subject to appropriate risk management strategies, including portfolio diversification, low concentration risk and stringent credit and social collateral requirements* (Farook & Shikoh, 2010: 20)".
2. "*Where IFIs do not have the risk capital, they can utilize their charitable funds to conduct such operations in a pilot project up until the project demonstrates sustainability of capital and profitability over a period of time, while minimizing risk for the IFI*. (Farook & Shikoh, 2010: 20)"
3. IFIs can invest in social/environmental projects that have proven to have a positive impact and provide a constant profitable revenue stream, such as, education, healthcare, water desalination, etc.

As a final remark, the authors defend IFIs to move from the negative screening criteria (first generation), based on avoidance, to the positive (second generation) that envisions a double screening criteria where both avoidance and engagement in socially responsible activities are recommended. The authors believe that this is where IFIs can really make a difference given their financial institution framework.

Chapter 9: Discussion of Results

In this section the aim is to relate as thoroughly as possible the theory described on this thesis with the findings based on the previous section and draw conclusion about the current state of Islamic Finance and its Institutions as a whole.

There is a consonance of ideals and conception of the Islamic Banking system (and other IFIs) that is present in the four articles analysed and the literature addressed throughout the thesis. In all the four documents analyzed, we find similar concept in terms of expected behaviour, beliefs, values and organizational features. For instance Dusuki & Dar (2005) expect that the majority of IBs to share with their stakeholders (especially Muslims) the same norms, beliefs and values as Shari'ah principles support stakeholders' norms. They conclude, as the literature states, that the very concept of CSR is not unknown in Islamic Banking and would lead, in the end, to a positive impact in IBs. On a similar tone, Haniffa & Hudaib (2007) identified the five components that distinguish IBs from conventional ones and advocate that the IBs share an "ethical identity" based on Shari'ah teachings. Sairally (2006) states that the Islamic Finance goal should be increasing the overall wellbeing of populations and thus defends the social commitment that IBs must have. Finally Farook & Shikoh (2010) do not make a literature review, but offer their opinion by stating that IFIs play a substantial role as a mean to distribute wealth equitably. Additionally, in the comments and analysis of the various topics that they address, there are various references to the Islam values and expectations regarding CSR.

All the authors identify inconsistencies and discrepancies between the literature, their expectations and the evidence that they have found. This is, once again, in line with some of the debates and controversies identified in the literature review of this thesis. For instance, there are several references of Leiss (2007) that explain in detail the controversy of the Profit-and-loss sharing and the role of interest in Islamic Banking system. This is coincidental with findings of Haniffa & Hudaib (2007) that indentify that the controversy surrounding IBs to be related with the "purity" and "sincerity" of the managers. They also expected banks to be transparent and disclose information about their financial activities, but found that out of the seven banks analyzed there was one that was using a mix of financing using conventional (with interest) and Islamic financing (interest-free) and only two demonstrated not to be involved in haram activities. Farook & Shikoh (2010) recognize that the industry is under some criticism and mention the Sukuk case[27]. The authors add the declarations of International Council of Fiqh Academy that, in 2009, affirmed that tawarruq[28] contained an element of usury and was deemed a deception.

It is possible to conclude that the ideals of Shari'ah and Islam, as a whole, are not being fully met in what comes to products and services offered. This is quite concerning, since problems regarding usury, interest or any other forbidden activity damage the whole financial system image and can hinder its development. This can also be attributed to a symptom of the expansion phase that the Islamic Finance system is experiencing, where there is eagerness to develop the corporation, even at the cost of Shari-ah compliance and credibility in the Muslim communities. To tackle this problem, IBs need to clearly communicate their Shari'ah compliance and the engagement in halal businesses only, while disclosing information relevant in this topic to avoid controversy and develop their corporations.

Moving the discussion of results to other dimensions of CSR, there is a general opinion that CSR in IFIs is becoming more disseminated and accepted. The literature also provides a good outlook on the future of Islamic Finance, regarding CSR, especially due to the Shari'ah, the Islamic values and its ethical system. However, as it was reported in this thesis there are conjuncture factors that may be slowing down this process. Jamali & Mirshak (2007) stated that there are priorities in the developing world that overlaps CSR and that due to the lack of knowledge many corporations may not feel any obligation to society. The findings support, to a certain extent, the literature and also add a cultural dimension in the case of Hannifa & Hudaib (2007) that identify the secretice culture and the gender segregation as important factors for the underdevelopment of CSR in the OIC countries. Sairally's survey (2006) showed evidence that support the literature, since the main activity of CSR in IFIs is staff welfare while on of the least important activity was environment-related activities. In Farook & Shikoh's (2010) survey there was evidence of good practices in terms of employee welfare while in what concerns environmental policies the results showed that only 52% responded that they had policies to dominish their activities' impact off the environment. The authors justify with the higher concern with social requirements over environment and stresses the benchmark setting of conventional bank's Islamic windows. Dusuki & Dar (2005) identified,

[27] Refer to section **7.2** for further details.
[28] Tawarruq is in its essence sale for cash of item purchased by installments. "In Islamic financing, an arrangement in which somebody purchases an item from a bank on a deferred payment plan, then sells it immediately to obtain money (QFinance)".

that the “Environmental practice” factor was rated important/very important – around 83% - on the decision making of bank patronizing by stakeholders.

The fact that CSR is enshrined in the Shari’ah and the ethical systems and values of Islam despite its importance and invaluable assistance in tackling societies problems, seems to sometimes be working against the development of CSR in countries where IFIs operate. This is particularly evident under two topics: the responsiveness to CSR issues and the screening mechanism of IFIs. Regarding the first, there are various areas where the responsiveness has been far from the desirable, that Is to say, defensive/accommodative rather than proactive. The survey results in Sairally’s (2006) paper, shows that although 78.3% considered their IFI as social responsible, only about 28% defined it as proactive. This is supported by the finding of Farook & Shikoh (2010) report where while 52% of the respondents target specific groups from donations and charitable activities, many other IFIs are not being proactive in finding needy and worthiness causes to endorse. Both authors critic IFIs lack of responsiveness in natural disasters situations, in particular Sairally (2006) specified the 2004 tsunami disaster. Both authors are critic regarding the negative screening criteria, currently endorsed by IBs. In their opinion, IBs have more to gain if they adopt a second generation of screening, where both negative and positive/inclusive criteria are used. Sairally (2006) argues that IBs should emulate SRI funds in some of its characteristics, and the screening criterion is one of them.

