ISLAMIC ECONOMIC STUDIES

Vol. 25 (Special Issue) Rajab 1438H (April 2017)

Articles

Exploring The Potentials of Diaspora *Ṣukūk* for OIC Member Countries
Abdou Diaw

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Ali Kafou
Ahmed Chakir

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Rashedul Hasan
Siti Alawiah Siraj

Ethical Banking and Islamic Banking A Comparison of Triodos Bank and Islami Bank Bangladesh Limited
Tariqullah Khan
Amiirah Bint Raffick Nabee Mohomed

Corporate Social Responsibility of Islamic Banks in Malaysia: Arising Issues
Wan Noor Hazlina Wan Jusoh
Uzaimah Ibrahim

Key Points from Conference Communique

Cumulative Index of Papers

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CONTENTS

Articles

Exploring The Potentials of Diaspora *Ṣukūk* for OIC Member Countries 1

Abdou Diaw

Is it costly to introduce SRI into Islamic portfolios? 23

Erragragui Elias

From Screening to Compliance Strategies: The Case of Islamic Stock Indices with Application on "MASI" 55

Ali Kafou
Ahmed Chakir

Toward Developing a Model of Stakeholder Trust in *Waqf* Institutions 85

Rashedul Hasan
Siti Alawiah Siraj

Ethical Banking and Islamic Banking A Comparison of Triodos Bank and Islami Bank Bangladesh Limited 111

Tariqullah Khan
Amiirah Bint Raffick Nabee Mohomed

Corporate Social Responsibility of Islamic Banks in Malaysia: Arising Issues 155

Wan Noor Hazlina Wan Jusoh
Uzaimah Ibrahim

Key Points from Conference Communique 173

Cumulative Index of Papers 177

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Vol. 25, No. Special Issue, April, 2017

Note to the Readers

This Special Issue of Islamic Economic Studies (IES) features selected papers from the 11th International Conference on Islamic Economics and Finance (11th ICIEF), which was held in Kuala Lumpur, Malaysia. The decision to bring out the special issue of IES comprising of some selected papers of the 11th ICIEF was taken to speed up the dissemination of research in Islamic Economics and Finance. This special issue of IES broadly covers two areas within Islamic finance: Socially Responsible Investment, and Corporate Governance. These two areas of research are crucial for the development of Islamic Finance sector. The socially responsible investment has experienced tremendous growth and change, while corporate governance is increasingly becoming an indispensable issue for Islamic financial institutions.

Other journals in the field were also encouraged to bring out their special issues. As a result, the Journal of King Abdulaziz University: Islamic Economics, the IIUM Journal of Economics and Management, and Economic Discourse all are issuing their respective special issues soon. These journals will be covering various other aspects of Islamic economics and finance in their pages. We are fully confident that the readers of the present special issue of IES will find the selected articles to be interesting. We hope that these efforts will contribute to further advancement of knowledge.

Editors

ARTICLES

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Exploring The Potentials of Diaspora *Ṣukūk* for OIC Member Countries

ABDOU DIAW•

Abstract

Diaspora bonds, for the issuing country, are believed to constitute a new source of external funding which is more stable and cheaper than the traditional instruments. For the investors, they represent an opportunity to meet, in a more efficient way, current liabilities in local currency back home, and to contribute to the development effort of the origin country by participating in the financing of infrastructure projects. With remittances inflow estimated at $136 billion, in 2014, the OIC member countries have at their disposal an untapped source of external funding as substantial as the Foreign Direct Investment and larger than the Official Development Assistance. This paper explores the adaptability of Diaspora bonds to the concept of Ṣukūk. The paper argues that the investors' base for Diaspora Ṣukūk is potentially wider than that of the Diaspora bonds in OIC countries and that it would positively impact the cost of capital for the issuing country. However, the success of Diaspora securities issuance largely depends on variables such as the size, the wealth, the level of education of the Diaspora as well as investors' trust in the issuing entity. The assessment of the OIC countries with respect to the above-mentioned factors reveal the existence of potential candidates. Thus, for the success of Diaspora Ṣukūk, the countries are encouraged to gather quality data on their Diaspora, to implement a well thought communication strategy, and to earmark the proceeds of Diaspora Ṣukūk to projects appealing to the Diaspora.

JEL Classification: G23, O16
KAUJIE Classification: K13, I14, I13
Key words: remittances, Diaspora *Ṣukūk*, external funding

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1. Introduction

The *Ṣukūk* market remains one of the most dynamic Islamic finance segments, in terms of geographic diversification as well as product development. Over the last two years newcomers from various regions in the world have entered the market. Hong Kong, the UK government, the Grand Duchy of Luxembourg and the Republic of South Africa, Senegal, Cote d'Ivoire are examples of countries that found in *Ṣukūk* a new financing instrument.

Besides this geographic expansion, the *Ṣukūk* market witnessed the emergence of innovative structures such as project finance *Ṣukūk*, amortizing *Ṣukūk*, export credit agency-based *Ṣukūk*, bank capital Tier 1/Tier 2 instruments and corporate hybrid *Ṣukūk* having both equity and 'debt'-like features (Ali, 2015). Moreover, the concept of *Ṣukūk* has been combined with other concepts to come up with innovative schemes in the use of *Ṣukūk* proceeds. Thus, in 2014 the International Finance Facility for Immunization Company (IFFIm) raised, through *Ṣukūk* issuance, US$ 500 million for children's immunization in the world's poorest countries through Gavi, the Vaccine Alliance. The transaction was considered as the first socially responsible *Ṣukūk* in the world. In the same logic, Malaysian Khazanah issued, in 2015, the first Ethical *Ṣukūk* (*Ṣukūk iḥsān*) whose proceeds were used to fund Sharī'ah-compliant eligible sustainable and responsible investment (SRI) projects.

With the growing importance of remittances inflows in the Organization of Islamic Cooperation (OIC) countries whose volume largely surpasses that of the Official Development Assistance (ODA), there is an opportunity to diversify the public source of funding. In fact, there already exist successful experiences of capturing part of the Diaspora wealth through the issuance Diaspora bonds.

The objective of this paper is therefore to explore the idea of adapting Diaspora bonds to the concept of *Ṣukūk*.

The following section discusses the potential economic contribution of Diaspora. The concept of Diaspora bonds, and their potential benefits are analyzed in the third section. The fourth section will look into the *Fiqh* issues as well as the operational ones related to the concept of Diaspora *Ṣukūk*. The conclusion provides a summary of the main findings and points out to a few recommendations.

2. Potential Economic Contribution of the Diaspora

Defined as people who have migrated and their descendents who maintain a connection to their homeland, Diaspora is gaining more consideration over last few years as one of the most important sources of funding for countries. According to Migrations and Remittances Factbook 2016, the number of international migrants rose from 175 million in 2000 to more than 247 million in 2013, or 3.4% of the world population, and will surpass 251 million in 2015.

Remittances are undeniably the most significant channel through which migrants positively impact the economy of their origin country.

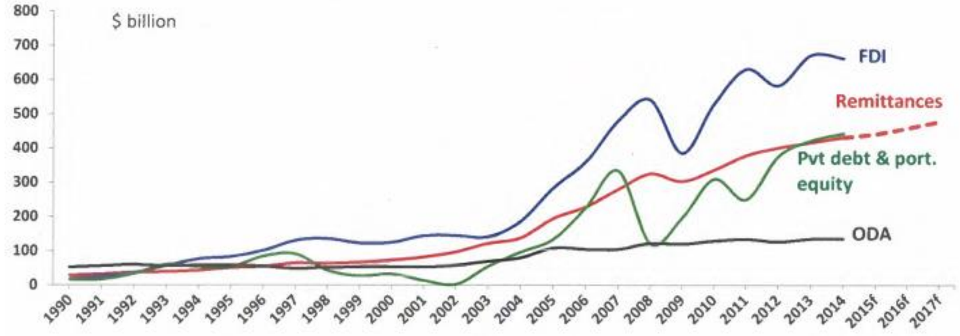
According to the International Monetary Fund (IMF) interpretation, remittances are recorded in three different sections of the balance of payments:

- Compensations of employees are the gross earnings of workers residing abroad for less than 12 months, including the value of in-kind benefits (in the current account, subcategory "income", item code 2310).
- Workers' remittances are the value of monetary transfers sent home from workers residing abroad for more than one year (in the current account, subcategory "current transfers", item code 2391).
- Migrants' transfers represent the net wealth of migrants who move from one country of employment to another (in the capital account, subcategory "capital transfers", item code 2431).

From less than $65 billion in the beginning of 1990s, worldwide remittance flows are estimated to have exceeded $601 billion, in 2015. The share of that amount received by the developing countries is estimated to about $441 billion, nearly three times the amount of official development assistance. The true size of remittances, including unrecorded flows through formal and informal channels, is believed to be significantly larger.

Graphs 1 as well as Table 1, while comparing remittance flows to developing countries to other external sources of funding, depict them as both substantial and stable. In addition to this, remittances are proven to be counter-cyclical, thus, providing buffer against economic shocks, as we will see later.

Graph 1: Remittances to developing countries versus other external financing flows.



Source: Migrations and remittances Factbook 2016

Table-1
Resources Flows to Developing Countries (in US $ billion)

	1990	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Remittances	29	73	194	229	280	325	303	336	378	401	416	431	441
FDI	19	125	284	361	480	541	385	529	630	583	671	662	-
ODA≠	53	54	108	105	105	123	121	129	135	127	135	135	-
Private debt & Portfolio equity	16	32	134	228	334	122	197	309	250	376	422	443•	-

≠OECD Development Assistance Committee (DAD) online database (http://www.oecd.org/dac)

• Estimated flow

Source: Migrations and remittances Factbook 2016

For the Organization of Islamic Cooperation (OIC) member countries, the stock of emigrants amounted to about 76 million in 2013 representing 31% of the world stock of emigrants and 43% of that of the developing countries. The remittances inflow to OIC member countries is estimated to $136 billion, in 2014, corresponding to 23% and 32% of the remittances inflow in the globe and to developing countries respectively. The amount is slightly lower than the net Foreign Direct Investment (FDI) received by OIC countries in 2013 ($140 billion) but largely higher than the net Official Development Assistance (ODA) they received in 2013 ($52 billion).

Table-2
Data Summary on Migrations and Resources Flow
OIC MC, Developing Countries, and World

	Population in 2014 (in million)	GDP in 2015 (in US$ trillion based on PPP)	Stock of emigrants in 2013 (in million)	Stock of emigrants as percentage of population in 2013	Migrant remittance inflows in 2014 (US$ million)	Net FDI inflow in 2013 (US$ million)	Net ODA received in 2013 (US$ million)
OIC MC	1693	17.1	76.7	4.5%	136170	140 640	52 240
Developing Countries	5 862	65.3	180	3.1%	431000	671 000	135 000
World	7 260	113.5	247.2	3.4%	593000	1 952 000	150 000

Source: author calculation based on Migrations and Remittances Factbook 2016

This massive amount of money into the OIC countries, if efficiently used, would be of great impact on their economy. Indeed, the literature discusses crucial issues such as effects of remittances on poverty, growth, and balance of payment.

Plaza and Ratha (2011) report findings on the important role of remittances in reducing the incidence and the severity of poverty. It is argued that remittances help households diversify their sources of income while providing a much needed source of savings and capital for investment. They are also utilized for basic consumption needs, investments in education, healthcare, and real estate. For example, a study carried out for the United Nations Conference on Trade and Development (UNCTD, 2011), shows that remittances significantly reduce poverty in recipient countries though the results are more reliable for countries with remittances greater than 5% of GDP.

This can be explained by the fact that, generally, remittances are either invested or consumed. When spent on entrepreneurial investment, they are proven to have positive and direct effect on employment and growth. On the other hand many studies show that remittances, even when not invested, can have an important multiplier effect. One remittance dollar spent on basic needs will stimulate retail sales, which stimulates further demand for goods and services, which then stimulates output and employment.

However, based on a few researches, remittances do not only have positive effects on the origin economy. If they generate demand greater than the economy's capacity to meet this demand, and if this demand falls on non-tradable goods, remittances can then have an inflationary effect. In Egypt, for example, the price for agricultural land rose between 1980 and 1986 by 600% due to remittances. Furthermore, it is suggested that remittances could encourage continued migration of the working age population and the dependence among recipients accustomed to the availability of these funds. All these would perpetuate an economic dependency that undermines the prospects for development (OECD, 2006).

The contribution of remittances to the receipt side of the origin country balance of payment is another facet of their economic impact. Remittances have the potential of offsetting chronic balance of payments deficits, through the reduction of foreign exchange shortage. Remittances are believed to have a more positive impact on the balance of payments than other monetary inflows (such as financial aid, direct investment or loans). The reasons are: they bear no interest and do not have to be repaid, and their use is not tied to particular investment projects with high import content. Moreover, as shown earlier, remittances are a much more stable source of foreign exchange than other external capital inflows and exhibit, for certain countries, an anti-cyclical character, in the sense that in difficult times, emigrants are more inclined to support the family back home, reflected through higher volume of remittances.

Nevertheless, the realization of these positive effects will depend on how the inflow remittances are spent or invested, as their effects on production, inflation and imports would be different. Thus, a crucial factor in this regard is the extent to which the additional demand induced by remittances can be met by expanding domestic output. Indeed, the flexibility with which domestic supply reacts to extra demand will determine whether remittances will have positive employment effects or adverse inflation effects, and whether additional imports will be necessary (OECD, 2006).

One channel used to mobilize migrant remittances to finance public sector spending is diaspora bonds which, though an old idea, are attracting more and more interest over the recent years. The following section discusses the concept of diaspora bonds and some aspects of its economics.

3. Diaspora Bonds: Concept, Benefits and Challenges

A Diaspora bond is a debt instrument issued by a country—or, potentially, a sub sovereign entity or even a private corporation—to raise financing from its overseas Diaspora (Ketkar and Ratha, 2011).

There is a growing interest in Diaspora bonds in the development finance literature. Many researchers have elaborated on their rationale, and benefits for the issuing entity as well as for the investors. The significant economic impact of Diaspora, as shown through the discussion in the previous section, helps in understanding this growing interest.

Diaspora bond is not a new concept. Indeed, Kayode and Spio (2012) report that the idea of tapping into migrant wealth goes back to the early 1930s with the Japanese and Chinese issuance of this innovative instrument. Their experiences were followed by Israel in the 1950s and later by India, in the 1990s. Thus, to undertake various development projects and support the occupation program in different events, Israel did have recourse to issuance of Diaspora bonds to mobilize close to $25 billion over the course of the last 30 years. From 1983 to 2003, Diaspora bonds represented 20-35% of Israel‘s outstanding external debt.

On the other hand, India rose funding from members of the Indian Diaspora in times of balance-of-payments weaknesses, through the State Bank of India (SBI). Thus, the SBI has issued Diaspora bonds on three separate occasions—India Development Bonds following the balance-of-payments crisis in 1991 (US$1.6 billion), Resurgent India Bonds following the imposition of sanctions in the wake of nuclear testing in 1998 (US$4.2 billion), and India Millennium Deposits in 2000 (US$5.5 billion) (Ketkar and Ratha, 2011).

Ethiopia has made many attempts to tap its emigrants' wealth through diaspora bonds with little success. For instance, the 2011 bond issuance aimed to mobilize funds from the Ethiopian diaspora to build a 5,250MW dam on the Nile River with an estimated cost of $4.8 billion. However, the objective is yet to be attained (Kayode and Spio, 2012).

Other countries such as Nigeria, Kenya, and Greece have expressed their intention to tap the Diaspora bonds market.

The literature on Diaspora bonds has put forth several of their benefits as rationale for their issuance and purchase.

For the issuing country Diaspora bonds constitute a new source of external funding more stable and, sometimes, cheaper than the traditional instruments.

Developing countries find it hard to get external funding, particularly in difficult time, where access to the financial markets becomes too stringent, in the one hand;

and on the other hand, the conditionalities of the multilateral financial institutions appear too rigid. In such situations, Diaspora can be of great support as it is shown, based on the previous experiences, that patriotism is the main motivation for purchasing Diaspora bonds. Taking into account the size and the stability of the remittances inflow to the developing countries (See Table 1), the potential of Diaspora as an alternative source of funds appears to be immense.

Another element related to the potential benefits of Diaspora bonds for the issuing country is associated to the issuance cost. Indeed, Ketkar and Ratha (2007) documented what they called 'patriotic discount' in pricing these bonds, indicating a lesser return to the investors as compared to other instruments with similar risk.

More interestingly for many developing countries, a lack of rating does not seem indispensable for the issuance of Diaspora bonds. In fact, experience shows that many Diaspora bond issuances were not tied to a rating. Even in the case of India where the country was downgraded in 1998 following the imposition of international sanctions, the success of Diaspora bond issuance in the same year and in 2000, was perceived as an attribute by Moody's and S&P (Kayode and Spio, 2012).

From the investors' perspective, this willingness to buy the Diaspora bonds even at premium translates their desire to contribute to the construction of the origin country by participating, for example, in the funding of infrastructure projects that will significantly impact the economic development of the country.

However, beyond patriotism, several other factors may also help explain diaspora interest in bonds issued by their home country. The principal among these is the opportunity such bonds provide for risk management. In fact, diaspora investors have current or contingent liabilities in their origin country. Therefore, they would be interested in having revenue generating assets that match those liabilities in local currency. According to study carried out by the common central bank of the West African Economic and Monetary Union (WAEMU), remittances inflow to this zone amounted to $3.85 billion in 2013. Of this, 54.6% were devoted to the households' consumption, 15.8% to real estate investment, 9.8% to education and healthcare expenses, and 5.5% to other investments (Kpégo and Gbenou, 2015). The uses of the received remittances in this region of the world can be considered as a proxy for developing countries. In this example, the figures show the importance of the size of current expenses such as, consumption, education, and healthcare, in the amount sent back by the emigrants to their country of origin. If these emigrants had the possibility of owning assets that generate regular revenues that meet part of their current liability, this would be preferable for them as in such a case they would not have to bear the costs related to sending back money.

Moreover, the default risk associated with Diaspora bonds, issued in local currency, is by far lower than if they were denominated in hard currency, since the ability of the issuing country to pay interest and principal in local currency terms is much stronger. Furthermore, Diaspora bonds give investors the opportunity to diversify their assets away from their adopted country (Ketkar and Ratha, 2011).

These are some of the benefits found in the literature on Diaspora bonds. Since they are a potential source of external funding, particularly for developing countries, it is, then, important to explore their adaptability to the concept of *Ṣukūk*. The rationale is to come up with innovative *Ṣukūk* structure that enables OIC member countries, which fall in the developing countries category, to take advantage of it. It is contended here that an Islamic financial instrument is potentially more acceptable than a conventional one in the context of Muslim countries because of the prohibition of *Ribā*, pari passu. It follows that the investors' base for Diaspora *Ṣukūk* is potentially wider than that of the Diaspora bonds in OIC countries and that would positively impact the cost of capital for the issuing country.

4. Exploring Diaspora *Ṣukūk*

In this section the possible underlying contracts for Diaspora *Ṣukūk* are analyzed. We discuss in the second subsection the factors are found crucial for the success of diaspora bonds issuance in the literature. Finally, the OIC countries are tested against the identified factors to determine those that more likely to succeed in issuing Diaspora *Ṣukūk*.

4.1. Which Underlying Contract for Diaspora *Ṣukūk* Issuance?

For the sake of simplicity we shall consider in this analysis the basic *Ṣukūk* structures which are based on either sale, lease or partnership contracts. As documented in the literature, the targeted investors for this type of instrument have generally three particular motivations: i) to meet current liabilities back home in local currency; ii) to contribute to the development effort for the origin country by participating in the financing of infrastructure projects; iii) risk management.

For those investors who are familiar to conventional bonds, lease-based *Ṣukūk* may look more attractive as they are tradable and can be structured in a way that mirrors bonds cash flows. However, many criticisms have been raised against those

Ijārah Ṣukūk that involve the sale and buy-back of existing assets as such a structure disconnects the financing activities from the productive ones. To better adhere to the spirit of Islamic finance it is preferable to earmark Diaspora *Ṣukūk* to well identified infrastructure projects. Such a stand has the advantage of enhancing the transparency of the operation and that will positively impact the investors' confidence as their money is being judiciously used for the benefit of the community.

Istiṣnā' Ṣukūk are undoubtedly suitable for developing infrastructure projects. Their unpopularity is mainly due to their non-tradability in the secondary market. Taking into account the above mentioned motivations of the potential Diaspora *Ṣukūk* investors, it appears that the tradability of the *Ṣukūk* is not a major issue for them. Therefore *Istiṣnā'* would be a suitable contract to issue Diaspora *Ṣukūk*.

The partnership based *Ṣukūk* involved the element of profit and loss sharing and are, in this regard, riskier than the *Ṣukūk* with predetermined return. Still with the proliferation of Build – Operate – Transfer (BOT) contracts for infrastructure development, one may consider that many investors would be willing to buy partnership-based *Ṣukūk* if the underlying asset projects are well designed. In particular, this would be true for the potential Diaspora *Ṣukūk* investors.

4.2. Factors to be considered for Diaspora *Ṣukūk* issuance

Given the pertinence of the idea of issuing Diaspora *Ṣukūk* it is useful to address a few practical issues crucial for the success of the operation. Part of the literature on Diaspora bonds drew a number of factors that need to be taken into account for a successful issuance, based on the previous experiences (See for example, Wenner, 2015).. Broadly, the factors can be classified into two main categories: the emigrants - related factors and the government related factors.

The emigrants - related factors cover variables such as the size, the wealth, and the level of education of the Diaspora that are certainly critical for the success of a Diaspora *Ṣukūk* issuance. This is so because the volume of Diaspora saving would positively influence the decision of purchasing the *Ṣukūk*. Moreover, given the low level of financial literacy in the Muslim world, the well - educated Diaspora members are more likely to participate in this investment.

This points out to the importance, for the government, to gather quality data on its Diaspora to get a clear picture on, for example, the size of the Diaspora, the income structure of its members, and their education level. Unfortunately, few governments have a complete mapping of their Diaspora, as documented by Plaza

(2009). The reason is data on Diasporas are mainly based on those who register with embassies. However, not only, such registration is incomplete, at best, but there is little coordination at the embassy or consular level when dealing with Diaspora. As a result, many governments have little knowledge of the locations of their Diaspora, and of how much members of their Diaspora earn, save, and invest.

Furthermore, a well thought communication strategy to reach the potential investors and increase their awareness of the benefits of Diaspora *Ṣukūk*, has been proven to be a key factor for the success of the issuance. In connection to this, it is suggested, in the literature, to open the sale of the instrument to all investors although the lion's share of marketing effort is channeled to the Diaspora (Kpégo and Gbenou, 2015).

The government-related factors inform about the ability of the government of a given country to succeed in exercises like issuing Diaspora securities.

As acknowledged in several studies on the determinants of investment in the financial markets, trust is one of the most important variables that influence investors' decision. Indeed, Ng et *al.* (2014) found that trust is a robust and positive determinant of stock market depth and liquidity and is, also, proven to be crucial for market development. The results are particularly true for non-OECD and OIC countries, characterized by weak rule of law. Thus, perception of transparency and good governance are key variables that enhance trust in a potential issuing entity and constitute, therefore, important factors to be considered when evaluating the likelihood for the success of Diaspora *Ṣukūk* issuance. In this regard, Kayode and Spio (2012) suggest earmarking the proceeds of Diaspora securities to projects appealing to the Diaspora such as infrastructure, housing and social amenities, as a possible way to address the issue of lack of transparency and mismanagement in the use of the proceeds.

4.3. Potential Issuers of Diaspora *Ṣukūk* Among OIC Member Countries

To identify the potential issuers from OIC countries we also consider the two above mentioned categories of factors as well as the willingness of the government authorities to use Islamic finance instruments for their investments.

For the emigrants-related factors we take the stock of emigrants as percentage of the population, the tertiary-educated as a percentage of the total emigrants in OECD countries, and remittances as a share of GDP as measures for the size, the level of education, and the wealth of the emigrants.

Similarly, we consider Corruption Perception Index (CPI) and Government Effectiveness Index (GEI) to gauge the government- related factors (See the detailed data in the Annex).

CPI has been published annually since 1995 by Transparency International to rank countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys. In the context of the CPI, corruption is defined as 'the misuse of public power for private benefit'.

On the other hand, GEI reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

Finally, to assess the willingness of a given government to use Diaspora *Ṣukūk* we examine whether it has already issued *Ṣukūk* or is reforming it regulatory framework for that purpose.

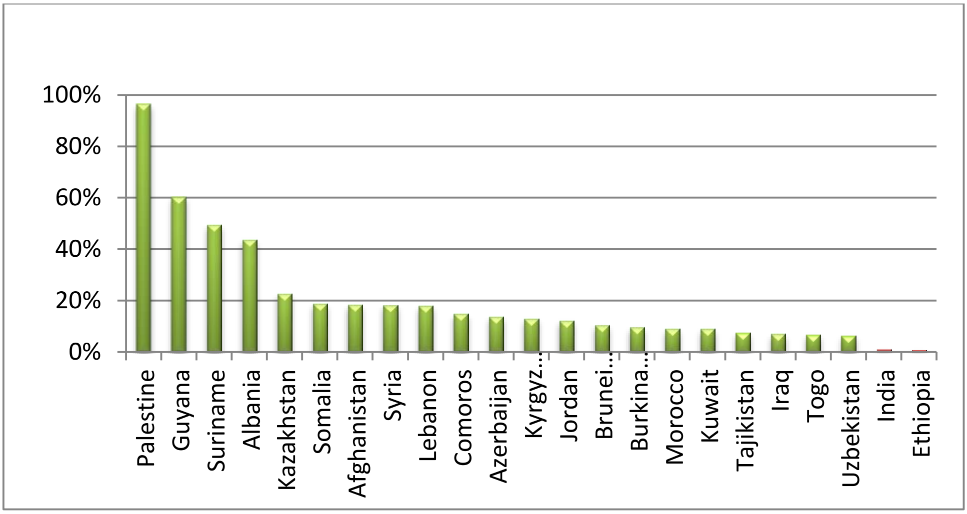
India and Ethiopia, two countries that have already issued Diaspora bonds, are brought in the analysis for benchmark purposes. While the former's experiences were successful, the latter is yet to find out its way in this new market.

For the simplicity of the analysis, we consider the ranking of the top 20 OIC countries, as compared to India and Ethiopia, for the above mentioned factors.

Figures 1 to 3 concern the emigrants – related factors. Except for the level of education – related factor, where India outperforms all OIC countries, the top 20 score better than India and Ethiopia relatively to the variables associated to the size and the income of the emigrants.

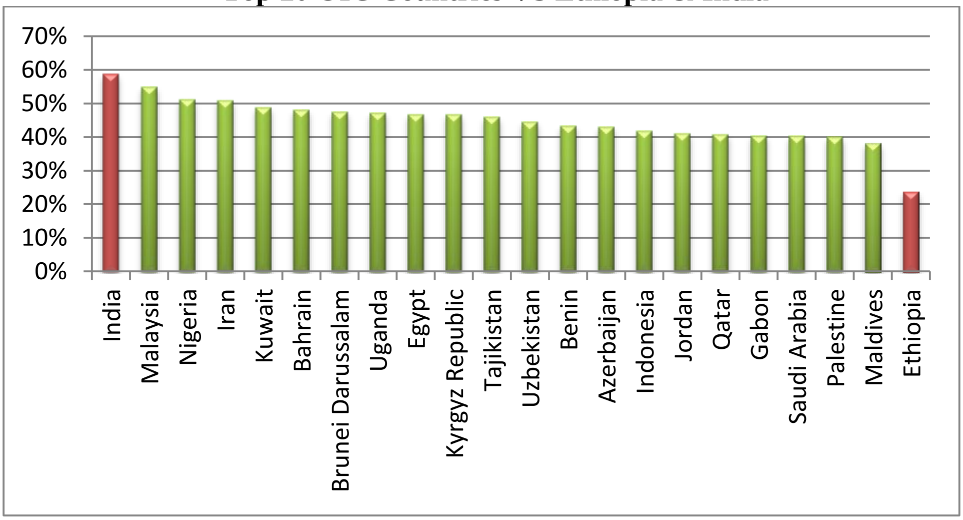
A few countries are ranked in the top 20 for all the three factors considered. That is the case for Jordan, Tajikistan, Kyrgyzstan, and Uzbekistan. For these countries, and for all those which are close to them, it can be inferred that their respective governments have potential new source of external funding. Therefore, they need to implement pertinent policies to take advantage of this opportunity.

Figure-1
Stock of Emigrants as Percentage of Population in 2013 - Top 20 OIC Countries VS Ethiopia & India



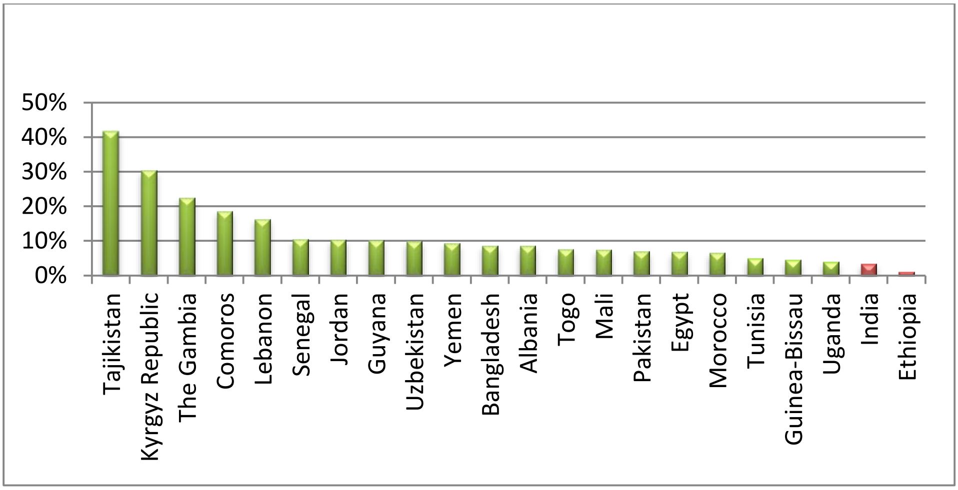
Source: Author's calculations based on data from Migrations and Remittances Factbook 2016.

Figure-2
Tertiary-Educated as % of Total Emigrants in OECD in 2011 - Top 20 OIC Countries VS Ethiopia & India



Source: Author's calculations based on data from Migrations and Remittances Factbook 2016.

Figure-3
Remittance as a Share of GDP in 2014 –
Top 20 OIC Countries vs Ethiopia & India



Source: Author's calculations based on data from Migrations and Remittances Factbook 2016.

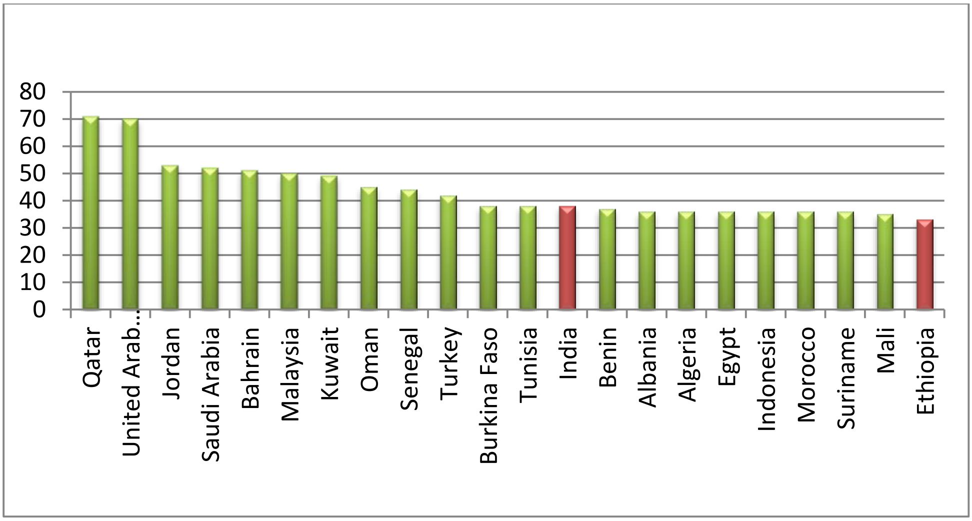
It is worth noting that the total external debt stock of OIC countries reached US$ 1.5 trillion in 2014 and the corresponding average debt-to-GDP, for the indebted OIC countries, was 22% in 2014. For the sake of comparison, the total external debt stock of OIC countries as percentage of total developing countries debt was 28.2% in 2014.

On the other hand, the world total monetary reserves, including gold, reached US$ 10.6 trillion in 2015, of which US$ 1.5 trillion are owned by OIC countries. It may be useful to point out that the share of OIC countries in total reserves of the developing countries declined from 23.6% in 2013 to 21.7% in 2015 (SESRIC, 2016).

Figures 4 and 5 correspond to the government – related factors. All the top 20 OIC countries outperform Ethiopia. However, for India the results are mixed. All the six (6) Gulf Cooperation Council (GCC) countries score better than India in both factors of this category. But if we look back to Figure 3, it appears that none of the GCC countries is ranked among the top 20, and for Figure 1, only Kuwait is ranked. This suggests that citizens from GCC are not emigrating for economic (poverty) reasons; hence, instead of sending money back home those pursuing their studies abroad do receive financial support either from the government or from families.

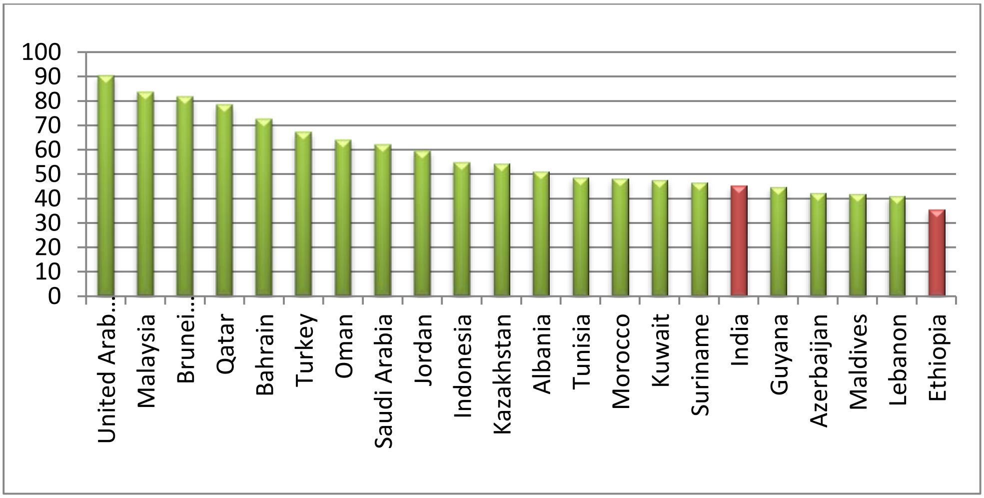
Again, Jordan is only OIC country which outperforms India for all variables.

Figure-4
Corruption Perception Index 2015 -
Top 20 OIC Countries vs Ethiopia & India



Source: Author's calculations based on data from Corruption Perception Index of Transparency International.

Figure-5
Government Effectiveness Index 2014 (Percentile Rank)-
Top 20 OIC Countries vs Ethiopia & India



Sources: Author's calculations based on data from World Governance Indicators.

If we factor in the willingness of a government to use *Ṣukūk* as an instrument for external funding, we find interesting profiles that would be potential issuers of Diaspora *Ṣukūk* in the medium term. We can mention as examples: Jordan, Senegal, Tunisia, Morocco, Algeria, Azerbaijan, Egypt, and Indonesia.

There are other countries with substantial volume of remittances and strong interest in Islamic finance which need, however, to improve their performance in the government-related factors to consider issuing Diaspora *Ṣukūk*. As examples we have: Pakistan, Bangladesh, Uganda, Mali and Nigeria[1]. The issue can be addressed by, for example, setting up an independent agency to handle all operations associated to the Diaspora *Ṣukūk*.

5. Conclusion

In this paper we have explored the pertinence of Diaspora *Ṣukūk* as a new instrument for public funding. Indeed, given the evolution of the volume of remittances flows worldwide, Diaspora is gaining more consideration, over the last few years, as one of the most important sources of funding for countries.

It is acknowledged that remittances are much more stable source of foreign exchange than other external capital inflows and, if efficiently used, have the potential of reducing the severity of poverty, and offsetting chronic balance of payments deficits.

Diaspora bonds, as a mean to take advantage of remittances, are believed to constitute for the issuing country a new source of external funding more stable and, sometimes, cheaper than the traditional instruments. For the investors, they represent an opportunity to meet, in a more efficient way, current liabilities in local currency back home and to contribute to the development effort for the origin country by participating in the financing of infrastructure projects.

A few countries have taken advantage of this opportunity through the issuance of Diaspora bonds.

With remittances inflow estimated to $136 billion, in 2014, corresponding to 23% of the remittances inflow in the globe, the OIC member countries have at their

[1] Countries such as : The Gambia, Yemen, and Lebanon are excluded in the analysis, despite their potential because of some issues pertaining to political Stability, and violence.

disposal an untapped source of external funding as substantial as the FDI and larger than the ODA.

We argued that the investors' base for Diaspora *Ṣukūk* is potentially wider than that of the Diaspora bonds in OIC countries and that would positively impact the cost of capital for the issuing country. However, the success of Diaspora securities issuance largely depends on variables such as the size, the wealth, the level of education of the Diaspora as well as investors' trust in the issuing entity.

The assessment of the OIC countries with respect to the above mentioned factors revealed potential candidates such as Jordan, Senegal, Tunisia, Morocco, Algeria, Azerbaijan, Egypt, and Indonesia. Other countries like Pakistan, Bangladesh, Uganda, Mali and Nigeria have substantial volume of remittances and strong interest in Islamic finance, but need to improve their performance in the government-related factors to consider issuing Diaspora *Ṣukūk*.

Based on the aforementioned findings, here are some recommendations:

- it is important, for the government, to gather quality data on its Diaspora to get a clear picture on, for example, the size of the Diaspora, the income structure of its members, and their education level;
- a well thought communication strategy to reach the potential investors and increase their awareness of the benefits of Diaspora *Ṣukūk*, has been proven to be a key factor for the success of the issuance;
- to address the issue of lack of transparency and mismanagement in the use of the proceeds, we suggest to earmark the proceeds of Diaspora *Ṣukūk* to projects appealing to the Diaspora such as infrastructure, housing and social amenities.