The basic of Islamic Finance is that the profitability, though desirable, is not the sole purpose of an IFI, as the social goals are to be considered as important. The findings show a surprising result of an unbalance between the social and the profit goals, particularly on the practitioners’ side. In Malaysia, the research of Dusuki & Day (2005) showed that employees were top of the stakeholders rank in terms of reputation and service delivery and convenience and price factor, while ranking only fifth in the CSR factor. Managers followed a similar pattern, ranking sixth (out of seven) in the CSR factor and third and fifth on reputation and service delivery and convenience and price factor, respectively. In Hannifa & Hudaib (2007) survey the commitment towards community and society, social goals, was ranked last in terms of informations disclosure by the analysed banks. . As it can be seen in **Annex 15** the financial soundness of income and asset levels is not a synonym of a better relation with the involving society. The corolary of this discrepancy is demonstrated in Sairally’s (2006) survey where 80.9% of the practitioners attributed IFIs a social responsibility functions, 63.8% said that financial and social goals are equally important but 48% still considered that it should be social organization’s responsibility to engage in morally-motivated finance rather than financial institutions, while the majority of IFIs spend only 0-2% of their profits in social causes.

Even though there are good indicators of the development and implementation of CSR, there is still margin for improvements. It is clear that the CSR concept, while intrinsic in Islam and in governance of IBs, it is still far from being fully developed and an established concern in the Islamic financial system. It is now possible to conclude that the literature of CSR and its relation with IFIs is far from being verified in practice. To tackle this issue and respect the ethics and values, like justice, of Islam, IFIs need to start by disclosing more information to stakeholders and public in general. This first step is a fantastic opportunity for IFIs to become more credible, trustable and mitigate the controversy that involves IFIs. This is also an opportunity for IFIs to enhance their image and reputations near the public and start to capitalize on the benefits that CSR can bring to a company. Additionally, and because IFIs are religious-bounded, an increase in communication level and quality have important religious implications, as IFIs are accountable to stakeholders, societies and ultimately to God. Another step forward is the finding that CSR is indeed a very important criterion in choosing an IFI from a stakeholder perspective. Even though the study was conducted in Malaysia, the experience of decades of CSR development makes it possible to extrapolate the results across the IFIs influence zone. Therefore, Islamic banking should make an effort to seize the exponential growth momentum and attempt to become the reference in terms of CSR practices. Two of the authors defended an approximation to the SRI funds screening model. They argue that this screening model is the ideal for the IFIs framework and can be a future key success factor and differentiator. There is also a concern with the development of institutions that can track down and benchmark the practices of IFIs in an index.

These changes are achievable and can make an important impact on IFIs and their stakeholders. However, these structural changes need time to be implemented and it is necessary to allow the Islamic banking/financial system, which has only 40 decades of existence, to establish and steadily develop all the policies that can prevent controversy, promote the balance between social and economic goal and guarantee a just redistribution of wealth, as envisioned in Islam.

Conclusion

The aim of this thesis was to comprehend if there were any incongruities between the CSR literature and the actual practice of IFIs. In ordered to do so, I recurred to four empirical studies, which I've treat as evidence and compared the findings with the literature review and the expectations for the CSR behaviour of IFIs. The objective that I set myself to achieve was concluded with success, as can be attested by reading chapter 9 of the present thesis.

There are some gaps between the literature and the practice, but in some situations this is not the case. For instance, the literature is consonant with the practice in recognizing and acknowledging CSR as common and positive practice. The evidence shows that stakeholders are becoming more concerned with this topic and consider it a relevant factor of their decision-making process, when choosing a bank. The ideal of CSR is present in the minds of stakeholders and evidence shows that managers are concerned and eager to promote CSR. These practitioners have in-built the Shari'ah concept that, by itself, is a mean to ensure social responsible activities. However, in the majority of the cases, IFIs fail to follow this ideal. There is a special concern with the lack of initiative of IFIs in promoting good practices. The values and ethics of Islam dictate that IFIs should be operating in a Shari'ah compliant way and should put the social goals at the same level as financial ones (profits). The evidence show otherwise, with the majority of the IFIs distribution only 0-2% of the profits to social causes. Environmentally wise the practices of CSR are not the best as well. Evidence shows that once again that the discrepancies are considerable, which is contrary to the modern CSR literature and Shari'ah law. The disclosure and transparency levels of IBs are quite below of the desirable and that may be one of the reasons for some relaxation of IBs in being proactive and socially active. Islamic Banking and overall financial system should try its utmost to be the focal point of good CSR practices. The benefits are to be taken for those that engage and communicate such activities. To ensure a bright future for Islamic Banks there are some developments that need to be made. For instance the disclosure policies should be stricter and more constant, as the assimilation of CSR and Islamic ideals are an integrant part of the fulfilling stakeholders' expectations. This combination is, in the end, what truly makes the Islamic Financial Institutions different from any other, thus it should deserve the utmost attention since it represents a differentiation and a prospective key success factor. To an industry that accounts just under five decades, the feats and developments it has achieved is no short of spectacular. For this staggering development, the results presented throughout the thesis are, overall, good. More importantly, it provides a encouraging future outlook.

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Annexes

1.

Annex 1 - CSR and profits, likely benefits and costs

Stakeholder group	Benefits	Costs
Directors	More independent non-executive directors	More meetings and briefings
Shareholders	Increased investment from ethically based pension funds	CSR premium on all company activities such as increased reporting costs, more openness, etc.
Managers	Better HR policies lead to increased motivation	Increased training in ethics
	More awareness of ethical issues from focus group sessions lead to more confidence about employees	Focus group sessions and reporting
Employees	Better HR policies lead to increased motivation	Inclusion of ethics training
	Good ethical conduct by superiors lead to improved productivity.	More intra-company communications
	Less labour relations disputes, less strikes	More effort on labour relations
	Better working conditions	
	Good company CSR leads to easier recruitment of high flyers and young people	Will need to implement human rights policies
	Reduced costs of recruitment	
Customers	Move to ethical consumption captured by Company	Costs of goods may increase in the short term
	Less disputes	
	Advertising can cite CSR	
	Enhanced reputation	
	Brand quality recognition	
Subcontractors /Suppliers	Better quality inputs	Cost of inputs may increase in short-term
	Less harmful effect on public image	
Community	More willingess to accept new investments	Requires continual interaction with community
	Improved public image	
Government	More confidence in company.	Costs of adhering to new regulations will increase.
	Fewer legal battles, no new potentially harmful legislation.	
	More favourable trading regime	
	More willingness to accept expansion or downsizing	
Environment	Less legal battles	Investment in environmental damage control.
	Improved public image	

Source: Hopkins (2004)

2. Clause 156: Duty to promote the success of the company

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole

Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes

In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) have regard to

- The likely consequences of any decision in the long term
- The interests of the company's employees
- The need to foster the company's business relationships with suppliers, customers and others
- The impact of the company's operations on the community and the environment
- The desirability of the company maintaining a reputation for high standards of business conduct
- The need to act fairly as between members of the company

The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company

Source: (Company Law Reform, 2005)

3.

Annex 3 - Most well-known business principles

Government and intergovernmental Iniciatives	Date	Main issues
ILO Tripartite Declaration on TNCs	Geneva, 1977 revised March 2000	Employment
OECD Guidelines	Paris, 1976, revised June 2000	Multi-stakeholder including employment and triple bottom line
UN Global Compact	New York, July 2000	Human rights, labour and environment
UNEP Financial Statement	Paris, 1992, revised May 1997	Environment
EU Principles	Brussels, 2001 ; revised 2002	Multi-stakeholder
Voluntary Principles on Security and Human Rights, US & UK Govt.	Wash. DC and London, Dec. 2000, London, Dec. 2000	Security and human rights for extractive and energy industries
US Model Business Practices,	Wash. DC, 1996	Health and safety, labour, environment, corruption, community, law
Ethical Trading Initiative, UK Gov and NGO	London, Sept 1998	Labour practices essentially on trade links
Company-led initiatives	**Date**	**Main issues**
Caux Principles	Minnesota, 1994	Multi-stakeholder
Fair Labor Association (FLA), US	California, Nov 1998	Labour practices
Global Sullivan Principles	USA, Nov. 1999	Mainly external stakeholders
ICC Business Charter for Sustainable Dev.	Brussels, 1991	Environment, health and safety
World Economic Forum	Davos/Geneva, 2002	Corporate governance, [word missing]
NGO-led initiatives	**Date**	**Main issues**
AccountAbility 1000	London, 1999 (revised 2002)	Social and ethical 'assurance' not environment, Stakeholder model (SK not defined)
Amnesty International HR guidelines	London, Sept. 1998	Human rights and security
CERES Principles	USA, 1989	Environmental ethical standards
Global Reporting Initiative (GRI)	Boston, 1997 revised 2002	Multi-stakeholder, triple bottom line indicators
ICFTU Code of Labour Practice	Brussels/Geneva, 1997	Labour and trade union issues
SA8000	London, 1998 (revised 2002)	Says CSR, but is mainly labour
Interfaith Center Global Codes of Conduct	New York, 1995	
Social Venture Network	Brussels, 1999	CSR multi-stakeholder, corporate
Standards on CSR		Governance mentioned, social audits
Sigma Sustainability Principles	London, 1999	Multi-stakeholder bias toward Environment, no management shareholders
Q-Res Codes of Ethics	Italy, 1999	Multi-stakeholder
Governance initiatives	**Date**	**Main issues**
General Motors Board Guidelines	Detroit	Management
OECD Principles/ Millstein Report International	Paris	Management
Bosch Report, Australia	Australia	Management
Merged Code Recommendations, Belgium	Brussels	Management
Turnbull Report, UK	London	Management
King Report, South Africa	Johannesburg, 2002	Management and ethics
King Report, Commonwealth	London, 2001	Management and ethics
World Bank Corporate Governance Forum	Wash., D.C., 2002	Management and finance

Source: Hopkins (2004)

4. AAOIFI Government Standards

Responsibilities under this standard Mandatory and Voluntary Conducts

Mandatory Conduct

Policy for screening clients

IFIs shall implement a CSR policy for screening prospective clients. This policy must include:

a) Screening criteria;

b) The approval of the Shari'a Supervisory Board of the screening criteria.

The policy stipulating the screening criteria may include provisions:

I. for review of the compliance of prospective client's investments with Islamic law, among other aspects, if any, based on the discretion of the IFI;

II. requiring that effective screening processes are in place to prevent third parties from using the IFI to engage in criminal activities such as money laundering;

III. for review of the prospective client's compliance with principles and rules of CSR as contained within this standard, particularly mandatory core conduct as stipulated in sections 5/2 (extended to the prospective clients);

IV. for review of the impact of the prospective client's investment on the economy, society and the environment;

V. stating that any future abrogation of the terms of financing, as stipulated under this policy, will result in violation of contractual terms (with the remedy to be decided by the IFI).

If these policy terms form part of the contractual agreement with clients, a policy disclosure must be made to prospective clients stipulating these policy terms prior to contractual agreement.

Policy for responsible dealing with clients

IFIs shall implement a CSR policy for responsible dealing with clients, including provisions relating to avoidance of onerous terms on clients, marketing ethics, implementing responsible financing practices in all types of transactions with clients and dealing with late repayments and insolvent clients. This policy shall stipulate:

a) that all contract forms have to be screened by the *Shari'ah* supervisory board or its agent to avoid the imposition of onerous terms and conditions to clients who are in a weaker bargaining position relative to the IFI;

b) provisions to ensure that all marketing campaigns and documents are ethically balanced promoting business without an exclusive focus on profits that may induce inappropriate behaviour/consumption and unsuitable products inconsistent with Islamic, social and cultural norms;

c) the obligations and rights of each party to transactions undertaken with the IFI;

d) the due process and responsible terms and conditions under which financing is extended to clients, taking into consideration the client's ability to repay and the effect on the client's financial and overall well-being, through assessment of the client's present disposable income capacity;

e) the remedies available, in the event that one or both parties violate their contractual terms;

f) the opinion of the *Shari'a* Supervisory Board regarding late payment charges;

g) late payment charges to be charged to clients, if any;

h) how the IFI allocates the late payment charges in its accounts (allocation to revenue or charity);

i) the conditions under which IFIs will defer collection of debt from insolvent clients.