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ANNEX

	Factors related to the quality and quantity of the emigrants								Factors related to Governments	
	Population in 2014 (in million)	Stock of emigrants in 2013 (in million)	Stock of emigrants as percentage of population in 2013	Tertiary-educated as a percentage of total emigrants in OECD countries in 2011 (%)	Remittances as a share of GDP in 2014 (%)	Migrant remittance inflows in 2014 (US$ million)	Net FDI inflow in 2013 (US$ million)	Net ODA received in 2013 (US$ million)	Corruption Perception Index 2015	Government effectiveness index, 2014 (percentile rank)
Afghanistan	31.6	5.632	18.4%	21.6%	3.1%	636	40	5270	11	8.2
Albania	2.9	1.264	43.6%	9.9%	8.5%	1 142	1250	300	36	51.2
Algeria	38.9	1.784	4.7%	20.3%	0.9%	2 000	1690	210	36	33.7
Azerbaijan	9.5	1.287	13.7%	42.9%	2.5%	1 846	2620	60	29	42.3
Bahrain	1.4	0.062	4.6%	48%			990	-	51	72.6
Bangladesh	159.1	7.572	4.8%	35.1	8.6%	14 969	1910	2670	25	21.6
Benin	10.6	0.487	4.7%	43.2%	2.4%	208	360	650	37	34.1
Brunei Darussalam	0.417	0.043	10.5	47.5%			780	-		81.7
Burkina Faso	17.6	1.643	9.6%	21.5%	0.9%	120	490	1040	38	30.8
Cameroon	22.8	0.361	1.6%	37.4%	0.8%	244	550	740	27	23.1
Chad	13.6	0.404	3.1%	37.9%			540	400	22	5.8
Comoros	0.77	0.111	14.8%	13.4%	18.6%	126	10	80	26	1.9
Côte d'Ivoire	22.2	1.02	4.7%	27.3%	1.1%	373	410	1260	32	21.2
Djibouti	0.876	0.015	1.7%	31.1%	2.3%	36	290	150	34	16.3
Egypt	89.6	3.386	3.9%	46.7%	6.8%	19 570	4190	5510	36	20.2
Gabon	1.7	0.0489	3.0%	40.3%			970	90	34	26.4
The Gambia	1.9	0.071	3.8%	19.2%	22.4%	181	40	110	28	28.4
Guinea	12.3	0.398	3.3%	20%	1.4%	93	0	500	25	11.1
Guinea-Bissau	1.8	0.091	5.2%	11.7%	4.5%	46	200	100	17	4.8
Guyana	0.764	0.463	60.2%	30.7%	10.2%	328	200	100	29	44.7

			Factors related to the quality and quantity of the emigrants						Factors related to Governments	
	Population in 2014 (in million)	Stock of emigrants in 2013 (in million)	Stock of emigrants as percentage of population in 2013	Tertiary-educated as a percentage of total emigrants in OECD countries in 2011 (%)	Remittances as a share of GDP in 2014 (%)	Migrant remittance inflows in 2014 (US$ million)	Net FDI inflow in 2013 (US$ million)	Net ODA received in 2013 (US$ million)	Corruption Perception Index 2015	Government effectiveness index, 2014 (percentile rank)
Indonesia	254.5	4.117	1.6%	41.7%	1.0%	8 551	23280	50	36	54.8
Iran	78.1	1.605	2.1%	50.9%	0.30%	1 330	3050	130	27	38
Iraq	34.8	2.37	7.0%	26.4%	0.1%	271	5130	1540	16	13.9
Jordan	6.6	0.782	12.1%	41.1%	10.3%	3 701	1750	1410	53	59.6
Kazakhstan	17.3	3.827	22.5%	14.9%	0.1%	242	9950	90	28	54.3
Kuwait	3.8	0.323	9.0%	48.8%	..	4	1430	-	49	47.6
Kyrgyz Republic	5.8	0.738	12.9%	46.6%	30.3%	2 243	760	540	28	18.8
Lebanon	4.5	0.811	18.0%	37.8%	16.3%	7 446	2880	630	28	40.9
Libya	6.3	0.147	2.3%	29.6%			700	130	16	2.9
Malaysia	29.9	1.683	5.7%	54.9%	0.5%	1 565	11300	120	50	83.7
Maldives	0.357	0.001	0.4%	38.1%	0.1%	3	360	20		41.8
Mali	17.1	0.896	5.4%	13.4%	7.4%	895	310	1390	35	14.4
Mauritania	4,00	0.136	3.5%	16.6%			1130	290	31	15.9
Morocco	33.9	3.04	9.1%	15.7%	6.6%	7 053	3360	1970	36	48.1
Mozambique	27.2	0.727	2.7%	32.3%	0.7%	118	6700	2310	31	24
Niger	19.1	0.29	1.6%	35.9%	1.9%	152	720	770	34	23.6
Nigeria	177.5	1.118	0.6%	51.2%	3.7%	20 921	5560	2530	26	11.5
Oman	4.2	0.024	0.6%	32.6%	0.05%	39	1630	-	45	63.9
Pakistan	185,00	6.17	3.4%	36.1%	6.9%	17 066	1330	2170	30	22.1
Palestine	4.3	4.018	96.4%	39.9%			190	2610		32.2
Qatar	2.2	0.02	0.9%	40.7%	0.2%	499	840	-	71	78.4
Saudi Arabia	30.9	0.292	1.0%	40.2%	0.04%	269	8860	-	52	62
Senegal	14.7	0.54	3.8%	19.3%	10.4%	1 614	310	980	44	38.9

	Factors related to the quality and quantity of the emigrants								Factors related to Governments	
	Population in 2014 (in million)	Stock of emigrants in 2013 (in million)	Stock of emigrants as percentage of population in 2013	Tertiary-educated as a percentage of total emigrants in OECD countries in 2011 (%)	Remittances as a share of GDP in 2014 (%)	Migrant remittance inflows in 2014 (US$ million)	Net FDI inflow in 2013 (US$ million)	Net ODA received in 2013 (US$ million)	Corruption Perception Index 2015	Government effectiveness index, 2014 (percentile rank)
Sierra Leone	6.3	0.336	5.4%	33.7%	1.4%	68	380	440	29	10.6
Somalia	10.5	1.921	18.7%	13.8%			110	990	8	0
Sudan	39.4	1.508	3.9%	31.7%	0.5%	343	1690	1160	12	3.8
Suriname	0.538	0.263	49.4%	17.2%	0.2%	10	140	30	36	46.6
Syria	22.2	3.971	18.2%	34.2%		1 623	-	3630	18	6.7
Tajikistan	8.3	0.608	7.5%	45.9%	41.7%	3 854	50	380	26	22.6
Togo	7.1	0.461	6.7%	31.4%	7.6%	345	200	220	32	9.6
Tunisia	11,00	0.671	6.2%	19.9%	4.9%	2 291	1060	710	38	48.6
Turkey	75.9	3.110	4.1%	8.9%	0.14%	1 128	12460	2740	42	67.3
Turkmenistan	5.3	0.25	4.8%	35.4%	0.07%	34	3080	40	18	17.8
Uganda	37.8	0.406	1.1%	47.1%	3.9%	1 029	1100	1690	25	38.5
United Arab Emirates	9.1	0.157	1.7%	31.4%			10490	-	70	90.4
Uzbekistan	30.8	1.913	6.3%	44.5%	9.9%	6 206	690	290	19	27.4
Yemen	26.2	1.269	5.0%	14.4%	9.3%	3 343	130	1000	18	7.2
OIC MC	1692.8	76.7	4.5%			136169,9	140 640	52 240		
India	1 295	13.885	1.1%	58.7%	3.4%	70389	28 150	2 440	38	45.2
Ethiopia	97	0.749	0.8%	23.7%	1.1%	624	95	3 830	33	35.6
Developing countries	5 862	180	3.1%	25%		431	671 000	135 000		
World	7 260	247.2	3.4%			593	1 952 000	150 000		

Sources: Author's calculations based on Migrations and Remittances Factbook 2016 data for remittances, Transparency International for Corruption Perception Index, and World Governance Indicators for percentile of government effectiveness, and World Bank database for GDP in nominal terms.

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Is it Costly to Introduce SRI into Islamic Portfolios?

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Abstract

Could Environmental, Social and Governance (ESG) performance be a criterion for Islamic investment? The development of socially responsible investment (SRI) has challenged the ethical approaches associated with Islamic investment as a means to promote social achievements. Noting similarities with the positive screening approach, we investigate the integration of ESG criteria, into Islamic portfolios using KLD social ratings. This research seeks to determine the financial price of being both Sharī'ah-compliant and socially responsible. We examine the financial performance of self-composed Islamic portfolios with varying ESG scoring. The results indicate no adverse effect on returns due to the application of Islamic and ESG screens, with a substantially higher performance for positive screening on governance during post subprime crisis' period. Significant outperformance still arises for portfolios with bad records in community and human rights though. Performances are controlled for market sensitivity, investment style, momentum factor and sector exposure.

JEL Classification: G11
KAUJIE Classification: I23, I41
KEYWORDS: socially responsible investing (SRI), Islamic investing, ESG scorings, corporate social responsibility (CSR), portfolio management.

1. Introduction

In 2013, a report by Human Rights Watch revealed systematic "ethnic cleansing" of the Rohingyas Muslim minority and massive human rights violations

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perpetrated by Burma's oppressive military government over the course of more than a decade[1]. Implicated in these egregious crimes were oil companies active in the region, such that Unocal (a subsidiary of the Chevron group) which was named in a civil lawsuit in U.S. federal court. In response socially conscious investors and sustainable index providers have excluded Chevron from their investment universes. From another perspective, even though Islamic investors promise that their primary objective when entering markets is compliance with Islamic ethics, controversial firms such as Chevron often appears prominently in Islamic indexes[2]. Modern investment processes and increasing use of extra-financial information render appreciation of firms' ethics in portfolios management less costly. As such, evidences of multinationals' social and environmental controversies challenge current Islamic investment's ability to address unethical behaviour.

Unlike conventional types of investments, socially responsible investment (SRI) applies a set of investment screens to exclude or include stocks on the basis of environmental, social and corporate governance (ESG) criteria, and often engages in local communities and in shareholder activism to further corporate strategies towards the above aims (Renneboog et al., 2008a). In Islamic investment, screening practices are limited to exclusion related to religious and normative prescriptions (Miglietta and Forte, 2007). Islamic investment refers to an investment practice that conforms with the Sharīʻah [3] whose guidelines and principles govern several aspects of investment practices, including portfolio allocation, trading practices and income distribution (Girard and Hassan, 2008). That is, fund managers establish industry and financial screens[4] to ensure the final portfolio's compliance with Islamic legal prescriptions.

Islamic asset management sector has come a long way from the appearance of the first Islamic fund several decades ago. This niche market was estimated at $ 62 billion in 2014 by Reuters[5], still minimal in comparison with the assets of SRIs, for which assets in socially screened portfolios climbed to $ 10.4 trillion at the start of 2010 for the European and U.S market that represent the two core SRI markets[6].

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[1] The full report is available at http://www.hrw.org/sites/default/ files/reports/Burma 0413webwcover_0.pdf.

[2] We can mention for instance the case of Dow Jones Islamic Market and MSCI Islamic index series.

[3] Sharīʻah is usually referred to as Islamic law, but it also embodies a more global meaning that encompasses all the ethical moral and legal principles governing all aspects of a Muslim's life.

[4] The first stage or industry screening relates to the main activity of a company and the second stage or quantitative screening refers to debt leverage, liquidity ratio and interest exposure.

[5] Figure extracted from Reuters' Global Islamic asset management Report published in 2014.

[6] Figure extracted from the USSIF and European SRI Study 2012 reports.

Islamic finance and SRI movement share obvious similarities in their objectives and claims (promotion of social welfare through an emphasis on ethics). Several studies have highlighted the compatibility of Islamic ethics and classical business ethics theory that served as foundational sources for SRI current practices (Rice, 1999; Beekun and Badawi, 2005; Brammer et al., 2007; Dusuki and Abdullah, 2007; Dusuki, 2008; Williams and Zinkin, 2010). Their conclusions suggest that a strategy that only focuses on excluding “sin” activities is not sufficient to comply with all the ethical and social guidelines prescribed by Islamic sources, pledging for the integration of ESG indicators into Islamic investment process. Although Islamic finance and SRI appear to trigger the same expectations among their proponents of being more ethical than conventional finance, they also face criticisms of not being able to tie to these expectations, as suggested by the “form-over-substance” issue in Islamic finance and the “green-washing” debate in SRI (Hayat, 2013). A survey conducted among Islamic finance practitioners revealed that 98.8% of respondents believed that promoting social responsibility in financial transactions would create value for Islamic financial institutions (Sairally, 2007). The author of the survey concluded that Islamic investment could further “learn from the more proactive engagement practices of SRI funds whereby they encourage companies to be more responsive to society’s expectations”.

Despite these calls for reconciliation, no serious attempt has been made to combine these two ethical investing styles in a single investment process (Hayat, 2013). This research intends to fill up this gap by examining the effect of positive ESG criteria in Islamic investment process.

Accordingly, we apply varying ESG screens to an Islamic stock universe and specify whether Islamic socially responsible portfolios vary in their performance and investment styles. Due to differences in sector exposure between Islamic and SRI investments, we test the robustness of the results using an industry-adjusted measurement model.

From a practical point of view, this research provides new diversification perspectives for funds managers that seek to increase their performance while adjusting for diversification risk. Additionally, by proofing the financial merit of SRI initiatives, our research may provide arguments for the promotion of CSR guidelines by Islamic finance regulatory institutions[7].

[7] Such as AAOIFI or IFSB

In the next section we present the theoretical background that served to derive our hypothesis and frame our empirical analysis. In the second section we describe the methodological settings of the study. In a third section we report the results and test their robustness. In the last section we discuss the major findings of our research and conclude.

2. Literature Review

This section reviews the literature on the performance and characteristics of SRI and Islamic investment as compared to unrestricted traditional investment portfolios. It gives a general view on the impact of applying SRI and Islamic screenings on the risk and return and investment style characteristics of funds or portfolios.

2.1 The Effects of Ethical Screening on Portfolios' Performance

2.1.1 Performance of Islamic Portfolios

The resilience observed by Islamic financial market during the last "subprime" crisis has triggered the interest of many researchers. Previous findings suggest that Sharīʻah screening criteria do not seem to provide inferior performance. Among the pioneering works we can mention those of Wilson (2001) and Ahmad (2001) who find that Islamic mutual funds are financially viable. Later on, Hakim & Rashidian (2004) used a co-integration technique to compare the performance of the Dow Jones Islamic Market Index (DJIMI) with Wilshire 5000 Index using data for period 1999 to 2002. Their findings show that on a risk-return basis, there is no loss from the screening process used for DJIMI stocks, and Islamic investors are not worse off by investing in an Islamic index as a subset of a much larger market portfolio. Similarly, Elfakhani & Hassan (2005), Abderrezak (2008) and Hayat & Kraeussl (2011) note that, on average, there is no statistically significant difference between the risk adjusted performance of Islamic equity mutual funds and their Islamic and conventional market benchmarks. Confirming previous studies' conclusions, Hoepner, Rammal & Rezec (2011) show that, in general, Islamic equity mutual funds do not significantly underperform their international benchmarks when its home economy account for a high Muslim population, in addition of being a relatively well developed market for Islamic financial services (e.g. Malaysia, UAE, Bahrain). However, the authors find that in non-Muslim countries, Islamic mutual funds tend to underperform compared to their market benchmarks.

From another perspective, Hussein & Omran (2005) suggest that Islamic indexes provide positive abnormal returns over the January 1996 – March 2003 period. Their study reveals that Islamic indexes performed well during the bull market period (January 1996 - March 2000) but they underperformed their index counterparts over the bear market period (April 2000 – July 2003). The authors explain that technology sector firms are responsible for the Islamic index positive abnormal returns. Small size, basic materials, consumer cyclicals, industrial and telecommunication firms turn out to be the dominant drivers. On the opposite, using the case of liquor firms that exhibited good performance despite the recent global recession, some have argued that excluding significant chunks of business from Islamic portfolio exposes a fund to losing out in overall performance. However the authors point out that in the recent global recession and on several occasions before the collapse of high-profile firms such as WorldCom and Enron, the DJIMI was able to detect signs of corporate distress and excessive indebtedness and eliminate those stocks from their constituents.

More recently, Forte & Miglietta (2007) offered a quantitative and qualitative comparison of Sharīʻah-compliant and SRI funds' investment styles and also perform a co-integration analysis. They reveal that Islamic and SRI funds exhibit different characteristics in terms of asset allocations, econometric profiles, and sector exposure. Islamic indices are found to be more oriented towards growth[8] and small-cap stocks, whereas SRI indices are more oriented towards value and large-caps.

Few studies have attempted to review the screening methodologies of Islamic Investments. A study conducted by Derigs & Marzban (2008) helped to examine the different screening approaches adopted by the providers of Islamic indexes. They touch on some points that are crucial to the development and expansion of the Islamic fund management industry. Indeed, the authors revealed the inconsistencies of Sharīʻah scholars in their screening approaches. Precisely, one firm could be considered Sharīʻah compliant for one index and non-Sharīʻah compliant for another. This discrepancy arises from the fact that the index providers use different threshold and ratios to exclude non-Sharīʻah compliant stocks from their universe. Arguably, the authors conclude that "mathematical formalism may not be able to fully account for the subtitle and subjective interpretation of the Islamic sources" and that "the effect of bundles of such formal constraints may be too complex to be anticipated on every possible asset universe". The latter conclusion provides

[8] Also confirmed by (Walkshaeusl and Lobe, 2012)).

justification for the need of reviewing the current Sharīʻah-compliance methodologies from a conceptual and a practical setting.

In fact, our review of the literature reveals that despite the clear prohibition of interest-based, speculative and "illicit" activities, no uniform Sharīʻah-compliant criteria has been set through a general consensus of scholars. Indeed, Islamic jurisprudence allows for diversity and flexibility in rulings that regard mundane affairs[9]. Each ruling should be specific to a context. Therefore, each IFI has its own Sharīʻah committee in charge of defining the appropriate set of guidelines based on its specific context[10]. Besides the criticisms regarding the lack of consistency of Sharīʻah-compliance methodologies, many researchers also express a common view that any Islamic investment screening process should emphasize both negative and positive screening criteria to invest in companies that make positive contributions to the society and avoid investing in companies that cause any harm (Dar Al Istithmar, 2010).

2.1.2. The Adverse Effect of Islamic Portfolio Selection

Another argument for the merit of incorporating ESG screening into Islamic investment could be found in the literature focusing on the corporate social performance (CSP) - corporate financial performance (CFP) link. The findings brought up by this literature suggest the existence of a double adverse effect of Islamic financial screenings.

The first one can be identified as a social adverse effect. Indeed, some authors found that ESG screening affects stock returns by increasing the market-to-book ratio (Galema et al., 2008) which suggest that socially responsible firms tend to have a higher market-to-book ratio than their non-socially responsible peers. When looking at Sharīʻah-compliant screening process, we find that some fund managers use firms' book value (i.e. total assets) to calculate the acceptable level of debt, cash and receivable of Sharīʻah-compliant firms. In a call for revising the current criteria for compliance, some researchers rejected the use of market capitalization, perceived to be inappropriate, in favor of balance sheet items, notably total assets (Khatkhatay and Nisar, 2007). However, CSP-CFP theory's evidence suggests quite the opposite. Therefore, we argue that relying exclusively on accounting

[9] The juristic discipline related to mundane affairs is referred as *fiqh mu'amalat* in Islamic scholarship.
[10] For instance a practice can be rejected in a particular context and tolerated in other conditions. Islamic jurisprudence usually quotes the example of a famished man in the desert that has no other choice than eating pork to avoid dying from starvation. In such critical situation referred as *darurat*, prohibited practices can become tolerated and even obligatory to preserve human life.

measure to estimate the economic value of a firm may lead Islamic fund managers to screen out companies with good CSP that tend to have a higher market to book ratio. Indeed, corporate intangible assets are proven to be linked to high ESG standards. For instance, a study focusing on environmental performance concluded that legally emitted toxic chemicals have a significant effect on the intangible asset value of publicly traded companies (Konar and Cohen, 2001). From a general perspective, studies on intangible assets suggest that traditional financial reports do not fully reflect a firm's value (Lev and Zarowin, 1999; Xu et al., 2007; Edmans, 2012). In today's high tech environment, firm's intangible and knowledge-based assets become a significant determinant of firms' social and economic performance. Intangible resources such as employee satisfaction, employee knowledge and innovation commitment, firm culture and reputation are often associated with CSP and can also represent invaluable assets to the firm (Branco and Rodrigues, 2006).

The second adverse effect deals with long term financial performance. While accounting information indicates a firm's current financial position, it does not necessarily reflect the firm's ability to increase or maintain its CFP in the future. For instance, Rogers, Choy and Guiral (2013) recently found that investors' perception of a firm's corporate social responsibility (CSR) efforts and its investment in innovation play a significant role in predicting a firm's long-term performance. Hence an Islamic index provider that uses a total-assets-based screening strategy (e.g. MSCI) will systematically exclude companies from intellectual property sensitive sectors from its asset universe which means the exclusion of assets with potentially good ESG standards and good return and risk profiles.

This double adverse effect provides another justification for a critical review of current Sharīʻah-compliance screening process found to be inappropriate both from an ethical perspective (Khatkhatay and Nisar, 2007) and from an economic viewpoint (Khatkhatay and Nisar, 2007; Derigs and Marzban, 2008). Since the adoption of total-assets based screening in Islamic portfolio selection disadvantage firms with the best ESG standards, a new portfolio selection strategy that includes positive ESG screenings is likely to mitigate the adverse effect produced by traditional Sharīʻah-compliant screenings.

2.1.3. The Effect of a Multiple and Transversal Screening Approach

Despite the classical argument suggesting that a reduction in stock universe due to the act of screening should impose an additional set of constraints to the optimization problem faced by the return-maximizing investor (Markowitz, 1952), arguments for the merits of increasing the number of ethical screens used to compose SRI portfolios appear in many studies (Barnett and Salomon, 2006; Kempf and Osthoff, 2007; Capelle-Blancard and Monjon, 2011; Humphrey and Lee, 2011). In these studies, the authors investigate the relationship between the number of ethical screens, defined as screening intensity, and mutual fund performance. Barnett & Salomon (2006) demonstrate the presence of a curvilinear relationship, such that performance suffers with low screening intensity, and then increases with intensified screening (i.e., as the number of social screens used by an SRI fund increases). Capelle-Blancard & Monjon (2011) also note that greater strategy distinctiveness is associated with better financial performance; the negative effects of transversal (also referred as positive or best in class) screens are less significant than those of sectoral (also referred as negative or exclusion) screens. Humphrey & Lee (2011) find weak evidence that funds with more screens overall provide better risk-adjusted performance but conclude that positive ESG screening significantly reduces funds' risk. These empirical findings thus provide strong arguments for the superior positive effect expected from a transversal screening approach based on positive ESG indicators. Another argument could be found in the study conducted by Statman & Glushkov (2009). The authors find that investors beneficiate from a better return advantage of tilts toward stocks of companies with high ESG scores but offset this advantage by the return disadvantage that comes from the exclusion of stocks of banned sectors. Considering all the arguments presented in the previous sub-sections, we formulate the following hypotheses:

H1a.Islamic portfolios with high ESG scores perform better than traditional Islamic portfolios.
H1b.Islamic portfolios with high ESG scores perform better than Islamic portfolios with poor ESG scores.

2.1.4 The Investment Style of SRI and Islamic Investment

Most of previous studies find that Sharīʻah and ESG screening processes tend to impact the investment style of the investment portfolios compared to their unrestricted conventional counterparts. Girard & Hassan (2005; Girard and Hassan, 2008) and Abderrezak (2008) show that Islamic investment portfolios seem to be more exposed to small and growth companies. Studies by Forte & Miglietta (2007) and Walkshaeusl & Lobe (2012) note a growth cap orientation associated with Islamic indices. Hoepner et al. (2011) only find an exposure towards small cap for Islamic mutual funds. Hassan, Khan & Ngow (2010) show that Malaysian Islamic mutual funds tend to be small cap oriented compared to their conventional counterparts. Regarding SRI portfolios' investment style, Statman & Glushkov (2009) indicate that applying different ESG criteria influences the investment style differently. Luther, Matatko & Corner (1992), Luther & Matatko (1994), Gregory, Matatko & Luther (1997) and Scholtens (2005) show that SRI mutual funds seem to be tilted towards small cap. Schröder (2004), Bauer, Koedijk & Otten (2005), Gregory & Whittaker (2007) and Cortez, Silva & Areal (2009) find small and growth cap bias to be associated with SRI mutual funds. Studies by Guerard (1997), DiBartolomeo & Kurtz (1999) and Statman (2006) indicate that the Domini Social Index (DSI 400) tends to be more exposed to growth caps than the conventional S&P 500 Index. This is consistent with Garz, Volk & Gilles (2002) who find growth tilt associated with the European Dow Jones Sustainability Index (DJS). Confirming previous studies' findings, Kempf & Osthoff (2007) and Statman & Glushkov (2009) indicate that SRI portfolios tend to be skewed towards growth stocks. On the other hand, Vermeir, Van de Velde & Corten (2005) find that, in general, SRI indices tend to be significantly more exposed to large cap, but their exposure to book to market factor is not significant. Bello (2005), Schröder (2004) and Bauer et al. (2005) find that while European SRI mutual funds tend to be biased towards small cap, US SRI funds tend to be tilted towards large cap. Considering these arguments, we formulate the following hypotheses:

H2a. Islamic portfolios with high ESG scores are more oriented towards big-cap stocks than traditional Islamic portfolio.
H2b. Islamic portfolios with high ESG scores are more oriented towards big-cap stocks than Islamic portfolio with poor ESG scores.

3. Methods and Data

3.1. Data Set

Our data set combines ESG ratings and financial data for 238 firms listed in U.S. stock markets as of 2007. We import the ESG ratings from Kinder, Lynderberg and Domini (KLD) Research & Analytics STATS (Statistical Tool for the Analysis of Trends in Social and Environmental Performance) and retrieve financial data from Datastream. Generous contributions by MSCI analysts provided us with the constituents of the MSCI U.S. Islamic index from its inception year in 2007[11] from which we formed our Sharīʻah-compliant stock universe. The methodology used by MSCI to screen Sharīʻah-compliant stocks is described in the Appendix. Because KLD is the property of MSCI, we assumed the MSCI Islamic index series coverage

[11] Our KLD ratings coverage lasts until the end of 2010.

would match the KLD universe, to ensure broader stock coverage. Of the 270 firms listed in the MSCI U.S. Islamic index in 2007, we retained the 238 firms that received ESG ratings from KLD.

KLD provides annual snapshots of the ESG performance of U.S companies, evaluated on the basis of multiple criteria that constitute two broad categories: qualitative and exclusionary. The qualitative criteria are used for the positive and the best-in-class strategies. The exclusionary screens eliminate companies involved in controversial business areas[12]. The seven qualitative screens are:

1. Community
2. Governance
3. Diversity
4. Employee relations
5. Environment
6. Human rights
7. Products

For each domain, KLD lists several criteria and considers both positive strengths and negative concerns. On each domain, each constituent criterion receives a score of either 0 or 1, and the rating lists strengths, concerns, both, or neither. Among the concerns, the indicators measure the severity of the controversies that the firm faces, such as fines/sanctions for causing environmental damage, violations of operating permits, emission of toxic chemicals, poor employee union relations, abuses of employee labour rights, and so forth. For the strengths dimension, the indicators measure positive ESG engagement by the firm's products/services, management, policies, or operations, which might include air emission mitigations, limited water discharges and solid waste from operations, the use of recycled materials, the establishment of pro-minority or local community involvement policies (e.g., indigenous peoples), strong health and safety programs, and the development of employee benefits or programs to address work–life balance concerns.

3.2. ESG Performance Measurement

Barnett & Salomon (2011) observe that most CSP studies based on KLD data measure the ESG performance using aggregate measures, which may be problematic (Brammer et al., 2006). As Sharfman (1996) notes, the simple addition

[12] Namely Alcohol, Gambling, Tobacco, Firearms, Military and Nuclear power.

of positive ratings and subtraction of negative ratings across screens using KLD data fails to give an accurate picture of ESG performance. As suggested by Waddock & Graves (1997), investors grant different levels of importance to different components of ESG performance (Waddock and Graves, 1997). Therefore, aggregate measurements of ESG performance may confound existing relationships between the specific sub-components of ESG performance and returns (Galema et al., 2008). The resulting confounded effects might explain why empirical literature yields contradictive conclusions regarding SRI performance. For example, positive news about a firm's recycling policies may relate positively to expected returns, whereas news pertaining to philanthropic activities, perceived as an unproductive cost, relates negatively. These insights motivated our choice not to rely on a single composite score for ESG performance but rather to use disaggregates measures that represent each of its sub-components. Our portfolio composition approach diverges from previous studies (e.g. (Dravenstott and Chieffe, 2011) in that we differentiate portfolios according to ESG performance's sub-components, dimensions and intensity. Importantly, the ESG performance measurement that we derive from KLD's data is based on declarative statement and reports.

3.3. Portfolio Composition

We adopt a self-composed portfolio approach to circumvent the methodological biases affecting traditional funds' studies (Orlitzky et al., 2003). Indeed, some authors showed that there is no uniformity in the rating process of SRI mutual funds; rather, the ratings tend to differ with local regulations, investors' preferences, and fund managers' abilities. It is therefore difficult to neutralize the singularity effect caused by each social indicator (Kurtz and Dibartolomeo, 2011).

The portfolio composition relies on a simple, passive, value-weighted methodology, which neutralizes any effect of managers' stock-picking skills and enables us to measure effects attributed exclusively to ESG strategic allocations. We isolate each of the seven ESG domains and separate out the two dimensions of the screening (*strength/concerns*) and the score level. Next, we classified the scoring according to three rankings: 0, 1, or greater than 1. For each ESG sub-components and depending on the type of dimension, 0 indicates "no engagement" or "no implication in controversies"; 1 indicates "partial engagement" or "partial controversies implication"; and a score greater than 1 indicates "significant engagement" or "significant controversies implication." In some ESG domains though, we found no scores greater than 1, so we obtained a short portfolio panel.

The final panel contains 28 portfolios (7 domains[13] × 2 dimensions × 2 score intensities), plus a subset of 6 portfolios that score above 1. The portfolios are non-mutually exclusive. Table 1 displays the portfolio panel structure.

Table-1
Islamic SRI Portfolios Panel Structure*

	ESG Engagement (Strengths)			ESG Controversies (Concerns)		
	No (score=0)	Partial (score=1)	Significant (score>1)	No (score=0)	Partial (score=1)	Significant (score>1)
Community	√	√	×	√	√	×
Governance	√	√	×	√	√	√
Diversity	√	√	√	√	√	×
Employee	√	√	√	√	√	√
Environment	√	√	√	√	√	√
Human Rights	√	√	×	√	√	×
Product	√	√	×	√	√	×

* The □ signifies that no portfolio was constructed for this category, due to the absence of scores.

To appreciate the relevance of the disaggregated ESG performance approach, we constructed a comparative subset of portfolios using an aggregate scoring approach. However, subtracting concerns from the strengths score would not be meaningful, because of the distinct nature of these two dimensions. Indeed, the issue related to "greenwashing" described in management literature (Laufer, 2003) explains how firms may be tempted to hide their social controversies by strategically emphasizing of positive ESG ratings[14]. To tackle this issue, we adopt an alternative method that overweight the presence of controversies in the measurement of ESG performance. The measurement formula is described as follow:

Total ESG scoringi = (total strengths scorei + 0.5)/(total concerns scorei+0.5)
where *total strengths scorei* and *total concerns scorei* represent the sum of firm's *i* strengths and concerns, respectively, across all ESG domains. To obtain a score for each firm, we normalize both the divisor and the numerator by adding a constant term.

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[13] In this study, the seven ESG domains form the seven sub-components of the ESG performance used to rank firms.
[14] By subtracting negative ratings from positive to obtain a global ESG score, the classical approach may favor "greenwashing" practices usually observed among firms with a specific CSR communication department (Parguel et al., 2011).

In terms of timing, at the end of year $t-1$, KLD reports the stock ratings. We used this rating to form portfolios at the beginning of year t and maintain the portfolios until the end of year t. New ratings then get published, and we restructure the portfolios for year $t+1$. Thus we obtain a time series of monthly returns from 2008 to 2011. The period limitation is due to the historical inception of the MSCI Islamic index, which started in 2007.

Table 2 contains the descriptive statistics for the 39 portfolios in our panel, grouped according to their level of ESG engagement and level of implication in ESG controversies. It gives descriptive statistics of monthly returns from January 2008–December 2011 [15] .Group 1 comprises neutral portfolios in terms of engagement and controversies. Group 2 encompasses portfolios that are partially engaged in ESG concerns or partially involved in ESG controversies. Group 3 includes portfolios significantly engaged in ESG concerns or significantly involved in ESG controversies. In the lower part of the table, we display the results for the five portfolios constructed on the basis of the aggregated ESG scores, which provides a benchmark for our panel.

3.4. Financial Performance Measurement

To assess the effect of ESG performance on financial performance, we performed two analyses. First, we used the four-factor model developed by Fama and French (1992) and Carhart (1997). Formally, we approached performance measurement with the following equation:

$$R(i,t) - RF(t) = \alpha i + \beta i[RM(t) - RF(t)] + siSMB(t) + hiHML(t) + miMOM(t) + \varepsilon(i,t) \quad (1.1)$$

where $R(i,t)$ is the return on portfolio i constructed as explained previously; $RM(t)$ is the return in month t on a value-weighted market proxy; $RF(t)$ is the return in month t of a one-month Treasury bill extracted from Kenneth French's data library[16]; $SMB(t)$ is the difference in monthly returns between small and large-cap portfolios; $HML(t)$ is the difference in returns between value and growth portfolios; and $MOM(t)$ is the monthly return on a portfolio long on past one-year winners and short on past one-year losers. The momentum factor captures the risk due to the

[15] The mean return, standard deviation, and Sharpe ratio (given by the mean excess return to the standard deviation of the returns) are all annualized. The last two columns provide skewness and kurtosis data. Group 3 does not contain all seven domains, because for some domains, no firms were significantly engaged in ESG issues or were significantly involved in ESG controversies. In the lower part of the table, the benchmark was a set of five portfolios constructed on the basis of aggregated scores. The sample period was

[16] Available at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french.

momentum found in stock returns (Jegadeesh and Titman, 1993). Controlling for investment style is particularly important in light of mounting evidence that returns on style account for a considerable portion of SRI portfolio performance (Bauer et al., 2005).

Table-2
Descriptive Statistics for Islamic-SRI Portfolios

	Mean	Std. Dev.	Sharpe Ratio.	Minimum	Maximum	Pr (Skewness)	Pr (Kurtosis)
Group 1: Non-engaged portfolios							
Panel A : Not engaged in ESG issues (strengths=0)							
Community	1.11	22	0.05	-16.47	17.58	0.32	0.17
Governance	-0.31	23.35	-0.01	-18.95	17.07	0.17	0.19
Diversity	1.99	26.22	0.08	-19.48	18.11	0.19	0.54
Employee	2.67	20.59	0.13	-19.29	13.95	0.04	0.05
Environment	2.68	21.16	0.13	-18.46	15.48	0.1	0.09
Human Rights	0.34	17.76	0.02	-15.06	11.04	0.08	0.26
Product	-0.67	18.95	-0.04	-15.25	13.68	0.19	0.27
Panel B: Not involved in ESG controversies (concerns=0)							
Community	1.12	18.74	0.06	-15.58	12.02	0.1	0.27
Governance	2.54	23.91	0.1	-21.33	15.52	0.04	0.1
Diversity	3.53	18.99	0.18	-17.45	10	0.02	0.12
Employee	0.55	17.78	0.03	-15.28	10.91	0.16	0.29
Environment	0.94	18.88	0.05	-17.7	10.58	0.03	0.09
Human Rights	-0.43	18.19	-0.02	-14.63	11.74	0.12	0.32
Product	0.67	21.88	0.03	-18.91	14.56	0.07	0.22
Group 2: Partially engaged portfolios							
Panel C : Engaged in ESG issues (strengths=1)							
Community	1.6	16.29	0.1	-14.17	9.25	0.05	0.21
Governance	3.08	15.24	0.2	-12.88	8.12	0.03	0.2
Diversity	-1.87	25.55	-0.07	-25.8	18.58	0.01	0.01
Employee	0.06	22.1	0	-17.96	13.62	0.14	0.38
Environment	-3.54	19.9	-0.18	-14.3	16.01	0.4	0.16
Human Rights	-8.92	35.44	-0.26	-57.45	12.48	0	0
Product	6.01	17.43	0.34	-15.22	10.56	0.04	0.14
Panel D: Involved in ESG controversies (concerns=1)							
Community	2.64	17.92	0.15	-14.94	8.89	0.06	0.45
Governance	2.64	18.91	0.14	-15.99	10.37	0.07	0.37
Diversity	-0.65	17.54	-0.04	-11.16	14.13	0.52	0.31
Employee	0.68	19.36	0.03	-15.38	13.78	0.15	0.29
Environment	2.11	18.6	0.11	-16.4	11.21	0.04	0.2
Human Rights	2.59	18.55	0.14	-15.97	10.76	0.08	0.33
Product	1.56	15.38	0.1	-12.16	8.31	0.14	0.52
Group 3: Significantly engaged portfolios							
Panel E: Significantly engaged in ESG issues (strengths>1)							
Diversity	3.34	15.39	0.21	-11.86	8.66	0.1	0.53
Employee	0.76	17.46	0.04	-12.27	14.56	0.55	0.17
Environment	2.72	16.68	0.16	-13.35	10.69	0.21	0.35
Panel F: Significantly involved in ESG controversies (concerns>1)							
Governance	4.37	16.19	0.26	-12.6	8.39	0.09	0.45
Employee	0.94	17.31	0.05	-15.08	9.06	0.06	0.26
Environment	0.43	18.1	0.02	-13.24	12.33	0.32	0.63
Portfolios based on aggregated scoring							
Worst ESG score	-2.07	26.42	-0.08	-20.77	20.2	0.29	0.14
Bad ESG score	0.43	20.35	0.02	-13.88	13.56	0.36	0.96
Mid ESG score	0.26	20.34	0.01	-17.08	14.35	0.11	0.18
Good ESG score	1.81	19.07	0.09	-15.45	9.43	0.08	0.39
Best ESG score	2.56	15.57	0.16	-13.62	8.15	0.05	0.24

In addition, we test returns on a difference portfolio, to measure relative performance (Derwall et al., 2005; Galema et al., 2008). To construct the difference portfolios, we first subtracted the returns of portfolios composed of firms that were not engaged in ESG concerns from the portfolios of firms engaged in ESG concerns, then subtracted the returns of portfolios of firms involved in controversies from portfolios composed of firms not involved in any controversies. The corresponding equation is as follows:

$$R(i,t,p) - R(i,t,n) = \alpha i + \beta i[RM(t) - RF(t)] + siSMB(t) + hiHML(t) + miMOM(t) + \varepsilon(i,t), \quad (1.2)$$

where $R(i,t,p)$ represents the returns on ESG-engaged and non-controversial portfolios[17] and $R(i,t,n)$ is the return on their accompanying non–ESG-engaged and controversial portfolios. The independent variables are similar to those in Equation (1.1), except that αi is the differential excess performance in this equation.

4. Results

4.1. Performance Analysis

4.1.1. Islamic SRI Portfolios Treatment

Table 3 reports the results of the four-factor regressions estimating disaggregated socially responsible and non-socially responsible portfolios' performance. We construct our value-weighted market proxy from MSCI U.S. Islamic index. We excluded from our analysis the ESG-engaged *human rights* portfolio (Panel C) which appeared to be an outlier, according to its small size (i.e., fewer than 20 stocks throughout the observation period). The extreme alpha reported for this portfolio is linked to the overweighting of one stock. The estimates of the four factors exhibited significant differences across panels. We report significant alpha values for five portfolios (out of 39). In particular, the portfolio composed of companies with partial engagement in *governance* outperformed its peer Islamic index (i.e. MSCI U.S. Islamic) over the observation period (α=4.91%, p<.05). Concerning the negative ESG performance, we observed that two portfolios, representing firms with partial implications in *community* relationship and *human rights* controversies, outperformed their peer index (α=6.04% and α=5.54% respectively, p<.05). Our results indicate the positive effect of positive ESG performance exclusively for the *governance* domain; they

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[17] We merged the partially engaged portfolios and significantly engaged portfolios into a single set of engaged portfolios.

also suggest a positive effect of ESG controversies in the *community* relationship and *human rights* domains.

Beyond the effect linked to each ESG performance sub-components, we found a tangible effect linked to ESG performance intensity. That is, considering portfolios representing firms that are significantly engaged in ESG concerns (Group 3) or significantly involved in ESG controversies (Group 4), we observed noticeable differences in comparison with the partially engaged and partially involved portfolios (Groups 1 and 2). The portfolio composed of firms with significant positive engagement in *diversity* outperformed its peer index (α=4.41%, p<.1). Surprisingly, the portfolio composed of firms with significant involvement in *governance* controversies also outperformed their peer index (α=7.06, p<.05).

For *diversity* and *governance* issues, the intensity of ESG engagement and respectively the intensity of controversy involvement thus appear to be determining factors of the ESG performance – financial performance relationship. These results thus suggest that the most financially successful companies overlook the negative impacts of their operations to local populations[18] and do not meet certain *human rights*. Concerning *governance* issues, the positive performance of significantly irresponsible and partially responsible portfolios highlights a paradox. When examining the indicators considered by KLD to evaluate corporate *governance*, we find that good *governance* is measured solely by firms' declared support to ESG public policies and the quality of their social reporting[19]. In addition of these indicators, bad *governance* is also measured by the severity of disputes regarding executives' compensations, *governance* structure and misbehavior such as bribery, tax evasion, inside trading and accounting irregularities. Thus, this dual-performance paradox suggests that firms with good market performance are more prone to *governance* bad practices and therefore tend to hide it by a positive CSR communication strategy[20].

The last rows of Table 3 present the results of the four-factor regressions for the five portfolios ranked on the basis of the firms' aggregate ESG performance. None of the reported alpha estimates were significant, which suggests the irrelevance of a composite social performance measurement and confirms Sharfman's (1996) argument on the potential opposing effect across ESG domains.

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[18] These negative impacts are evaluated by KLD on the basis of NGOs or independent observers' complaints.
[19] Reports' quality assessment is based on the compliance with the Global Reporting Initiative.
[20] Accordingly, based on the numerous "greenwashing" evidences, some authors such as Parguel et al. (2011) argue on the necessity to review current social ratings methods.