A policy disclosure shall be made to clients prior to execution of any contract. This policy disclosure shall form part of the contractual terms and conditions.

Policy for earnings and expenditure prohibited by Shari'ah

IFIs shall implement a CSR policy for earnings and expenditure prohibited by Shari'ah (impermissible or *haram* transactions). This policy must include a due process procedure wherein the following must be documented for impermissible transactions:

a) Specific description of each material transaction and aggregate description of accumulated immaterial transactions;

b) revenue, expense, liability or asset amount of each material transaction and aggregate revenue, expense, liability or asset amount of accumulated immaterial transactions;

c) reasons for undertaking such transactions;

d) the Shari'a Supervisory Board's verdict on the necessity of these transactions;

e) how the IFIs intends to dispose of such revenues, assets or liabilities; and

f) recommendations for finding viable permissible or *halal* alternatives for similar impermissible transactions in the future.

The procedure above should be read in conjunction with and supplements any existing AAOIFI standards that relate to earnings and expenditure prohibited by Shari'ah.

Policy for employee welfare

IFIs shall implement a CSR policy for employee welfare. This policy shall stipulate provisions for the rights and obligations of employees, including provisions affording fair treatment of all employees, avoidance of discrimination, as well as expected behaviour of all employees. This policy may include specific provisions relating to:

a) equal opportunity for all employees, regardless of gender, race, religion, disability or socio-economic background;

b) merit-based salary and promotion structure for all employees, regardless of gender, race, religion, disability or socio-economic background;

c) establishing long term incentive schemes and further development and training incentive schemes for all employees;

d) provisions for maternity leave and flexible work hours for female employees;

e) maximum allowable work hours under full-time, part-time and casual employment for all employees;

f) prohibition of discrimination, including and not limited to gender, race, religion, disability or socio-economic background, penalties for such discrimination and avenues for complaints for such discrimination without any manner of recrimination (Appointment(s) should be made within the organization to deal with such discrimination; the person(s) appointed must be seen to be just and fair to all employees, regardless of the employee's gender, race, religion, disability or socio-economic background);

g) pro-actively establishing, monitoring and acting on realizable quotas/targets for employment of staff from disadvantaged backgrounds, with disabilities, from a minority group, and/or from under-represented groups in the formal economy (including females) (affirmative action);
h) elimination of child labour from the workforce and if not feasible, educational and familial support for children;
i) elimination of class and race barriers between higher and lower ranking employees;
j) expected behavior of all employees in line with the *Code of Ethics for the Employees of Islamic Financial Institutions;*
k) expected behavior (humility, modesty and mutual respect) of higher ranking employees towards lower ranking employees, vice versa; and
l) occupational health and safety measures to be taken by the IFI and by the employees.

A policy disclosure must be made to all employees before commencement of the employment contract and preferably be disclosed in any form of media that is utilized to advertise employment vacancies. This policy disclosure should form part of the contractual terms and conditions. Efforts should be made to communicate this policy disclosure to all employees in their native language (language most frequently used by the employee).

Policy for Zakat

Recommended Conduct

Policy for *Qard Hasan*

IFIs may implement a CSR policy for *Qard Hasan* for social reasons. The provisions of this policy may include matters pertaining to:

a) establishing a *Qard Hasan* fund;
b) maintaining a record of sources of *Qard Hasan* funding (depositors, shareholders and/or other parties) (sources of funds);
c) types of allowable beneficiaries of the *Qard Hasan* funds as determined by the bank (allowable uses of funds);
d) circumstances in which such loans are distributed to individuals (or to organizations);
e) contractual enforcement measures for debtors able to repay loans;
f) write off conditions for debtors unable to repay loans; and
g) developing a strategy to increase *Qard Hasan* loans from the sources referred to in 5/3/1b, which are to be used solely for charitable purposes, and pro-actively establishing, monitoring and acting on realizable quotas/targets for this particular strategy.

This policy may be monitored on a yearly basis. If implemented, this policy may supplement any provisions contained elsewhere in the AAOIFI standards including, *Statement of Financial Accounting No. 2 Concepts of Financial Accounting for Islamic Banks and Financial Institutions* section 4/7.

Policy for reduction of adverse impact on the environment

IFIs may implement a CSR policy for reducing the impact of the IFI on the environment. The provisions of this policy may include matters pertaining to:

a) establishing organization wide guidelines on efficient and minimal usage of non-renewable resources;
b) initiatives to educate employees to efficiently use non-renewable resources and increase use of renewable resources;
c) incentives and initiatives to find alternatives to non-renewable sources of energy and materials for operations (e.g. e-mail bank statements instead of paper bank statements); or
d) incentives and initiatives to recycle renewable sources of materials within the organization.

The provisions of this policy may be reviewed on a yearly basis to implement new and innovative methods by which to minimize the environmental impact of the IFI.

Policy for social, development and environment based investment quotas

IFIs may implement CSR policies for social, development and environment based investment quotas. This policy may include provisions for pro-actively establishing, monitoring and acting on *realizable and profitable* investment quotas/targets, based on the extent to which the investments directly or indirectly contribute to social, development and environmental causes.

I. **Social Impact Investments:** These policies may include quotas/targets for social-impact investments, based on the role that the investments play in:
   a) assisting poor and needy individuals and families, by financing business opportunities and/or education;
   b) assisting orphans;
   c) assisting heavily indebted individuals or families with unfortunate Circumstances;
   d) assisting in the provisioning of health and medical services to impoverished communities or areas;
   e) assisting in the development of research and education facilities, particularly those that utilize and empower disadvantaged individuals or communities;
   f) assisting the development of small and medium sized entrepreneurs and family businesses;
   g) encouraging the development of Islamic and native societal culture, and discouraging contemporary social ills and vices.

II. **Development Impact Investments**: These policies may include quotas/targets for development impact investments:
   a) that offer significant growth potential for the country of operation or for another developing country;
   b) that significantly contribute to the development of infrastructure in the country of operation or for another developing country;

c) that have a significant proportion of small to medium size enterprises (SME) or indirectly rely on small to medium size enterprises (SME); and/or
d) that directly or indirectly assists in the alleviation of social and economic disadvantages and discrimination, including and not limited to micro-finance industry and third-sector organizations.

III. Environmental Impact Investment: These policies may include quotas/targets for environmental impact investments, based on the role that the investments play in:
a) protecting the environment;
b) reducing the impact of development on the environment;
c) encouraging individuals and institutions to protect and preserve the natural environment and reduce the impact of development on the environment; and
d) increasing the use of renewable, sustainable sources of energy and/or reducing the reliance on scarce non-renewable sources of energy.

Policy for par excellence customer service

IFIs may implement a CSR policy to develop *par excellence* customer service skills of employees and contractors. The provisions of this policy may include matters pertaining to:

a) establishment of a code of conduct for all employees and contractors in dealing with customers (The code of conduct for customer service may include the provisions from the *Code of Ethics for the Employees of Islamic Financial Institutions* section 6/3);
b) active measures to be taken by management to develop customer service skills of employees; and
c) surveys that provide customer service feedback on performance/quality and likely areas of improvement.

Policy for micro and small business and social savings and investments

IFIs may implement a CSR policy to assist micro and small business and social savings and investments. The provisions of this policy may include matters pertaining to:

a) encouragement of micro and small business savings through special features and terms for these types of investment depositors;
b) encouragement of social savings for marriages, children’s education, community based programs and other social welfare programs through special features and terms for these types of investment depositors;
c) encouragement of both micro and small business savings and investment through combination features and terms for these types of investment depositors (for e.g. savings deposit with higher rates of return and investment loans discounts etc); and
d) encouragement of both family savings and investment through combination features and terms for these types of investment depositors (for e.g. savings deposit with higher rates of return and investment loan discounts etc).

Policy for charitable activities

IFIs may implement a CSR policy for charitable activities. The provisions of this policy may include matters pertaining to:

a) establishing a charity fund;

b) establishing avenues for voluntary donations by donors (e.g. from depositors, shareholders, clients, contractors and employees) for the charity;

c) establishing fund raising drives (emergency or otherwise) from bank's clients through existing operational means;

d) establishing target groups, communities and institutions that require assistance, including those described in policy for social impact based investment quota (section 5/3/4) and policy for environmental impact based investment quotas (section 5/3/5);

e) means by which charity may be distributed to prospective donees; and

f) contracting an agent or establishing a trust foundation to distribute funds to allocated charities.

Policy for Waqf management

IFIs may implement a CSR policy for managing *Waqf* properties on behalf of their beneficiaries. The provisions of this policy may include matters pertaining to:

a) establishing a *Waqf* management department or allocating staff to a *Waqf* management function;

b) establishing rules and guidelines based on *Shari'a* for *Waqf* management;

c) establishing a fair rate structure for the provision of services by the bank; and

Source: (AAOIFI, 2010)

5.

Annex 5 - Islam's emphasis on key ethical issues by stakeholder		
Relationship	Stakeholder(s)	Issues
Relationship of the firm to its shareholders	Shareholders	Safeguarding and fructifying the investments; transparent and ethical business transactions in permissible (*halal*) business ventures
Relationship of the firm to its employees	Employees	Hiring and firing; emphasis on competence and fair working conditions; rejection of sexism; wages and working condition; privacy
Relationship of employees to the firm	Firm	Conflicts of interest; secrecy; honesty; skills training and qualifications
Relationship of the firm to derivative stakeholders	Suppliers	Cost of inputs; transparent production process; provision of *halal* products/services
	Buyers	Hoarding and price manipulation; quantity and quality of goods sold; selling strategy; use of *riba* in financing sales
	Debtors	Repayment terms
	Competitors	Fair competition
	The environment	Use does not imply abuse; stewardship

Source: Beekun & Badawi (2005)

6.

Annex 6 - Obligations and rights of different stakeholders from na Islamic perspective		
Stakeholder	Description	Related Islamic Ethical Principle
Shareholder	*Rights:* Profits, personal property, control	Trusteeship
	Obligation: Transparency, ethical activities, fairness, investment in *Halal* businesses	Justice, Trusteeship, Unity
Employees	*Rights:* Fair compensation, dignified life, good working conditions regarding safety, fair work load, secrecy, training and development	Justice, Trusteeship, Unity
	Obligations: No cheating in work, optimal utilization of time and skills, privacy of company policies, working as a Trustee of owners	Justice, Trusteeship
Supplier	*Obligations:* Declaration of quality, exact quality and quantity, safety, hygienic production process, fair prices, no hoarding, provision of *Halal* products and services	Justice, Unity
	Rights: fulfilling contracts by the company regarding credit and other terms	Justice, Unity
Customers	*Obligations:* fulfilling contracts by the company regarding credit other terms	Justice, Unity
	Rights: Declaration of quality, exact quality and quantity, safety, hygienic production process, fair prices, no hoarding, provision of Halal products and services	Justice, Unity
Competitors	Fair competition	Justice, Trusteeship, Unity
Environment	Stewardship	Trusteeship
Community	*Obligations:* Considering the company as a community member and helping it succeed. Meeting contractual obligations	Justice, Unity
	Rights: Clean environment, employment, health, education, no discrimination, company meets all its obligations as a member of the community	Justice, Trusteeship, Unity
The Poor	Although they don't contribute anything substantial to the company, yet, they have the right, in form of *Zakat*, to monetary benefits from the company and other stakeholders	Justice, Trusteeship, Unity

Source: Ullah & Jamali (2010)

7. The following are the main areas of the OECD principles and its annotation:

Principle 1: ***Ensuring the basis for an effective corporate governance framework*.**

Annotation: The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

Principle 2: ***The right of shareholders and key ownership functions*.**

Annotation: The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

Principle 3: ***The equitable treatment of shareholders*.**

Annotation: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunities to obtain effective redress for violation of their rights.

Principle 4: ***The role of stakeholders in corporate governance*.**

Annotation: The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Principle 5: ***Disclosure and transparency*.**

Annotation: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Principle 6: ***The responsibilities of the board*.**

Annotation: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and board's accountability to the company and the shareholders.