Table-3
Performance of Islamic-SRI Portfolios (4-factor model)

	α	t stat	SMB	t stat	HML	t stat	MOM	t stat	Rm-Rf	t stat	Adj. R^2
Group 1: Non-engaged portfolios											
Panel A : Not engaged in ESG issues (strengths=0)											
Community	0.96	0.36	0.15	1.3	0.06	0.55	0.01	0.27	1.17***	15	0.93
Governance	-2.02	-0.68	0.30***	3.44	-0.08	-0.68	-0.06	-2.42	1.23***	19.7	0.94
Diversity	-0.12	-0.02	0.40**	1.69	-0.09	-0.59	-0.01	-0.24	1.32***	13.3	0.86
Employee	0	-0.01	0.41***	2.73	-0.13	-1.05	-0.06	-1.33	1.04***	16.8	0.92
Environment	0.96	0.33	0.29***	4.05	-0.11	-1.09	-0.05	-2.7	1.12***	18.7	0.94
Human Rights	1.21	0.69	-0.03	-0.89	0.05	0.87	0	0.44	0.99***	117	0.98
Product	0.36	0.18	-0.04	-0.74	0.02	0.24	0.03	2.3	1.06***	32.4	0.95
Panel B: Not involved in ESG controversies (concerns=0)											
Community	-1.07	-0.51	0.41***	3.3	0.02	0.27	-0.03	-0.68	0.92***	30.9	0.92
Governance	0.36	0.1	0.35***	2.04	-0.07	-0.62	-0.08	-1.8	1.22***	14.3	0.91
Diversity	3.29	1.25	0.13	0.88	0.05	0.63	-0.02	-0.79	1.00***	17	0.92
Employee	-0.48	-0.18	0.17	1.31	-0.04	-0.56	-0.05	-0.94	0.91***	20.8	0.89
Environment	-1.31	-0.59	0.37***	4.75	0.01	0.13	-0.08**	-3.16	0.93***	16.8	0.94
Human Rights	-1.19	-0.88	0.21***	4.08	0.08	1.32	-0.03	-1.15	0.94***	40	0.96
Product	1.09	0.4	0.04	0.64	0.08	0.9	-0.03	-0.87	1.18***	24	0.94
Group 2: Partially engaged portfolios											
Panel C : Engaged in ESG issues (strengths=1)											
Community	1.94	1.14	0.05	0.44	0.01	0.31	0.01	0.45	0.89***	30.2	0.94
Governance	4.91**	2.54	-0.1	-1	0.13	1.86	0.05	1.83	0.84***	24.9	0.93
Diversity	-4.24	-1.22	0.38**	2.6	-0.25*	-1.72	-0.04	-1.02	1.34***	12.5	0.9
Employee	-0.48	-0.16	0.22*	1.27	0.01	0.06	0.03	1.01	1.16***	19.4	0.9
Environment	-1.79	-0.53	-0.15	-1.18	-0.07	-0.64	0.06	2.13	1.12***	15.4	0.88
Human Rights	-11.04	-0.61	0.19	0.75	-0.53	-0.86	-0.06	-0.73	1.07***	10.8	0.21
Product	5.03	1.68	0.19	1.36	0.14	1.31	-0.09*	-1.48	0.78***	9.61	0.8
Panel D: Involved in ESG controversies (concerns=1)											
Community	6.04**	1.99	-0.33	-4.96	0.11	1.47	0.04	1.55	1.03***	23.8	0.94
Governance	1.81	0.63	0.27***	2.16	0.15*	2.12	-0.01	-0.2	0.94***	20.6	0.92
Diversity	0.12	0.04	0.06	0.52	0.04	0.51	0.09**	2.75	0.95***	12.3	0.9
Employee	1.57	0.84	0.02	0.38	0.15***	1.94	0.02	0.92	1.05***	26.7	0.97
Environment	2.43	1.01	0.06	0.75	0.06	0.86	-0.01	-0.6	1.00***	31.7	0.94
Human Rights	5.54**	1.61	-0.30***	-4.75	0.02	0.25	0.04	1.81	1.07***	38.4	0.93
Product	2.67	1.15	-0.06	-1.16	0.07	1.1	0.01	0.42	0.84***	22.9	0.92
Group 3: Significantly engaged portfolios											
Panel E: Significantly engaged in ESG issues (strengths>1)											
Diversity	4.41*	2.06	-0.01	-0.09	0.14*	2.15	0.03	0.87	0.82***	25.2	0.91
Employee	1.57	0.54	0	-0.01	0.04	0.4	0.03	1.68	0.96***	11.5	0.92
Environment	3.29	1.83	0.04	0.55	0.16**	2.09	-0.02	-0.46	0.87***	19.7	0.93
Panel F: Significantly involved in ESG controversies (concerns>1)											
Governance	7.06**	1.98	-0.24**	-1.49	0.07	0.81	0.05	2.22	0.90***	20.5	0.88
Employee	2.43	0.9	-0.14	-1.64	-0.03	-0.5	0.01	0.43	0.98***	20.1	0.91
Environment	3.04	1.1	-0.23***	-4.14	0.06	0.85	0.05	3.42	1.04***	28.2	0.94
Portfolios based on aggregated scoring											
Worst ESG score	-3.43	-0.77	0.24	1.26	-0.28*	-1.75	0	-0.04	1.41***	15.4	0.86
Bad ESG score	3.66	0.77	-0.31**	-2.79	0.03	0.23	0.08	1.66	1.14***	20.1	0.86
Mid ESG score	1.33	0.63	-0.04	-0.34	0	0	0.02	0.82	1.13***	20.8	0.93
Good ESG score	2.43	1.13	0.06	0.52	0.24***	3.33	-0.03	-0.98	0.96***	19.9	0.91
Best ESG score	1.21	0.43	0.23	1.6	0.1	1.19	-0.08	-1.21	0.67***	8.38	0.75

Note: The table displays the R^2, coefficients, and their respective t-stat and p-values for each regression. Portfolios are grouped into three categories. All alphas are annualized. T-statistics are derived from Newey–West heteroscedasticity and autocorrelation-consistent standard errors. The sample period was from January 2008–December 2011.* 10% significance. ** 5% significance. *** 1% significance.

4.1.2. Difference Portfolios Treatment

The exposed differences between ESG-engaged and non–ESG-engaged portfolios and between non-ESG controversial and ESG controversial portfolios helped reduce the dimensionality of our panel, in addition to revealing the differences in factor exposure. Thus, we could estimate the differential performance of an ESG engagement strategy from one side and a controversy disengagement strategy from the other. As we show in Table 4, for *governance* domain, the return difference between ESG-engaged and non–ESG-engaged portfolio is significantly positive (7.06%, $p<.1$), whereas for *community* relationship and *human rights* domains the return difference between non-controversial and controversial portfolios is significantly negative (-6.74% and -6.40% respectively, $p<.1$). Accordingly, while a strategy favouring good *governance* seem to be positively linked to portfolios performance, a strategy excluding companies involved in *community* and *human rights* controversies seems to be negatively linked to portfolio returns.

Table-4
Relative Performance of Islamic-SRI Difference Portfolios (4-factor model)

	α	t stat	SMB	t stat	HML	t stat	MOM	t stat	Rm-Rf	t stat	Adj. R^2
Panel A: ESG engagement											
Community	0.96	0.3	-0.11	-0.6	-0.05	-0.43	0.01	0.12	-0.28***	-2.62	0.3
Governance	7.06*	1.86	-0.39***	-2.77	0.22*	1.34	0.11	2.23	-0.39***	-4.16	0.53
Diversity	-4.24	-1.32	-0.02	-0.16	-0.16	-1.5	-0.03	-0.69	0.02	0.19	-0.04
Employee	-0.48	-0.12	-0.19	-1.63	0.14	1.2	0.09**	1.49	0.12**	2.03	0.1
Environment	-2.73	-0.57	-0.43***	-2.79	0.04	0.27	0.11**	3.06	0	0.01	0.24
Human Rights	-12.11	-0.62	0.22	0.77	-0.58	-0.86	-0.06	-0.7	0.08	0.75	-0.07
Product	4.66	1.01	0.23	1.23	0.13	0.81	-0.12	-1.66	-0.28***	-2.51	0.15
Panel B: ESG controversies disengagement											
Community	-6.74*	-1.76	0.74***	5.04	-0.09	-1.09	-0.07	-1.04	-0.1	-1.72	0.39
Governance	-1.43	-0.36	0.08	0.54	-0.23*	-1.85	-0.07	-1.08	0.28***	3.5	0.29
Diversity	3.17	0.6	0.07	0.38	0.01	0.06	-0.11**	-2.17	0.05	0.34	0.07
Employee	-2.02	-0.76	0.15	1.03	-0.19*	-1.98	-0.07	-1.33	-0.14**	-1.93	0.13
Environment	-3.66	-1.17	0.31**	3.15	-0.06	-0.49	-0.07	-2.33	-0.07	-1.46	0.1
Human Rights	-6.40*	-1.75	0.51***	4.71	0.06	0.57	-0.07	-1.5	-0.13*	-2.57	0.29
Product	-1.55	-0.39	0.11	0.9	0	0.03	-0.04	-0.65	0.33***	3.99	0.37

Note: This table displays the results of the multifactor regressions conducted on difference portfolios expressed by the following equation: $R(i,t,p) - R(i,t,n) = \alpha i + \beta i[RM(t) - RF(t)] + siSMB(t) + hiHML(t) + miMOM(t) + \varepsilon(i,t)$. The table displays the R^2, coefficients, and their respective t-stat and p-values for each regression. All alphas are annualized. T-statistics are derived from Newey–West heteroscedasticity and autocorrelation-consistent standard errors. The sample period was from January 2008–December 2011.* 10% significance. ** 5% significance. *** 1% significance.

4.2. Investment Style Analysis

4.2.1. Islamic SRI portfolios treatment

Size Effect

Firstly, the results reported in table 3 show a significant exposure to SMB factor for portfolios that are neutral in terms of ESG performance (i.e. neither engaged in ESG issues nor involved in controversies) suggesting a rating bias. Regardless of the ESG domain of focus, small companies seem to be less concerned with ESG issues in their activities. From the negative ESG performance point of view, we find balanced results depending on the type of ESG performance and its intensity. Indeed, the results only show a significant exposure for portfolios representing significant involvement in *governance* and *environment* controversies and partial involvement in *human rights* issues. This suggests that big firms are exposed to *human rights* controversies in general, and that they are only exposed to severe *governance* and *environment* concerns. This result is also confirmed by the negative exposure to SMB factor found for one benchmark portfolio representing negative ESG performance (namely Bad ESG). From the positive ESG performance side, we found a significant exposure towards small stocks only for the two portfolios representing partial engagement in *diversity* and *employee relations*.

Book-to-Market Value Effect

The loadings for the HML factor reveal the compounding and balanced links between the book-to-market ratio of a firm and the type and intensity of its ESG performance. Indeed, the results in table 3 show a significant exposure to growth stocks for the portfolio partially engaged in *diversity*. On the opposite, we find a positive exposure to value stocks for the portfolios significantly engaged in *diversity* and *environment* strategies but also for the portfolios partially involved in *governance* and *employee* concerns. These results reveal that if firms with high book-to-market ratio are more exposed to substantial *governance* and *employee* concerns they are at the same time significantly more engaged in *diversity* and *environment* strategies. It also suggests that these firms suffer from undervaluation due to *governance* and *employee* issues and thus seek to counterbalance the negative perception of investors by overinvesting in *diversity* and *environment* issues to enhance their public image and increase their market value. The loadings of the aggregated ESG performance portfolios give a less explainable result. We note that the portfolio representing the worst aggregated ESG score is more exposed toward growth stock while the portfolio representing good aggregated

ESG score is more exposed toward value stocks. This suggests that the market value of a stock is inversely correlated to its ESG performance and contradicts theory (Galema et al., 2008). These findings confirm the importance of considering the multi-dimensionality of ESG performance and its confounding effects even from an investment style view point.

4.2.2. Difference Portfolios Treatment

Size Effect

The estimates in Panel A of Table 4 show that two difference portfolios related to ESG engagement exerted significant negative exposures on the SMB factor. In contrast, Panel B shows that three difference portfolios linked to controversies disengagement had significant positive exposures to the SMB factor. That is, portfolios with no controversial implications for *community* relationships, the *environment* or *human rights* are more sensitive to small size effects. Thus, disengaging from controversial companies in one of the three specific domains orients investment towards smaller firms. Furthermore, portfolios representing either *governance* or *environment* engagement are less sensitive to the small size effect than their accompanying non-engaged portfolios; thus engaging in good *governance* or *environment* strategies favours big firms.

Book-to-Market Value Effect

Ultimately, the results from Panel A of Table 4 show that the difference portfolio representing ESG engagement in *governance* has a significant positive exposure to HML; a SRI strategy targeting good corporate *governance* behaviour emphasizes value-oriented stocks. In addition, the difference portfolio representing *governance* and *employee* controversies disengagement revealed a significant negative exposure to the HML factor, suggesting that an investment strategy targeting good corporate *governance* behaviour leads to favouritism for value-oriented stocks.

These results suggest that screening a Sharīʻah compliant stock universe according to SRI principles produce effects that varies according to dimension (positive vs. negative), sub-components (i.e. *employee*, *environment*…) and intensity of ESG performance.

In summary, our analysis of Sharīʻah-compliant SRI investment style confirms the existence of a relationship between the size and book-to-market value of a firm and its ESG performance. However our findings provide balanced conclusions. While the positive dimension of ESG performance expressed by ESG engagement or "strengths" is found to be positively related to firm size and to a lesser extend to its book-to-market value, its negative dimension expressed by ESG controversies or "concerns" is also positively related to firm size and to lesser extend its book-to-market value. Therefore, by combining the positive and negative dimensions of ESG performance through the construction of a single composite ESG score, previous empirical works might have failed to observe a significant relationship between ESG performance and financial performance due to the neutralization bias produce by composite ESG measurement approach.

4.3 Robustness

4.3.1 Industry-Adjusted Seven-Factor Model

Kurtz & DiBartolomeo (2011) provide evidence that sector exposures substantially drive SRI portfolio returns. Moreover, because Islamic screenings are based on exclusion, including the effect of sector exclusion in Sharīʻah-compliant portfolios could be relevant. We investigate whether our portfolio loadings change after controlling for industry effect. We used an approach similar to that adopted by Jones & Shanken (2005) and previously applied to SRI funds and SRI portfolios by Geczy, Stambaugh & Levin (2003) and Derwall et al. (2005). It involves the construction of a factor model composed of the four investment style regressors and three industry factors, orthogonal to the primary factor. To derive these regressors, we performed a principal-components analysis on the portion of Fama and French's excess industry-sorted portfolio returns that cannot be explained by the four-factor model (i.e., the model's intercept and residual series). We used seven industry-sorted portfolios: consumer, manufacturing, energy, high-technology, telecommunication, shops, utilities, and others. The exhaustive industry-sorted portfolios list composed by French was not appropriated to our study because of the limited number of sectors composing our Sharīʻah-compliant universe.

In turn, we retained the first three components, which captured most remaining industry return variation, and added them to the four-factor model. The resultant model takes the following form:

$R(it) - RF(t) = \alpha i + \beta i[RM(t) - RF(t)] + siSMB(t) + hiHML(t) + miMOM(t) + piIP1\text{-}3(t) + \varepsilon(it)$ (1.3) where *IP1-3(t)* represents three factors (principal components) that capture industry effects. After performing this regression, we obtained the industry bias-free alpha estimates. The results of this industry-adjusted regression provide robust, unbiased estimates (Table 5). The loadings recorded for industry-adjustment variables cannot be interpreted with respect to specific industry exposure but provide evidence of industry effects, as revealed by significant alphas obtained in the regressions performed on the eight portfolios in the original four-factor model. The results confirm the robustness of our original alpha estimates. We notice slight changes in the significance level too, that is the alpha estimates for the difference portfolio attached to *community* controversies disengagement lost its significance.

Table-5
Performance of Industry-Adjusted Islamic-SRI Portfolios (7-Factor Model)

	Industry-adjusted α	SMB	HML	MOM	Rm-Rf	*IP1*	*IP2*	*IP3*	Adj. R^2
ESG baseline portfolios									
Group 2: Partially engaged portfolios									
Panel C : Engaged in ESG issues (strengths=1)									
Governance	4.91**	-0.1	0.13*	0.04***	0.85***	0	0.30**	-0.45***	0.94
	2.47	*-1.56*	*1.86*	*2.81*	*33.3*	*0.04*	*2.01*	*-3.25*	
Panel D: Involved in ESG controversies (concerns=1)									
Community	6.04*	-0.33***	0.11	0.05**	1.01***	-0.20**	0.02	0.11	0.94
	1.96	*-5.12*	*1.55*	*2.18*	*25.2*	*-2.4*	*0.1*	*0.62*	
Human Rights	5.54*	-0.29***	0.03	0.04***	1.05***	-0.21**	-0.35*	0.09	0.93
	1.75	*-4.66*	*0.34*	*2.56*	*28.2*	*-2.53*	*-1.83*	*0.5*	
Group 3: Significantly engaged portfolios									
Panel E: Significantly engaged in ESG issues (strengths>1)									
Diversity	4.41**	-0.02	0.13**	0.02	0.84***	0.12	0.41***	-0.5***	0.94
	2.06	*-0.25*	*2.15*	*1.11*	*29.8*	*0.97*	*2.67*	*-2.75*	
Panel F: Significantly involved in ESG controversies (concerns>1)									
Governance	6.98**	-0.24**	0.07	0.04*	0.90***	-0.2	0.18	-0.38	0.89
	1.99	*-1.84*	*0.8*	*1.82*	*22.6*	*-1.57*	*0.7*	*-1.47*	
Difference portfolios									
Panel A: ESG engagement									
Governance	7.06**	-0.41***	0.21	0.10***	-0.35***	0.22	0.74***	-0.57**	0.51
	1.94	*-3.8*	*1.31*	*4.25*	*-4.38*	*0.9*	*2.6*	*-2.47*	
Panel B: ESG controversies disengagement									
Community	-6.74	0.74***	-0.1	-0.08*	-0.08	0.22	0.19	-0.69**	0.62
	-1.61	*5.65*	*-1.18*	*-1.67*	*-1.25*	*1.54*	*0.6*	*-2.39*	
Human Rights	-6.40*	0.50***	0.05	-0.08**	-0.09	0.29**	0.53**	-0.40**	0.28
	-1.89	*4.81*	*0.53*	*-2.48*	*-1.66*	*2.51*	*2*	*-2.05*	

Note: The equation used for industry adjustment is derived from the classical four-factor model. Added industry factors are represented by the *IP* variable. The equation is modified as follows: $R(it) - RF(t) = \alpha i + \beta i[RM(t) - RF(t)] + siSMB(t) + hiHML(t) + miMOM(t) + \theta iIP1\text{-}3(t) + \varepsilon(t)$. T-statistics (in italics) are derived from Newey–West heteroscedasticity and autocorrelation-consistent standard errors. The sample period was from January 2008–December 2011.*10% significance. **5% significance. *** 1% significance.

5. Discussion

5.1. Performance Analysis

The results exposed by the four-factor model measurement and confirmed by the industry-adjusted seven-factor model provide substantial conclusive evidences regarding the outperformance of Islamic portfolios expressing partial engagement in good *governance* and significant engagement in *diversity* issues as compared to their traditional peer Islamic index during the 2007-2011 periods. Moreover, our investigation reveals that controversial portfolios in *community*, *human rights* and *governance* exhibit higher performance than their Islamic peer index during these periods. This finding balances previous assertion and potentially suggests that well performing firms care less for the negative reputation originated by *human rights* and *community* concerns violations. Concerning *governance* matters, the results show that when taken separately, positive *governance* performance (i.e. engagement) and negative *governance* performance (i.e. concerns) lead both to superior performance and suggest that an ESG screening based on a composite ESG score may produce compound effect that annihilate the outperformance. Therefore we may only partially accept our hypothesis *H1a* and reformulate our final assertion accordingly: Islamic portfolios with high ESG scores in *governance* and *diversity* engagement perform better than traditional Islamic portfolio.

The results brought by the difference portfolios investigation provide a more balanced conclusion in the fact that it relatives previous assertion. Precisely, when comparing the relative performance of high ESG scores portfolios with their poor ESG scores counterparts, we find that the outperformance observation only holds for *governance* engagement. It appears that engagement in *governance* brings superior performance as compared to non-engagement, but non-involvement in *governance* concerns doesn't provide superior performance as compared to involvement in *governance* concerns. A possible explanation for this can be found in the principle-agent theory literature whereby agency issues and information asymmetries related to governance concerns may mislead investors' perception of a firm value. Well-informed investors can thus obtain superior returns by selecting firms that are undervalued by traditional investors because of their governance concerns. We conclude that the positive effect of an Islamic *governance*-oriented investment strategy is more guided by engagement in good *governance* practices than alleviation of controversial *governance* behaviour. Therefore, we reformulate the second hypothesis *H1b* accordingly: Islamic portfolios with high scores in *governance* engagement perform better than Islamic portfolios with poor scores in *governance* engagement.