Source: (Abu-Tapanjeh, 2007)

8. Basic Islamic Financial Instruments:

Basic Islamic Financial Instruments	
1. Bai' al-inah (sale and buy-back agreement) 2. Bai' bithaman ajil (deferred payment sale) 3. Bai muajjal (credit sale) 4. Bai salam contract in which advance payment 5. Hibah (gift) 6. Ijarah lease, rent or wage 7. Ijarah-wal-iqtina (lease contract) 8. Ijara & Ijarah thumma al bai' (hire purchase) 9. Istisna (contract on resale on manufacturing)	10. Mudarabah: (profit sharing) 11. Musharakah: (joint venture) 12. Murabaha: (cost plus) 13. Musawamah trading negotiation 14. Qard hassan / Qardul hassan (good loan/benevolent loan) 15. Salam (trade-based instrument) 16. Sukuk (Islamic bonds) 17. Takaful (Islamic insurance) 18. Wadiah (safekeeping) 19. Wakalah (power of attorney) 20. Islamic Equity funds

Source: (Ahamed & Hameed, 2007)

9. AAOIFI Shari'ah Standards concerning Sukuk

AAOIFI Shari'ah Standards concerning Sukuk

First: Sukuk, to be tradable, must be owned by Sukuk holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of Shari'ah, in accordance with Articles (2) and (5/1/2) of the AAOIFI Shari'ah Standard (17) on Investment Sukuk. The Manager issuing Sukuk must certify the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as his own assets.

Second: Sukuk, to be tradable, must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally, in accordance with the guidelines mentioned in AAOIFI Shari'ah Standard (21) on Financial Papers.

Third: It is not permissible for the Manager of Sukuk, whether the manager acts as Mudarib (investment manager), or Sharik (partner), or Wakil (agent) for investment, to undertake to offer loans to Sukuk holders, when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. It is not objectionable to distribute expected earnings, on account, in accordance with Article (8/8)3 of the AAOIFI Shari'ah Standard (13) on Mudaraba, or to obtaining project financing on account of the Sukuk holders.

Fourth: It is not permissible for the Mudarib (investment manager), sharik (partner), or wakil (agent) to undertake {now} to re-purchase the assets from Sukuk holders or from one who holds them, for its nominal value, when the Sukuk are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2)4of AAOIFI Shari'ah Standard (12) on Sharikah (Musharaka) and Modern Corporations, and Articles (2/2/1)5 and (2/2/2)6 of the AAOIFI Shari'ah Standard (5) on Guarantees. It is known that a Sukuk manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether the manager is a Mudarib (investment manager), Sharik (partner) or Wakil (agent) for investments. In case the assets of Sukuk of al-Musharaka, Mudarabah, or Wakalah for investment are of lesser value than the leased assets of "Lease to Own" contracts (Ijarah Muntahia Bittamleek), then it is permissible for the Sukuk manager to undertake to purchase those assets - at the time the Sukuk are extinguished - for the remaining rental value of the remaining assets; since it actually represents its net value.

Fifth: It is permissible for a lessee in a Sukuk al-Ijarah to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided he {lessee} is not also a partner, Mudarib, or investment agent.

Sixth: Shari'ah Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of Sukuk. All relevant contracts and documents related to the actual transaction must be carefully reviewed {by them}, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with Shari'ah guidelines and requirements as specified in the Shari'ah Standards. The investment of Sukuk proceeds and the conversion of the proceeds into assets, using one of the Shari'ah compliant methods of investments.

Source: (AAOIFI, AAOIFI's Shari'a Board Resolutions on Sukuk, 2008)

10. Annual ethical identity index and ranking under each dimension across IBs

Annex 10 - Annual Ethical Identity Index (EII) and ranking under each dimension across IBs

	ADIB EII (rank)			ABB EII (rank)			ARB EII (rank)			BIB EII (rank)			DIB EII (rank)			KFH EII (rank)			SIB EII (rank)			Annual Mean *EII* for each Dimension			Overall mean (rank)
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	
1) Vision & Mission statements	0,44	0,66	0,33	0,33	0,33	0,33	0,11	0,11	0,11	0,77	0,77	1,00	0	0	0,11	0,22	0,33	0,33	0,33	0,44	0,33	0,31	0,38	0,36	**0,35 (7)**
	(2)	(2)	(2)	(3)	(4)	(2)	(6)	(6)	(6)	(1)	(1)	(1)	(7)	(7)	(6)	(5)	(4)	(2)	(3)	(3)	(2)				
	0,48 [$]			0,33			0,11			0,85			0,04			0,29			0,37						
2) BoDs and top management	0,08	0,15	0	0,31	0,62	0,62	0,15	0,15	0,08	0,69	0,46	0,54	0,23	0,23	0,23	0,54	0,54	0,33	0,62	0,69	0,69	0,37	0,41	0,39	**0,39 (5)**
	(7)	(6)	(7)	(4)	(2)	(2)	(6)	(6)	(6)	(1)	(4)	(3)	(5)	(5)	(5)	(3)	(3)	(3)	(2)	(1)	(1)				
	0,08			0,52			0,13			0,56			0,23			0,54			0,67						
3) Product and services	0,50	0,40	0,40	0	0,25	0,25	0,3	0,13	0,13	0,86	0,86	0,71	0,8	0,8	1,00	0,60	0,13	0,40	0,71	0,30	0,30	0,54	0,41	0,46	**0,47 (2)**
	(5)	(3)	(3)	(7)	(5)	(6)	(6)	(6)	(7)	(1)	(1)	(2)	(2)	(2)	(1)	(4)	(6)	(3)	(3)	(4)	(5)				
	0,43			0,17			0,19			0,81			0,84			0,38			0,44						
4) *Zakah,* charity & benevolent loans	0,38	0,38	0,38	0,50	0,50	0,50	0,27	0,20	0,20	0,67	0,80	0,80	0,15	0,23	0,31	0,36	0,36	0,36	0,25	0,25	0,25	0,37	0,39	0,40	**0,39 (5)**
	(3)	(3)	(3)	(2)	(2)	(2)	(5)	(7)	(7)	(1)	(1)	(1)	(7)	(6)	(5)	(4)	(4)	(4)	(6)	(6)	(6)				
	0,38			0,50			0,22			0,76			0,23			0,36			0,25						
5) Commitments toward employees	0,67	0,56	0,44	0,33	0,22	0,22	0,33	0,10	0,10	0,67	0,44	0,44	0,10	0,22	0,33	0,33	0,56	0,33	0,56	0,78	0,67	0,43	0,41	0,36	**0,40 (4)**
	(1)	(2)	(2)	(4)	(5)	(6)	(4)	(7)	(7)	(1)	(4)	(2)	(7)	(5)	(4)	(4)	(2)	(4)	(3)	(1)	(1)				
	0,56			0,25			0,18			0,52			0,22			0,41			0,67						
6) Commitments toward debtors	0,67	0,33	0,33	0,67	0,67	0,67	0,33	0,33	0,33	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	0,67	0,67	0,33	0,33	0,76	0,67	0,62	**0,68 (1)**
	(4)	(5)	(5)	(4)	(4)	(3)	(7)	(5)	(5)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(3)	(4)	(5)	(5)				
	0,44			0,67			0,33			1,00			1,00			0,80			0,44						
7) Commitments towards society	0,29	0,29	0	0,14	0,14	0,14	0,14	0	0	0,29	0,14	0,14	0	0,14	0,14	0,29	0,57	0,29	0,14	0,43	0,14	0,18	0,24	0,12	**0,18 (8)**
	(1)	(3)	(6)	(4)	(4)	(2)	(4)	(7)	(6)	(1)	(4)	(2)	(7)	(4)	(2)	(1)	(1)	(1)	(4)	(2)	(2)				
	0,19			0,14			0,05			0,19			0,09			0,38			0,24						
8) SSB	0,50	0,50	0,50	0,60	0,70	0,70	0,10	0	0,25	1,00	0,67	0,54	0,30	0,40	0,40	0,27	0,27	0,27	0,63	0,63	0,63	0,49	0,45	0,47	**0,47 (2)**
	(4)	(4)	(4)	(3)	(1)	(1)	(7)	(7)	(7)	(1)	(2)	(3)	(5)	(5)	(5)	(6)	(6)	(6)	(2)	(3)	(2)				
	0,50			0,67			0,12			0,74			0,37			0,27			0,63						
Overal *EII*	**0,41**	**0,41**	**0,29**	**0,34**	**0,43**	**0,43**	**0,21**	**0,12**	**0,14**	**0,72**	**0,63**	**0,61**	**0,22**	**0,28**	**0,33**	**0,41**	**0,42**	**0,38**	**0,48**	**0,51**	**0,45**				
Overal rank:	**3**	**5**	**6**	**5**	**3**	**3**	**7**	**7**	**7**	**1**	**1**	**1**	**6**	**6**	**5**	**3**	**4**	**4**	**2**	**2**	**2**				
3-year mean *EII*:	**0,37**			**0,40**			**0,16**			**0,65**			**0,28**			**0,40**			**0,48**						
	(5)			**(3)**			**(7)**			**(1)**			**(6)**			**(3)**			**(2)**						

Note: refers to three-year mean *EII* for each bank under each dimension

Source: Hanniffa & Hudaib (2007)

11.

Annex 11: Patronage Studies on Islamic Banking									
Literature	Criteria in Banking Selection								
	A	B[a]	C[b]	D[c]	E[d]	F[e]	G[f]	H	I
Erol and El Bdour (1989)	-	+	+	+	+	+	+	+	+
Erol, Kaynak and El-Bdour (1990)	-	+	+	+	+	+	+	+	+
Haron, Ahmad et al. (1994)	-	+	+	+	+	+	+	+	+
Kader (1993)	+	-	+	+	n/a	+	n/a	+	+
Kader (1995)	+	-	+	+	n/a	+	n/a	+	+
Gerrard and Cunningham (1997)	±	+	+	+	+	+	+	+	+
Metawa and Almossawi (1998)	+	+	n/a	n/a	n/a	+	n/a	+	n/a
Naser, Jamal and Al-Khatib (1999)	+	+	+	+	+	+	+	+	n/a
Othman (2001)	-	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-
Othman and Owen (2002)	+	+	+	+	n/a	+	+	n/a	+
Ahmad and Haron (2002)	-	+	+	+	+	+	n/a	n/a	n/a
Omer (2002)	+	+	n/a	n/a	n/a	n/a	n/a	+	n/a
Abbas, Hamid et al. (2003)	±	+	+	n/a	+	+	+	+	n/a

Notes: + indicates a positive and important result, ± indicates an equivocal result, – indicates negative or no significant result and n/a indicates variable was not investigated/examined in the study.

A: Religious factor	D: Size and Reputation	G: Confidentiality
B: Cost/Benefit	E: Staff factors	H: Friends' and relatives' influence
C: Service Delivery	F: Convenience	I: Mass media Advertising

[a] Cost/benefit factors include the cost of the services and products offered by the bank perceived by the customers e.g. Rate of return on deposits, investments etc.
[b] Service Delivery criteria include factors such as provision of a fast and efficient service e.g. Application process and a wide range of services offered.
[c] Size and reputation here imply the bank's reputation and image.
[d] Staff factors include the competence and courtesy of bank staff and their ability to convey trust and confidence. For example, politeness and friendliness of staff; efficiency and effectiveness in handling any transaction; and knowledgeable and preparedness in providing solutions and answers concerning bank's products and services.
[e] Convenience criteria include the location, ample parking space, the external appearance and interior comfort.
[f] Confidentiality means the extent customers can have trust in their transactions with the bank.
Source: Dusuki & Dar (2005)

12.

Annex 12 - Variables	
X_1	Product price factor
X_2	Customer Service quality (e.g. Fast and efficient services) factor
X_3	Convenience (e.g. Available parking space, interior comfort) factor
X_4	Location being near home or work factor
X_5	Friendly personnel factor
X_6	Knowledgeable and competent personnel factor
X_7	Islamic working environment factor
X_8	Economic and financial reputation factor
X_9	Respect for Human rights factor
X_{10}	Islamic reputation and image factor
X_{11}	Involve in community (e.g. Giving donation, scholarship) factor
X_{12}	Environmental practise and impact factor

Source: Dusuki & Dar (2005)

13. Questions Asked in Social Responsibility Trends at Islamic Financial Institutions

Questions asked in Social Responsibility Trends at Islamic Financial Institutions

Screening and dealing responsibly with clients
Does your organisation have a policy to screen prospective clients that is actively implemented?
Does your organisation have a policy for responsible dealing with clients that is actively implemented?