5.2. Investment Style Analysis

As presented in the results section, we find that ESG screening produce different style effect in relation to its dimension, its sub-components and its intensity. Concerning our initial hypothesis *H2a*, the results displayed by partially engaged and significantly engaged ESG portfolios provide no support for its validity and on the contrary suggest quite the opposite. Indeed, the results show clearly that screening on the basis of ESG concerns orients portfolios towards small caps suggesting that large companies are more concerned with ESG controversies. Big firms thus appear to be more exposed to *human rights*, *governance* and *environment* concerns. Interestingly, the results of SMB factor exposure suggest that because small companies are less involved in ESG controversies, they tend to be less concerned with implementing ESG practices. Furthermore, the results indicate that when small companies engage into ESG, they do it only partially and only for specific domains that relate to internal stakeholders issues (i.e. diversity and employee relations).

The results provided by our difference portfolios treatment balance our previous finding and suggest that Islamic portfolios with high ESG scores for *governance* and *environmental* issues are more oriented towards big-cap stocks than their Islamic portfolios counterparts with poor ESG scores. We therefore reformulate *H2b* accordingly and state that Islamic portfolios with high governance and environmental performance are more oriented towards big-cap stocks than Islamic portfolio with low governance and environmental performance.

Our investment style analysis shows that an ESG strengths engagement strategy applied to an Islamic stock market redirects Islamic portfolios toward value and big caps stocks. Additionally, it shows that an ESG controversies disengagement strategy intensify the original growth and small cap effects initially produced by Islamic screens.

6. Conclusion

Islamic Equity investments are ready for the next step in their development. The current practice of negative screening in Islamic investing has been the stepping-stone for Islamic equity investments. Now, in order to expand the equity asset class of Islamic investments and bring Islamic investment closer to the social tenets of Islam law, more and more scholars and practitioners argue on the need to include a positive approach targeting the social responsibility of businesses. Prior studies have highlighted the perfect compatibility of ESG criteria with the principles of Islamic ethics. Our study goes one step further and proposes to study the financial impact of merging Islamic investment with SRI practices. To do so we used KLD's ESG ratings and conducted an experimental analysis, using a panel of self-constructed portfolios formed from an Islamic stock universe. We set out to investigate the combined effect of ESG and Islamic screenings using the four-factor model defined by Carhart (1997), through both a simple portfolios treatment and a difference portfolios treatment. An industry-adjusted model is used to confirm the robustness of the four-factor model loadings. Our results indicate the presence of different and confounding effects with regard to the dimension (positive vs. negative), the sub-components (i.e. different ESG domains) and the intensity of ESG performance.

From the financial return perspective, significant compound effects, through the presence of positive effects for both positive and negative dimensions of ESG performance, balance the conclusion we can draw from the results and suggests that though good corporate *governance* may be a possible determinant of financial performance, the presence of controversial firms in a portfolio does not necessarily harm its financial performance but rather the contrary.

From the investment style perspective, we found evidence of different style effects produced by the combination of Islamic and ESG screens. That is, good corporate *governance* and *environment* engagement are prominent among big firms that are compliant with Islamic screens. However, big firms are more involved in *community*, *environment* and *human rights* concerns than smaller firms. From the negative perspective, our result suggests that ESG engaged Islamic investors have to make an ethical trade-off when targeting large caps in their portfolio selection. From a more positive perspective, Islamic investors that only seek to disengage from socially controversial firms will beneficiate from higher growth potential. From a broader scope, we find that the intensity of ESG engagement or controversy involvement may act as a moderator in SRI – financial performance relationship and provide avenues for further empirical studies looking into the role of ESG performance measurement approach in SRI mutual funds' performance.

Thus, this study provides theoretical and practical contributions to the debate on the merits of ethical investing. First, it provides empirical evidence that incorporating ESG criteria into an Islamic investment process doesn't harm its financial performance and gives supporting conclusion to the SRI performance argument (Derwall et al., 2005; Galema et al., 2008). Additionally, the study enrich the discussion related to CSP-CFP debate by highlighting the benefit of investigating the relationship using disaggregated measurement of ESG performance that takes into account its two dimensions (i.e. ESG engagement and ESG concerns), the distinct nature of its sub-components (i.e. different ESG domains) and the intensity of the scoring. From a practical perspective, this pioneering experimental study offers to Islamic investors a venue to consider the potential financial benefit of considering additional ethical issues.

If Islamic investors value good *governance* behaviour as a major corporate social responsibility (CSR), the positive financial implications of good *governance* practices reported herein provide an additional argument for adopting this way. Moreover, because Islamic screening favours smaller companies that are less liquid than companies with higher market capitalization, the adoption of ESG standards by these firms should increase transparency, mitigate informational asymmetry and improve stocks liquidity (Chung et al., 2010).

APPENDIX

MSCI Islamic Index Series Methodology

Index Construction

Following Sharīʿah investment principles, MSCI excludes securities using two types of criteria: business activity and financial ratios. Securities for which sufficient financial information was not available to determine the business activity information and financial ratios described in the following sections were considered non-compliant with the Islamic Index Methodology.

Business activity screening. Sharia investment principles do not allow investment in companies that are directly active in or derive more than 5% of their revenue (cumulatively) from the following prohibited activities:

- Alcohol: distillers, vintners and producers of alcoholic beverages, including producers of beer and malt liquors, owners and operators of bars and pubs.
- Tobacco: cigarettes and other tobacco product manufacturers and retailers.
- Pork-related products: companies involved in the manufacture and retail of pork products.
- Conventional financial services: commercial banks involved in retail banking, corporate lending, investment banking; companies involved in mortgage and mortgage-related services; providers of financial services, including insurance, capital markets and specialized finance; credit agencies; stock exchanges; specialty boutiques; consumer finance services, including personal credit, credit cards, lease financing, travel-related money services, and pawn shops; financial institutions primarily engaged in investment management, related custody and securities fee-based services; companies operating mutual funds, closed-end funds and unit investment trusts; financial institutions primarily engaged in investment banking and brokerage services, including equity and debt underwriting, mergers and acquisitions; securities lending and advisory services institutions; and insurance and reinsurance brokerage firms, including companies providing property, casualty, life disability, indemnity or supplemental health insurance.
- Defense/weapons: manufacturers of military aerospace and defense equipment, parts or products, including defense electronics and space equipment.

- Gambling/casino: owners and operators of casinos and gaming facilities, including companies providing lottery and betting services.
- Music: producers and distributors of music, owners and operators of radio broadcasting systems.
- Hotels: owners and operators of hotels.
- Cinema: companies engaged in the production, distribution, and screening of movies and television shows, owners and operators of television broadcasting systems and providers of cable or satellite television services.
- Adult entertainment: owners and operators of adult entertainment products and activities.

Financial screening. Sharīʻah investment principles do not allow investment in companies deriving significant income from interest or companies that have excessive leverage. MSCI uses the following three financial ratios to screen for these companies:

- Total debt over total assets
- Sum of a company's cash and interest-bearing securities over total assets
- Sum of a company's accounts receivables and cash over total assets

None of the financial ratios may exceed 33.33%. Securities are considered non-compliant with respect to financial screening if any of the financial ratios exceeds 33.33%. To reduce index turnover resulting from financial screening, a lower threshold of 30% is used to determine new inclusions to the Islamic indices. A security that is currently not a constituent of the MSCI Islamic Indices is considered compliant only if all three financial ratios do not exceed 30%.

Index Maintenance

Rebalancing. MSCI reassesses the composition of the Islamic indices by applying the business activity screening and financial screening annually at its May index review. MSCI also reassesses the composition of the Islamic indices by applying the financial screening to all applicable securities on a quarterly basis during quarterly index reviews. New additions to the MSCI Equity Indices resulting from a quarterly index review may be considered for inclusion at the following quarterly index review. For example, a security added to the MSCI Equity Indices as a result of a November index review may be considered for inclusion at the February quarterly index review.

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From Screening to Compliance Strategies: The Case of Islamic Stock Indices with Application on "MASI"

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Abstract

The aim of this paper is to study the screening methodologies, as practiced by the mainstream Islamic stock market indices (ISI), through their application on the Moroccan All Shares Index (MASI). Thus, the possibility of providing the Casablanca stock exchange with its own Sharīʻah-compliant stock index will be studied. First, the specific processing to construct ISI will be explained. Then, the screening is performed based on the methodological rules set by the mainstream ISI. The use of screens, as recommended by these indices' Sharīʻah committees, leads to different decisions about rejection or acceptance of stocks in the constructed index. This leads, in turn, to a plurality of ISI even when created using the same starting investable universe. Finally, compliance strategies were presented and applied to the MASI.

JEL Classification: G11
KAUJIE Classification: L41
Keywords: Islamic stock indices, screening, compliance strategies, MASI.

Introduction

Though Islamic finance is a relatively new industry, it is growing rapidly and has become a significant financial sector in many countries (see Ahmed et al., 2015). Assets in the Islamic finance industry have grown 500% in the last five years,

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reaching US$1.3 trillion in 2011 (Ajmi et al., 2014) and expected to reach US$1.8 trillion by 2016 (Walkshäusl and Lobe, 2012). According to IFSB (2014), the Islamic Financial Services Industry is estimated to chart a compound annual growth rate of 17.04% between 2009 and 2013 with assets expected to surpass US$2 trillion in 2014. This growth is due to development of Gulf countries which continue to advance rapidly with accumulation of oil wealth (Ho et al., 2013). On the other hand, relaxing the constraints on interest-based activities by Sharīʻah scholars led to the growth of Islamic mutual fund industry (Binmahfouz, 2012). This industry is by far the fastest-growing segment within the Islamic financial system (Hassan and Girard, 2010). Abul (2014) argued that most of the growth of the Islamic finance industry originates from non-Muslim countries.

Among the aspects of this growth was the launch of the ISI. Indeed, after *Rashid Hussain Bank Islamic Index* (RHBII), the first ISI, was launched in 1996, the mainstream index providers (e.g., Dow Jones, FTSE, MSCI and S&P) have expanded their offerings to include Sharīʻah-compliant indices. A Sharīʻah-compliant stock index tracks the performance of listed companies that are deemed compatible with the Sharīʻah's tenets. The Sharīʻah compliance is set and monitored by the index's *Sharia* committee. It is worth noting the pressing need for a stock market in Islamic finance industry because of prohibition on interest (Iqbal et Molyneux, 2005); hence the importance of studying ISI.

The screening process is an essential step in constructing any ISI; it is a process to move from conventional to ISI. The Islamic screening rules are interpretations of Sharīʻah rulings by the Sharīʻah supervisory committee of the index. The peculiarity of these interpretations is the fact they transform rules that are qualitative in essence to quantitative measures that can be used for screening. Thus, diverging views among the different Sharīʻah committees is unavoidable. This divergence leads, even when starting from the same universe (i.e., the conventional index), to different ISI compositions depending on the screening methodology that is used (see Kafou and Chakir, 2013 and 2014).

I. Stock Market Indices: a Theoretical Framework

General Background

A stock index tracks changes in the value of a hypothetical stock portfolio (Hull, 2009). Indeed, a stock market index can be viewed as a portfolio comprising all or part of existing securities on a financial marketplace. This portfolio is representative of one or more risk factors (Amenc, 2003). A sector index, such as industry, is representative of this sector's risk. However, a stock index is not equivalent to a portfolio; the value of a portfolio is expressed in monetary terms. Typically, the value of the market portfolio (i.e., the market capitalization), can reach amounts of more than ten digits which is not convenient for market participants. The stock indices, by cons, are expressed in points that rarely exceed five digits. This is more convenient and makes comparison, calculation and tracking easier.

The main feature of indices is the fact of not being affected by adding or delisting of companies. This is not the case for a portfolio whose value changes for each purchase or sale of constituent stocks. The stability[1] and reducing of digits' number to handle for an index are achieved using the divisor[2].

Equity indices can be classified according to several criteria and the same index can simultaneously belong to several classes of indices. Thus, we can classify indices using their geographical scope to local, regional or global indices. A classification can also be performed based on the economic activities; this will result in sector indices. The size of the index constituent stocks can also serve as a classification criterion to distinguish indices of large, medium and small caps. There are also stock indices for emerging markets and others for developed markets. One can classify the stock indices according to weighting method into equal weighed, price weighted and market cap weighted. The last category encompasses indices that consider the market capitalization of each stock. Thus, the higher are the price and the number of outstanding shares more the company is represented in the index. The MASI, which is the starting universe to apply different screens, is a market cap weighted index.

Index Mathematics Methodology

A stock index level at time "t" can be written as follows:

$$index\ \ level_t = \frac{\sum Q_{it} \times P_{it}}{Divisor_t} \qquad (1)$$

The numerator on the right hand side of (1) is the price multiplied by the number of each stock in the index. The weight of a stock in the portfolio equals the proportion of the portfolio invested in the stock (Hull, 2009: p.59). The formula (1) is created by an adjustment of a *LasPeyres* index, which uses base period quantities (share

[1] Stability here does not mean that a stock index is frozen, but it is only fluctuations of stocks prices in the index that will impact its level.
[2] The divisor is a key concept to understand how stock market indices work. For more details (see S&P Dow Jones Indices, 2012; Kafou and Chakir, 2013 and 2014).

counts) to calculate the price change (S&P Dow Jones Indices, 2012). The divisor represents the initial market value and sets the base value for the index[3].

Creating a stock market index involves a set of concepts such as floating, the capped weights and the divisor adjustment. For more details about how to construct stock indices, see S&P Dow Jones Indices (2012) and Kafou and Chakir (2013 and 2014).

II. Islamic Equity Indices: from the Benchmark to a Sharī‘ah-Compliant Index

Screening is the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on the religious and ethical precepts of the Sharī‘ah (Hassan, 2000). The ISI are constructed from benchmarks (that form the starting universe) to which are applied financial screens (i.e., quantitative screens) and activity-based screens (i.e., qualitative screens). The Islamic screening is monitored by a Sharī‘ah committee that identifies eligible stocks to be part of the ISI.

Activity-Based Screening

The Islamic investment has first to be in line with the Sharī‘ah rules which forbid some activities. However, it is worth mentioning that most types of trade are permitted in Islam, where prohibition is the notable exception (El-Gamal, 2000). The first step in the screening process is qualitative. Nevertheless, it is necessary to distinguish between main and secondary activity.

a) The Main Activity

When the screening is done, it is necessary to exclude companies operating in the following sectors:

- Alcohol;
- Tobacco;
- Pork-related products;
- Conventional financial services (e.g., banking, insurance, etc.);
- Weapons and defense; and
- Entertainment (e.g., hotels[4], casinos and gambling, cinema, music, etc.).

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[3] For the MASI, the base market capitalization is that of 31/12/1991.

[4] Except income from hotels operating in Saudi Arabia (see MSCI, 2011).

And all activities considered illegal by Sharīʻah rulings. The ISI use nomenclatures with the codes of different sectors to rank companies and decide their compliance with Sharīʻah (see El Khamlichi, 2012).

b) The Secondary Activity

Companies in sectors considered unlawful by the Islam are unanimously considered *ḥarām* regarding the sale and buy of their shares. However, if a company has exceptional income from *ḥarām* activities including the investment of cash excess in interest bearing instruments, opinions are divergent. Some Sharīʻah scholars consider investment in these companies' shares as *ḥarām*, while others issued a legal opinion (i.e., *fatwa*) that allows this investment under two conditions:

- ❖ Interest income and income from non-compliant activities must be less than 5 %[5] of the total income; and
- ❖ To purify dividend.

1) The Ratio-Based Screening

The ratio-based screening considers the financial structure of the issuing companies. Therefore, a series of ratios has been established. In this section, we will mainly focus on the ratios used by the mainstream ISI including: *Dow Jones Islamic* (DJIMI), *S&P* Sharīʻah, *Islamic MSCI*, *FTSE* Sharīʻah and *Islamic STOXX*.

a) Debt Level

Table 1 resumes the ratios used by the mainstream ISI to screen the Indebtedness of a company.

One can notice that, as numerator, all committees use total debt. Besides, the threshold is almost the same for the five indices. The 33% threshold is not fixed either by the Qur'ān or the *Sunna***,** but set by the Muslim jurists. The 33% limit is a questionable extension of the threshold from which shareholders have a veto at the general meetings (Cekici, 2009), or of the *Hadith*: "*One-third, and the one-third is too much*" (Binmahfouz, 2012: p. 89; El-Gamal, 2000; Obaidullah, 2005). Critics of the one-third rule assert that it involves an out-of-context use of the above *ḥadīth* (Obaidullah, 2005). Indeed, this is clearly an out-of-context use of the *ḥadīth*, and

[5] Note that for the S&P and Dow Jones, any involvement in sectors that are excluded when screening the main business results in screening out from these two indices.

jurists do not claim that it is used as a legal proof, but rather as a comforting rule of thumb (El-Gamal, 2000).

Table-1
Debt Screens of the Mainstream ISI

Index	Debt screen
Dow Jones Islamic	$\frac{\text{Total debt}}{\text{Trailing 24-month average market capitalization}} < 33\%$
S&P Sharīʻah	$\frac{\text{Total debt}}{\text{Trailing 36-month average market capitalization}} < 33\%$
MSCI Islamic	$\frac{\text{Total debt}}{\text{Total assets}} < 33,33\%$
FTSE Sharīʻah	$\frac{\text{Total debt}}{\text{Total assets}} < 33\%$
STOXX Islamic	$\frac{\text{Total debt}}{\max(\text{Total assets, Total market capitalization})} < 33\%$

Source: by authors based on the Index methodology guide of the considered indices **(**FTSE, 2011**;** MSCI, 2011**;** S&P, 2011**;** STOXX, 2013**;** Dow Jones Indexes, 2012)

The debts to screen are those that produce interests. Thus, it should not include the trade payables, outstanding salaries, taxes owed to the government and all other debts not generating interests.

In the denominator, by cons, two trends are revealed: indices that use the market capitalization and others using total assets. The use of market capitalization faces three major problems (see Ali, 2005: pp.26-27; Khatkhatay and Nisar, 2007). The market value of a security may be driven by feelings about future earnings and movements regardless of the company's fundamentals. In addition, the market conditions, whether they are favorable or unfavorable, can lead to volatility in the market value of a company. Thus, a company's capitalization may experience considerable variations while its managed assets remain the same. Finally, the market capitalization cannot be used to check the compliance of private companies. However, the use of the market capitalization has the advantage of allowing a continuous screening of listed stocks. The use of total assets, in turn, is not a suitable measure because it depends on the accounting standards the company chooses to evaluate its assets. It is worth mentioning that using the higher of either total assets or market capitalization will broaden the investment universe.

Another approach proposed by Khatkhatay and Nisar (2007) is to use a denominator based on the objective of the screen. Thus, the use of capitalization to calculate the liquidity ratio is more suitable given its objective to ensure that liquid assets are traded at par (i.e., the rule of *ṣarf* is observed) (Binmahfouz, 2012). For the debt screen, using total assets is more suitable, since the objective is to control the company's main source of financing (Binmahfouz, 2012). However, in the Moroccan case, the use of total assets is hindered by the frequency of the financial statements' publication. These statements are generally published yearly. This will make the index review (see II.3) also annual which is not practical.

b) Liquidity Screen

Table 2 resumes the ratios used by the mainstream ISI to check the liquidity level of a company.

Table-2
Liquidity Screens of the Mainstream ISI

Indices	Liquidity screen
Dow Jones Islamic	$\frac{\text{Cash and interest-bearing securities}}{\text{Trailing 24-month average market capitalization}} < 33\%$
S&P Sharīʻah	$\frac{\text{Cash and interest-bearing securities}}{\text{Trailing 36-month average market capitalization}} < 33\%$
MSCI Islamic	$\frac{\text{Cash and interest-bearing securities}}{\text{Total assets}} < 33,33\%$
FTSE Sharīʻah	$\frac{\text{Cash and interest-bearing securities}}{\text{Total assets}} < 33\%$
STOXX Islamic	$\frac{\text{Interest-bearing assets}}{\max(\text{Total assets, Total market capitalization})} < 33\%$

Source: by authors based on the Index methodology guide of the considered indices

The liquidity screen removes companies with an overwhelming part of assets held in cash and interest bearing securities. The stock of these companies would have a quasi-monetary underlying assets and consequently eligible for application of the *ribā* prohibition rules (Cekici, 2009). Indeed, negotiating such a company's stock equals an exchange of money for money. This exchange is only possible, within the framework of Islamic finance, hand-to-hand and at par. Otherwise, the transaction falls under the forbidden *ribā*.

c) Accounts receivable screen

Table 3 resumes the screens used by the mainstream ISI to control receivables level of a company.