Earning and Expenditure prohibited by Shari'ah
Does your organisation have a policy to deal with earnings and expenditure prohibited by Shari'a (impermissible or haram transactions) that are actively implemented?

Employee Welfare
Does your organisation have any policy which requires equal opportunity for all employees, regardless of gender, race, religion, disability or socio-economic background?
Does your organisation have any policy that specifically requires merit-based salary and promotion structure for all employees, regardless of gender, race, religion, disability or socio-economic background?
Does your organisation have any policy that specifically requires establishing, monitoring and acting on realisable quotas/targets for employment of staff from disadvantaged backgrounds, with disabilities, from a minority/excluded group, and/or from under-represented groups in the formal economy (including females)?
Does your organisation have any policy that specifically prohibits discrimination, including and not limited to gender, race, religion, disability or socio-economic background, penalties for such discrimination and avenues for complaints for such discrimination without any manner of recrimination?

Zakat
Does your organisation have a policy to collect and distribute Zakah revenues on behalf of clients, customers or shareholders?

Qard Hassan
Does your organisation have a policy for Qard Hasan distribution for social reasons?

Reduction of impact on environment
Does your organisation have a proactive policy for reducing the impact of your organisation on the environment?

Social, development and environment based investment quotas
Does your organisation have a proactive policy for social, development oriented and/or environment based investment quotas?
Does your organisation have quotas/targets for social-impact investments, based on the role that the investments play in any of the following:
a) assisting poor and needy individuals and families, by financing business opportunities and/or education?

b) assisting orphans?
c) assisting heavily indebted individuals or families with unfortunate circumstances?
d) assisting in the provisioning of health and medical services to impoverished communities or areas?
e) assisting in the development of research and education facilities, particularly those that utilize and empower disadvantaged individuals or communities?
f) assisting the development of small and medium sized entrepreneurs and family businesses?
g) encouraging the development of Islamic and native societal culture?
h) discouraging contemporary social ills and vices, opportunities and/or education?

Does your organisation have quotas/targets for development impact investments (tick the box if your organisation is active in any of the following)

a) that offer significant growth potential for the country of operation or for another developing country?
b) that significantly contribute to the development of infrastructure in the country of operation or for another developing country?
c) that have a significant proportion of small to medium size enterprises (SME) or indirectly rely on small to medium size enterprises (SME)?
d) that directly or indirectly assists in the alleviation of social and economic disadvantages and discrimination, including and not limited to the micro-finance industry and third-sector organizations?
Does your organisation have quotas/targets for environment impact investments, based on the role that the investments play in:
a) protecting the environment?
b) reducing the impact of development on the environment?
c) encouraging individuals and institutions to protect and preserve the natural environment and reduce the impact of development on the environment?
d) increasing the use of renewable, sustainable sources of energy and/or reducing the reliance on scarce non-renewable sources of energy?

Par excellence customer service
Does your organisation actively implement any policy to develop AND monitor par excellence customer service skills of employees (and contractors)?

Small Business and social savings
Does your organisation actively implement any policies to assist micro and small businesses and/or social savings and investments?
Does your organisation encourage through pro-active policies social savings for marriages, children?s education, community based programs or other social welfare programs?
Does your organisation encourage, through pro-active policies, family savings and investment?

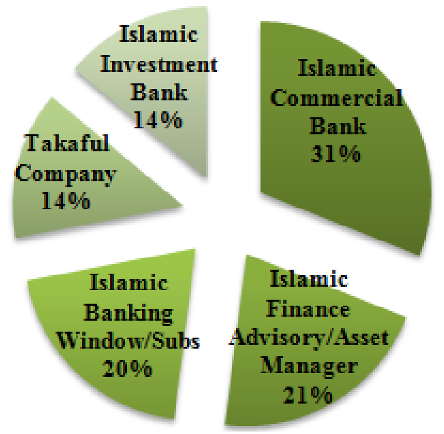
Charitable activities
Does your organisation have pro-active policies/support for charitable activities?
Does your organisation establish/admin. fundraising drives (emergency, other) from amongst its clients?
Does your organisation actively target groups, communities or institutions that require assistance, including and not limited to poor and needy individuals, orphans, heavily indebted individuals or families with unfortunate circumstances, health and medical services?

Management of Waqf properties
Does your organisation have pro-active support/policies to manage Waqf properties on behalf of their beneficiaries?

Source: (Farook & Shikoh, Social Responsibility Trends at Islamic Financial Institutions, 2010)

14.

Annex 14 - Distribution of IFI's by type & Distribution of IFI's by country



Source: Farook & Shikoh (2010)

Country	# Responses	% Responses
Algeria	1	3,45%
Bahrain	5	17,24%
Bangladesh	1	3,45%
Brunei	1	3,45%
Canada	2	6,90%
France	1	3,45%
Hong Kong	1	3,45%
Indonesia	1	3,45%
Iran	1	3,45%
Jordan	1	3,45%
Malaysia	3	10,34%
Pakistan	1	3,45%
Saudi Arabia	2	6,90%
Singapore	1	3,45%
South Africa	1	3,45%
Sudan	1	3,45%
Thailand	1	3,45%
Turkey	1	3,45%
UAE	3	10,34%
Total	**29**	**100,00%**

15. Ranking of Islamic Banks by Income and Assets in 2008

Annex 6 - IBs rankings by Income & Assets

Banks \ Criteria	Income	Assets
Al-Baraka Bank (Bahrain)	?	79
Abu Dhabi Islamic Bank (UAE)	14	25
Al-Rajhi Bank (KSA)	1	1
Bahrain Islamic Bank (Bahrain)	38	62
Dubai Islamic Bank (UAE)	6	10
Kuwait Finance House (Kuwait)	3	16
Shamil Islamic Bank (Bahrain)	57	53

Source: CIBAFI (2010)