Table-3
Accounts Receivable Screen of the Mainstream ISI

Indices	Receivables screen
Dow Jones Islamic	$\frac{\text{Accounts receivable}}{\text{Trailing 24-month average market capitalization}} < 33\%$
S&P Sharī'ah	$\frac{\text{Accounts receivable}}{\text{Trailing 36-month average market capitalization}} < 49\%$
MSCI Islamic	$\frac{\text{Accounts receivable}}{\text{Total assets}} < 33{,}33\%$
FTSE Sharī'ah	$\frac{\text{Accounts receivable} + \text{cash}}{\text{Total assets}} < 50\%$

Source: by authors based on the Index methodology guide of the considered indices

The first observation is that the Sharī'ah committee of STOXX does not use this screen. The receivables screen is interpreted as a yardstick for characterizing "core business" of the company in question. In this regard, if the majority (more than 50 percent) of a company's assets are financial, rather than real, the main business of the company is deemed to be financial dealings, and it is thus excluded (El-Gamal, 2006: p.127).

The *FTSE* Sharī'ah is the only index using in the numerator, besides receivables, available liquidity. This divergence in the ratio's calculation components and the tolerance threshold is mainly due to the need to consider the operational needs of companies.

2) Periodic Review[6]

The index composition is reviewed periodically by the managers of the index by deciding the new companies to include and those to exclude from the index. Thus, companies must consistently go through the screening. An audit of Sharīʻah compliance is performed quarterly in March, June, September and December for the Dow Jones Islamic Indices, FTSE Sharīʻah and Islamic STOXX. For the S&P Sharīʻah, the review is conducted every month.

3) Criticism Addressed to the Islamic Screening:

a) Financial Viability

One of the criticisms to the screening is to bring down the investors' universe which leads to low-performing indices. However, there is no consensus about the relative performance of ISI. Thus, from the used overall period, Atta (2000), Hakim and Rashidian (2002), Hussein (2005), Abul et al. (2005), Hussein and Omran (2005), Hooi and Parsva (2012), Affaneh et al. (2013) and Ho et al. (2013) supported the thesis of outperformance of ISI compared to their conventional benchmarks. Nevertheless, Zamri and Haslindar (2002) and Al-Khazali et al. (2013) found that ISI underperformed conventional ones. On the other hand, Hakim and Rashidian (2004), Hussein (2004), Albaity and Rubi (2008), Guyot (2008), Girard and Hassan (2008 and 2010) and Lobe et al. (2012) inferred that no significant difference in performance exists between ISI and their conventional counterparts.

Another approach used to study the Islamic indices' performance is reasoning through market cycles and geographical localization. Thus, Zamri and Haslindar (2002), Hussein (2004 and 2005[7]), Hussein and Omran (2005) and Girard and Hassan (2010) found that ISI underperform their conventional counterpart during the bear market and outperform them during the bull market. The ISI underperforming conventional ones during the bear market was an agreed characteristic of them. Authors explained it by the exclusion of liquor companies (Hussein, 2004) and the event of September 11th (Hussein and Omran, 2005). The subprime crisis was an inflection point of this belief, the ISI performed better than conventional indices (Lobe et al., 2012; Ho et al., 2013). Lobe et al. (2012) argued that "*Islamic screens*

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[6]Note that here we consider the review on the grounds of Sharia compliance. Other events occurring at different times during the year can raise the need to review an index; such as the delisting of a company, bankruptcy and companies merge.

[7] Note that in this study, during the second bull market period, the ISI underperformed their conventional benchmarks.

might not affect unconditional performance through the cycle, but might well affect performance conditional on the cycle. However, it is hard to tell ex ante [...]". The outperformance of ISI during the recent financial crisis may be explained by the exclusion of financial sector, but this performance is not guaranteed for the next downturn. Adding a geographical dimension to the analysis, Walkshäusl et Lobe (2012) found that ISI outpaced their conventional counterparts in the developed market but the inverse is true for emerging markets.

b) Social Responsibility

It is noticeable that screening rules applied by the Sharīʻah committees do not include social concerns and are exclusively based on exclusion (i.e., negative screening). Thus, human rights violations and environmental damage are not considered in deciding the Sharīʻah compliance of a company. This raises reasonable questions like how a company involved in violations of human rights and serious environmental damage may be conform to Sharīʻah? Isn't it contrary to the principles of Sharīʻah to disrespect the human rights and cause environmental damage? (Binmahfouz, 2012). This is surprising because it contradicts the fundamental principles of Islamic finance and investment as a socio-economic and financial system that requires the integration of ethics and morals in all economic activities (Binmahfouz, 2012: p.98).

c) The Lack of Consensus and Stability of Screening Rules

As it can be noticed from tables 1 to 3, each index uses its own screening rules. The calculation method and the thresholds differ from one index to another. In fact, the tolerance threshold for receivables ranges between 100% and 33%, while the debt and liquidity ones are less dispersed. It is worth noting that some Sharīʻah committees, such as the Sharīʻah Advisory Council (SAC) in Malaysia, do not apply any quantitative screens (see Azhar et al., 2010).

Furthermore, the screening ratios are not the same from one period to another for the same index. This instability is another criticism to the screening process. For example, during the subprime crisis, the DJIMI and the S&P Islamic indices increased the moving average of the market capitalization divisor from trailing 12 months to 24 and 36 respectively (see Binmahfouz, 2012). This was done to further smooth the ratio. Another example of evolving screening rules is the changing of denominator from total assets to the market capitalization by DJIMI for the receivables screen (Binmahfouz, 2012). These changes can render a Sharīʻah-compliant stock non-compliant and vice versa while the issuing company's structure has remained the same. All these elements will create confusion among investors guided by their faith.

d) An Automated Screening

Screening is usually performed automatically. Thus, based on an industry classification, the screening excludes automatically companies whose activity code corresponds to the sectors listed above without any other consideration. This treatment will automatically exclude an Islamic bank or a Takaful insurance company because they belong to the category of Banking and Insurance (Siddiqui, 2011). Therefore, many experts propose to conduct screening at the company's level not based on the sector (Alqahtani, 2009). In this perspective, Reuters and IdealRatings launched in 2011 the Research-Based screening indices. Unlike the automated screening, the Research-Based screening examines the various sources of non-compliant income rather than a broad sector classification. Moreover, this screening is based on research of financial data and does not count the Sharī'ah-compliant debt such as *ṣukūk* in calculating the debt screen (Ghoul, 2012).

III. Applying the Screening to the MASI

The MASI is a comprehensive index that includes all stocks listed on the Casablanca Stock Exchange (BVMC). The MASI was calculated for first time in 1991 and the transition to floating was in December 2004. The MASI consists currently of 76[8] companies spread across different industries. The last IPO, at the time of writing this paper, concerns TOTAL MOROCCO which dated on 29/05/2015.

1) Research Questions and Methodology

a) Research Questions

This work is articulated around two main research questions:

Q1: the ISI of the BVMC, in case of existence, is it unique or depends on the used screening rules?

[8] Note that several changes occurred since the present study as the delisting of FERTIMA, SCE and SOFAC and an IPO of TAQA MOROCCO. On the other hand, a Public Offer of Withdrawal by CGI is expected.

The first question will allow confirming an existing result in the Islamic investing literature, in the Moroccan context, which states that the composition of ISI depends on the used screening rules. If ISI composition depends on the screening methodology, it is important to know:

Q2: What are the most important areas of concordances and discrepancies in the screening process?

This question seeks essentially to identify screens and sectors that have the highest rate of discrepancies.

b) Methodology

To answer the research questions, we took a sample of 76 companies that represents all companies listed on the BVMC. Data for these companies (i.e., sector, summary statements, quotation and market capitalization) are collected from the BVMC's website.

The collected data are then combined to consider only information that is necessary to perform the qualitative screening or to calculate the needed ratios. After this step, the screens recommended by the Sharīʿah committees of the mainstream ISI are applied to get the Islamic version of the MASI.

2) Applying Screens

a) Sector-based Screening

The first step in constructing an ISI is to check whether the main activity of every company is Sharīʿah-compliant. Companies excluded because of their main business are shown in table 4.

b) Quantitative Screening

⌗ The share of *ḥarām* revenues

Details on secondary activities are not available on the BMVC's website. Thus, screening based on secondary activity, belonging to the qualitative screening, is not possible. In this section, we will rather focus on the portion of interest income in the total turnover. This share must not exceed 5%. The application of this screen on the companies that passed the qualitative screening allowed detecting companies with interest income exceeding that threshold.

Table-4
The BVMC's Companies Screened out because of the Activity Sector

Company	Sector	Nbr. shares	Price	IWF	Free Mar Cap	Weight
WAFA ASSURANCE	Insurance	3 500 000	2 925,00	0.25	2 559 375 000,00	2.66%
CNIA SAADA	Insurance	4 116 874	1 000,00	0.25	1 029 218 500,00	1.07%
ATLANTA	Insurance	60 190 436	63.36	0.20	762 733 204,99	0.79%
AGMA LAHLOU-TAZI	Insurance	200 000	2 370,00	0.25	118 500 000,00	0.12%
ATTIJARIWAFA BANK	Banking	201 243 086	319.50	0.25	16 074 291 494,25	16.69%
BCP	Banking	173 141 923	192.00	0.25	8 310 812 304,00	8.63%
BMCE BANK	Banking	179 463 390	197.50	0.20	7 088 803 905,00	7.36%
BMCI	Banking	13 278 843	770.00	0.20	2 044 941 822,00	2.12%
CIH	Banking	26 608 085	231.00	0.20	1 229 293 527,00	1.28%
CDM	Banking	9 223 916	579.90	0.15	802 342 333,26	0.83%
BRASSERIES DU MAROC	liquor	2 825 201	2 500,00	0.10	706 300 250,00	0.73%
RISMA	Hotels	7 882 935	184.95	0.20	291 589 765,65	0.30%
EQDOM	Conventional financial service	1 670 250	1 620,00	0.25	676 451 250,00	0.70%
SALAFIN	Conventional financial service	2 394 497	560.00	0.25	335 229 580,00	0.35%
MAGHREBAIL	Conventional financial service	1 025 320	858.90	0.20	176 129 469,60	0.18%
TASLIF	Conventional financial service	21 472 500	36.00	0.15	115 951 500,00	0.12%
MAROC LEASING	Conventional financial service	2 776 768	383.05	0.10	106 364 098,24	0.11%
AXA CREDIT	Conventional financial service	600 000	328.80	0.15	29 592 000,00	0.03%
SOFAC	Conventional financial service	1 416 664	350.00	0.05	24 791 620,00	0.03%
DIAC SALAF	Conventional financial service	1 053 404	26.25	0.45	12 443 334,75	0.01%
	Nbr.	20		Total excluded weight		44.11%

Source: by authors

At the end of the sector-based screening stage, 20 companies have been excluded representing 44.11% of the free float market capitalization.

Table-5
The BVMC's Companies Screened out because of Impure Income

Company	Interest revenue	Total turnover	%	weight
ALLIANCES	103,784,740.74	266,546,007.10	39%	1.51%
MINIERE TOUISSIT	77,533,253.47	675,756,131.65	11%	0.72%
DELTA HOLDING S.A	4,450,641.35	73,265,400.38	6%	0.68%
ZELLIDJA S.A	4,615,867.76	8,844,601.30	52%	0.02%
Nbr.	4	Excluded weight :		2.93%

Source: by authors

⌗ Debt screening

The debts screening has detected three types of companies:

- ❖ Companies accepted in the index composition, regardless of used screen for debts;
- ❖ Companies excluded, regardless of used screen for debts; and
- ❖ Companies that may be excluded or accepted according to used screen for debts.

Existing conflict (i.e., acceptance or rejection) is due to the fact that divisor is not the same: some screens use the market capitalization whereas others use total assets or the higher of the two as for STOXX. Thus, the first result of this work is that the composition of the ISI depends on the used screens. From now, we will only exclude companies that are screened out, regardless of the used ratio.

Table-6
The BVMC's Companies Excluded Regardless of Used Debt Screen

Company	Market Cap	Total Assets	T24MAMC	T36MAMC	Total Debt	Debt screen (DJIM)	Debt screen (S&P)	Debt screen (MSCI/FSTE)	Debt screen (STOXX)
HOLCIM (Maroc)	6,378,150,000	4,648,797,110	6,179,184,966	5,823,926,144	2,243,951,561	0.36	0.39	0.48	0.35
ALUMINIUM DU MAROC	533,051,376	827,253,950	556,194,784	501,085,842	314,873,570	0.57	0.63	0.38	0.38
SNEP	420,600,000	1,179,564,936	404,934,579	396,806,061	450,497,942	1.11	1.14	0.38	0.38
LABEL VIE	3,817,915,500	361,804,730	3,806,776,015	3,807,386,414	1,893,547,141	0.50	0.50	5.23	0.50
STOKVIS NORD AFRIQUE	344,818,125	1,056,643,291	361,393,672	340,407,118	438,950,376	1.21	1.29	0.42	0.42
FERTIMA	165,600,000	629,808,368	161,519,112	146,452,789	315,803,318	1.96	2.16	0.50	0.50
DOUJA PROM ADDOHA	15,781,500,000	34,243,196,450	15,427,137,944	14,471,051,397	11,405,205,935	0.74	0.79	0.33	0.33
SAMIR	3,316,436,636	35,086,143,700	3,470,777,215	3,470,429,087	20,521,711,950	5.91	5.91	0.58	0.58
MED PAPER	58,365,743	628,481,842	58,310,289	53,481,217	355,505,007	6.10	6.65	0.57	0.57
	Nbr.			9		Exluded weight:			12.69%

Source: by authors

The following table summarizes the results of concordances and discrepancies between different screens. The green areas show the number of companies being accepted or rejected jointly by each pair of screens (i.e., consensus). The gray areas display companies which raise mismatch between each pair of screens. Elements on the diagonal are the number of companies that passed the debt screen of the index, divided by the number of companies resulting from the previous step of screening.

It is noticeable that the debt screen of DJIMI and S&P gives the same results. The same thing is true for FTSE and MSCI. The greatest divergence, in terms of debt screening, is recorded between DJIMI (and thus S&P) and FTSE (and thus MSCI). This is due to the nature of divisor in both cases. Indeed, there is a crossing from the average market capitalization to total assets. Using the higher of either total assets or market capitalization may seem like a solution to ensure harmony between different screening ratios. Thus, the Islamic STOXX would be in line with other ISI. However, it is worth noting that even for indices using the market capitalization, the divisor used is not the same. Some indices use the average capitalization over 24 months, while others use the average over 36 months. Another case is the use of the calculated market capitalization at the time of screening. The averaging of market capitalization causes the smoothing of the ratio and thus leads to a greater stability of the index composition. The STOXX has lower concordance with the indices using market capitalization than those using total assets[9].

Table-7
Results of the Debt Screening

	DJIMI	S&P	FSTE	MSCI	STOXX
DJIMI	31/52	0	13	13	12
S&P	52	31/52	13	13	12
FSTE	39	39	42/52	0	1
MSCI	39	39	52	42/52	1
STOXX	40	40	51	51	43/52

Source: by authors

The following graph illustrates the concordances and discrepancies by activity sector. A concordance means that the company is subject to consensus (retention or rejection from the index), regardless of the used screen. The discrepancy is to understand in the sense there is a case in which decision on a company (i.e., retention or rejection) is not the same for a pair of screens.

Given the limited number of companies in the MASI before screening and thus the limited number of companies by sector, it is difficult to rule definitively on the sectors leading to divergence in debt screening. Arguably, firms in the Construction and Building Materials, Consumer Goods, Distributors and

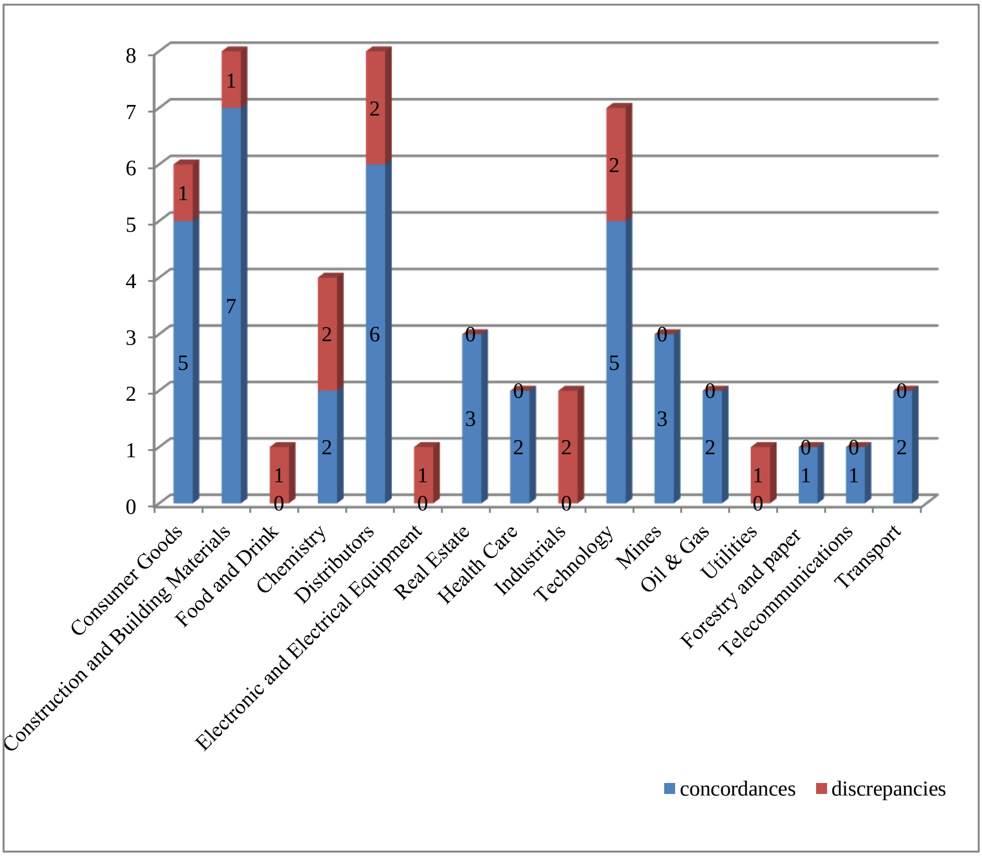
[9] Note that 39 out of 52 companies in the screening universe had total assets greater than the market capitalization.

Technology recorded the highest number of concordance cases. This is because companies in these sectors have market capitalization that is close to total assets.

⌗ Liquidity Screen

For liquidity screen, the three previously met cases were found. The liquidity screen allows to definitively excluding one company.

Graph-1
Concordances and Discrepancies for Debt Screen by Activity Sectors



Source: by authors

Table-8
The BVMC's Companies Excluded Regardless of Used Liquidity Screen

Company	Market Cap	Total Assets	T24MAMC	T36MAMC	IBS*	cash
M2M Group	140,340,887	174,656,112	133,847,733	135,976,937	59,322,765	29,914,973.87
Liquidity screen (DJIM)	Liquidity screen (S&P)	Liquidity screen (MSCI/FSTE)	Liquidity screen (STOXX)	Nbr.	1	
0.667	0.656	0.511	0.340	Weight	0.04%	

* IBS are interest bearing securities
Source: by authors

As for the debt screen, table 9 summarizes the concordances and discrepancies detected when applying the liquidity screen.

Table-9
Results of Applying the Liquidity Screen

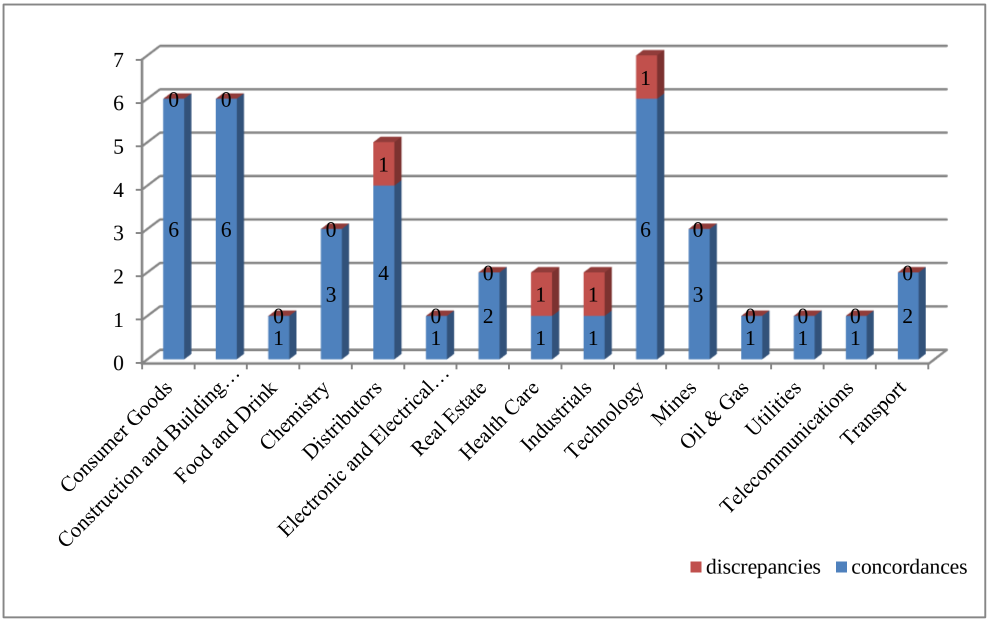
	DJIMI	S&P	FSTE	MSCI	STOXX
DJIMI	39/43	0	3	3	3
S&P	43	39/43	3	3	3
FSTE	40	40	40/43	0	2
MSCI	40	40	43	40/43	2
STOXX	40	40	41	41	42/43

Source: by authors

As for debt screens, besides the DJIMI and S&P, FTSE and MSC give the same results for liquidity screening. The highest divergence for liquidity screen is recorded between DJIMI (and thus S&P) and FTSE, MSCI and STOXX on the other hand. Yet, the number of discrepancies is relatively smaller than the one encountered when screening debts[10]. This can be explained by the fact that IBS and cash represent, for the BVMC's companies, negligible amounts compared with market capitalization and total assets. Graph 2 shows the concordances and discrepancies by activity sectors.

[10] Note that although the companies' number was reduced by debts screening, this is true since the previous universe was reduced only by companies that are excluded by all screening methodologies. Thus, it is the number of concordance cases that was reduced.

Graph-2
Concordances and Discrepancies for Liquidity Screen by Activity Sectors



Source: by authors

It is noted that sectors of Construction and Building Materials, Consumer Goods, Distributors and Technology continue to record the highest number of concordance cases.

⌗ Receivables Screen

For receivables screen, the three cases met in screening debts and liquidity still persist. However, receivables screen allowed screening out definitively five companies.

The first finding is the absence of a pair of screens giving the same result. The highest discrepancy is recorded between the DJIMI and STOXX; it is of 21 cases. This difference is due to the absence of receivables screen for STOXX. Even for indices using this screen, the discrepancy cases are of 14 companies between DJIMI/S&P in one hand and MSCI on the other hand. This can be explained by differences in calculation components and tolerance thresholds. In addition, screening according to DJIMI and S&P shows some differences even though both use the average market capitalization. Thus, we can notice that the period over which the moving average is calculated causes some differences between the two indices. The longer the duration is, the greater is the smoothing. This smoothing allows including more companies in the index. The receivables screen is by far the one that causes discrepancies. Graph 3 shows the concordances and discrepancies by activity sectors.

Table-10
The BVMC's Companies Excluded Regardless of Used Receivables Screen

Company	Market cap	Total Assets	T24MAMC	T36MAMC	Receivables	Cash	receivables screen (DJIM)	receivables screen (S&P)	receivables screen (MSCI)	receivables screen (FSTE)
HPS	206,858,106	275,880,660	202,672,225	194,580,011	124,483,547	16,344,276	0.61	0.64	0.45	0.51
S.M MONETIQU	151,400,000	168,411,082	150,981,378	141,230,986	97,219,750	4,982,352	0.64	0.69	0.58	0.61
MICRODATA	188,160,000	156,591,923	195,317,425	195,928,719	102,800,225	24,505,794	0.53	0.52	0.66	0.81
INVOLYS	47,839,500	83,050,098	45,872,228	42,464,693	40,090,925	16,581,614	0.87	0.94	0.48	0.68
IB MAROC.COM	45,923,460	334,511,895	46,416,397	47,190,597	228,138,244	701,522	4.92	4.83	0.68	0.68
	Nbr.			5.00			Excluded weight :			0.29%

Source: by authors.

As for debt and liquidity screens, table 11 summarizes the results of receivables screens.

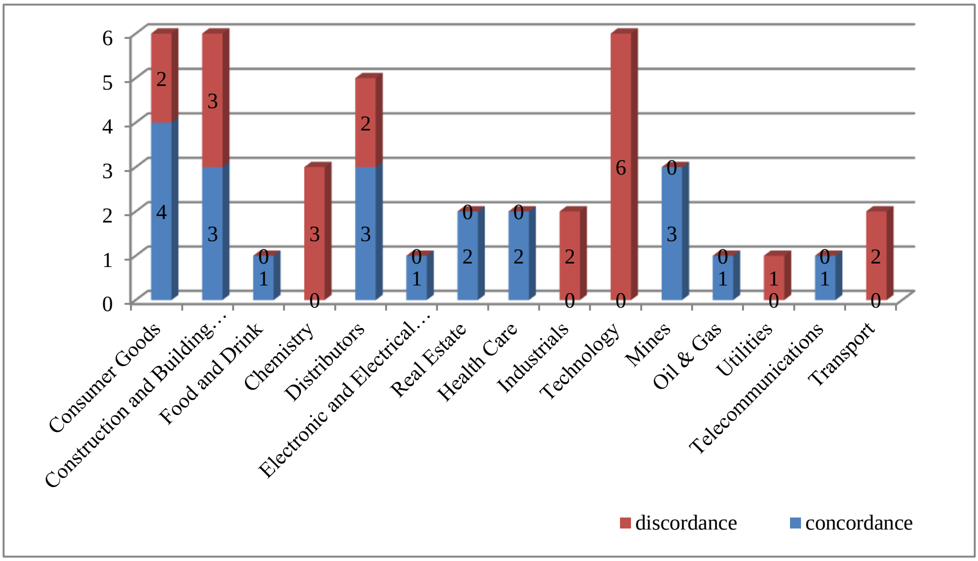
Table-11
Results of Applying Receivables Screen

	DJIMI	S&P	FSTE	MSCI	STOXX
DJIMI	21/42	4	9	14	21
S&P	38	25/42	9	14	17
FSTE	33	33	28/42	7	14
MSCI	28	28	35	35/42	7
STOXX[11]	21	25	28	35	42/42 (N/A)

Source: by authors

[11] The number of companies accepted in this index is the same as at the end of liquidity screening. The concordance between STOXX and other indices is nothing but the number of companies included in these latter. Similarly, the discrepancies are calculated as the companies rejected by a given screening methodology.

Graph-3
Concordances and Discrepancies for Receivables Screen by Activity Sectors



Source: by authors

For receivables screen, it is difficult to comment on an industry trend regarding concordances and discrepancies. However, it is noticeable that the Technology sector reversed its trend. Indeed, given the importance of receivables in this sector, the four variants of screening exclude 5 out of 6 companies operating in this sector (see table 10 above). Meanwhile, the STOXX screening methodology keeps all companies because it does not perform any receivables screen.

3) The Composition of Islamic MASI (IMASI)

After applying different screens, we will continue with describing the BVMC's ISI we called "IMASI". This index will include, according to the screening methodology, a more or less important number of companies. The following table summarizes the IMASI's composition according to the used screening:

One can notice that even if screening leads to different results, the free float market capitalization of the different variants of the IMASI is almost the same. This is due to the small market capitalization of the companies raising conflict between the different families of indices. For a comprehensive details about the IMASI see Kafou and Chakir (2013 and 2014).

Table-12
The IMASI's Composition According to the Screening Methodology

Screens	Nbr. of Companies	Weight to the MASI's free float market cap
DJIMI	21	38,69 %
S&P	25	39.02 %
FSTE	28	39.26 %
MSCI	35	39.70 %
STOXX	42	40.22 %

Source: by authors

IV.Compliance Strategies

The compliance strategies are designed to combine the different basic screening rules. Thus, from these basic rules, we define other strategies that meet specific objectives. These latter may be related to portfolio management (i.e., performance), the need to further refine the screening (i.e., to take a conservative approach) or other objectives pursued by the organization or the investment funds.

1) Mathematical Notation:

Let "S" be the set of basic screening strategies and "G" the set of all financial screens within these strategies. A basic strategy is defined as a set of guidelines $G_s \subset G$. For the present study; noting s (a) the screening strategy adopted by the index "a" we will have:

- S={s (DJIMI), s (S&P), s (FSTE), s (MSCI) and s (STOXX)};
- G= {G_{DJIMI}, $G_{S\&P}$, G_{FSTE}, G_{MSCI}, G_{STOXX}};
- G_{DJIMI}= {Debt screen $_{DJIMI}$, Receivables screen $_{DJIMI}$, liquidities screen $_{DJIMI}$}; and
- T (DJIMI)={ 33 %, 33 %, 33 %}.

We can see that "G" is nothing more than the combination of tables 1 through 3. Let's $g \in G$ be a screening rule, we have to calculate a financial ratios $r_i(g)$ for each asset "i". The calculated ratio is then compared with the threshold value T (g). Thus, we need to control a set of constraints as follows:

$$r_i(g) \leq T(g)$$

Thus the weight of each asset in the index (or the portfolio) will be equal to 0 if $r_i(g) > T(g)\ \forall i \in I$, with I being the resulting investment universe from the qualitative screening. Derigs et Marzban (2009) introduced four compliance strategies; namely *Ijmā'*, liberal, majority and "best of". These strategies will be discussed in the following sections.

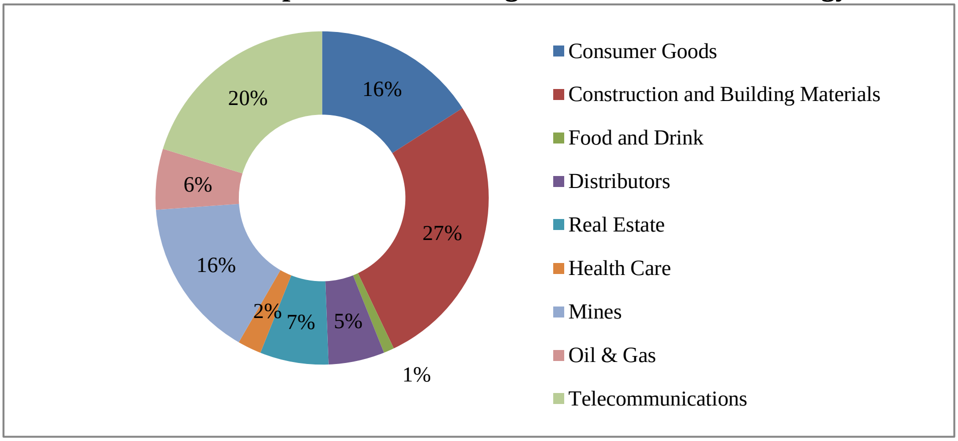
2) The Consensus or *Ijmā'* Strategy

In this strategy, we choose the portfolio that fulfills all requirements of all basic screening strategies. Thus, a stock is said to be complaint in the sense of *ijmā'* strategy if and only if:

$$r_i(g) \leq T(g)\ \forall i \in I\ \forall g \in G$$

Applying this strategy on MASI gives a total number equal to 21 companies to include in the index. This represents 24.78% of the free float market capitalization of the MASI. The consensus strategy and the DJIMI screening give almost identical results, confirming its reputation of being the most conservative among the ISI (Alqahtani, 2009).

Graph-4
Index Composition According to the Consensus Strategy



Source: by authors

The findings show that only 9 sectors are represented in the index created using the consensus strategy. The largest share of index capitalization is made up by

Construction and Building Materials (27%) followed by Telecommunications (20%).

3) The Liberal Strategy

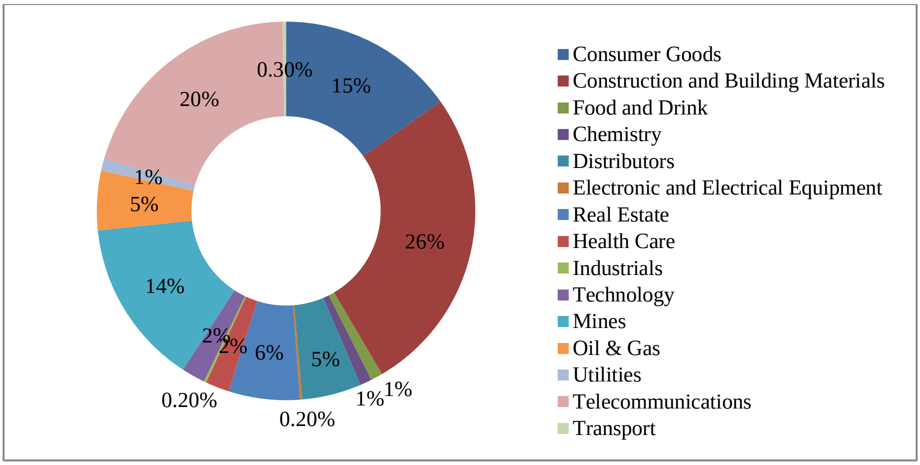
This strategy consists of reducing the investable universe of assets that are jointly defined as non-compliant by all basic screening strategies. In this case, compliance is defined as follows:

$$\forall i \in I \; \exists s / \forall g \in G_s \;\; : r_i(g) \le T(g)$$

Thus, "*I*" will be reduced by companies in tables 6 and 8. This strategy is very useful, especially when the *card(I)*[12] is too small. In this case, the liberal strategy will allow including a number for stocks that permits a reasonable diversification.

This strategy, in this study, produces results identical to those got using the STOXX screens. It allowed including 42 companies representing 40.22% of the free float market capitalization of the BVMC. The sector allocation using the liberal strategy is given by the following graph:

Graph-5
Index Composition According to the Liberal Strategy



Source: by authors

[12] The cardinal number of a set is the number of distinct elements in this set.

We note a greater variety of sectors in the index constructed using the liberal strategy. The Construction and Building Materials sector continues to grab the largest share of the capitalization (26%) followed by Telecommunications (20%).

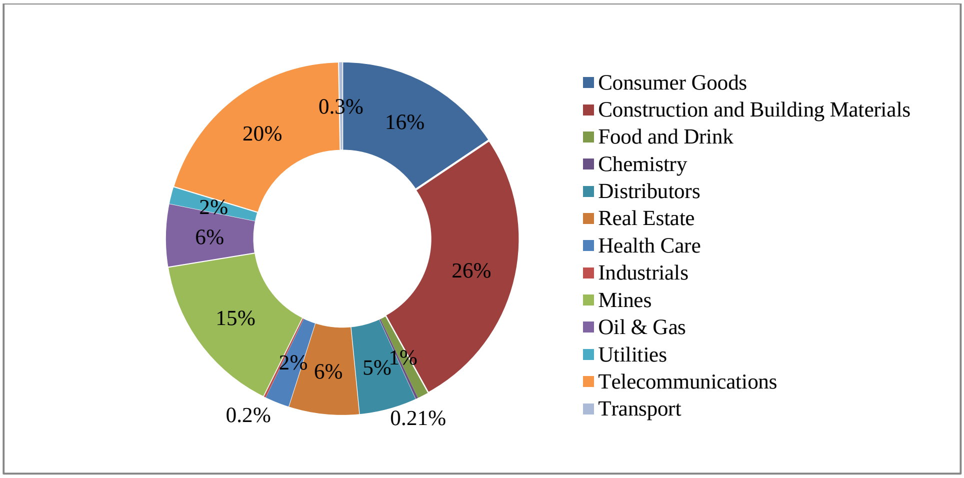
4) The Majority Strategy:

This strategy consists in keeping the portfolio of companies that are accepted by most of the screening guidelines. This strategy can be formalized as follows:

$$\forall i \in I \ \ for\ H \subset S \ / \ \forall s \in H \ \forall g \in G_s : r_i(g) \leq T(g) \ \ and\ card(H) \geq \frac{card(S)-1}{2} + 1$$ [13]

The use of this strategy allows including 30 companies representing 39% of the free float market capitalization of BVMC. We can see that the *ijmā'* strategy is always included in the majority one. The sector allocation using the majority strategy is given by the following graph:

Graph-6
Index Composition According to the Majority Strategy



Source: by authors

It is found that only 13 sectors out of 15 are represented in the index constructed using the majority strategy. The Construction and Building Materials sector

[13] When card (S) is even, we can take card (S)/2 and consider, in this case, that the set "S" includes the screening rules of the SAC. Indeed, this latter does not apply quantitative screening and thus would retain all elements of "I".

continues to grab the largest share of the total free float market capitalization (26%) followed by Telecommunications (20%).

5) The "Best of" Strategy:

In the "best of" strategy, we choose the basic screening strategy leading to the portfolio with the best performance for chosen criteria. This strategy involves a trade-off between different basic screening strategies.

Conclusion

Morocco is lagging behind his counterparts in the Gulf regarding Islamic finance. On the eve of Islamic banks' launch in Morocco under the label "participative banks", this paper tries to shed light on another important compartment for financing the economy, namely the stock market.

Sharīʻah's experts have made many compromises to allow the existence of ISI. The strict application of Sharīʻah will lead to few compliant companies, making a reasonable diversification impossible (El-Gamal, 2000). Thus, screening rules have been set by indices' Sharīʻah committees. These rules rely heavily on *ijtihād* which explains the divergence in rulings between committees.

In this paper, we focused on the screens used by Sharīʻah committees of mainstream ISI, the various criticisms to these screens and the possible ways to harmonize the practice of screening globally.

The study focused on listed companies on the BVMC. While the activity-based screening leads to the same results, financial screening produces different results depending on the used ratio. This situation will lead to a plurality of the ISI even if constructed from the same starting universe. This plurality can create confusion among investors who are guided by their faith. In the case of Morocco, where the financial statements are published yearly, financial ratios based on the market capitalization are more suitable for screening. Indeed, these ratios will allow a reasonable review frequency of the IMASI. On the other hand, the limited number of companies listed on the BVMC will render easy the research-based screening.

The results of this study show that activity-based screening removed a total of 20 companies. This represents almost 44% of the free float market capitalization of the BVMC. The financial screening, in turn, removed between 13% and 15% of this floating capitalization and a number of companies ranging from 10 to 31. For financial screening, the STOXX committee remains the most liberal. Indeed, its screening methodology allowed to include in the index the highest number of companies (42 in total), whereas the screens used by Dow Jones allowed only to include 21 companies in the IMASI. This confirms that the screening of the Dow Jones Islamic remains the most conservative among the ISI (Alqahtani, 2009). The averaging of market capitalization causes the smoothing of the ratio and thus leads to a greater stability of the index composition. This smoothing is important especially in times of crisis and its effect is proportional to used period to calculate the moving average.

In this paper, we also discussed the compliance strategies. The first finding is that liberal strategy and the STOXX screening lead to the same results. The *Ijmā'* strategy, which is underpinned by conservative considerations, is close to screening methodology of the DJIMI.

Nevertheless, the Islamic screening may be biased: an example is the breach of the principle of profits and losses sharing because of the existence of preferred stock. On the other hand, one must distinguish between the Islamic screening and trading of securities on the stock market. Indeed, a stock can pass the screening process successfully, but without any insurance that transactions on it are in line with the Sharīʻah. In fact, stocks are subject, for example, to short selling that is prohibited by Sharīʻah. Hence the need for an Islamic stock market not only ISI.

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Toward Developing a Model of Stakeholder Trust in *Waqf* Institutions

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Abstract

Sustainability of Waqf institutions for poverty alleviation depends directly or indirectly on the donations received from the donors and the awareness of the society. This conceptual paper is an attempt to construct a model of stakeholder trust that could provide valuable insight on the issues that should be focused by the regulators, the mutawallis and the waqifs for ensuring a sustainability of waqf Institutions. The Modified Key Mediating Variable (MKMV) Model proposed in the paper includes a total number of eight variables. Commitment-trust theory is combined with Islamic Accountability and Stewardship theory toward shaping three conceptual models of trust into a much-needed unified model for exploring trust in the context of waqf institutions. Stakeholder trust is positioned as a mediator between independent (board benevolence, board ability, board integrity, board opportunism, communication and accountability) and the dependent variable (stakeholder commitment). Empirical results to support the model could not be provided due to the conceptual nature of the paper. The model can provide direction for reform towards sustainability of waqf institutions. The model is general enough that it can also be used for other conventional and non-profit religious organisations.

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KAUJIE Classification: E22, E23
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1. Introduction

Waqf administration is receiving increasing attention from the Muslim community based on its socio-economic contribution in providing a broad range of public goods (Yaacob, 2013). *Waqf* is a charitable vehicle in Islam that can make a profound socio-economic impact. In South and South-east Asian region, *waqf* properties play a vital role in serving the educational needs of the pupils coming from low-income families. However, history provides evidence that *waqf* properties used to finance entire government operation and was an important part of the Muslim economic system (Cizakca, 1997). In time, *Waqf* has lost its strength and significance as a charitable instrument. The ability of this tool toward shaping the economy of a country cannot be ignored and thus have proven to be a viable research agenda among scholars in recent years.

Waqf comes from Arabic word "*waqf*" which means to hold still and last long. In short, *waqf* involves the transformation of personal properties into public resources. Sadeq (2002) mentioned that *waqf* assets could not be disposed of, its ownership cannot be transferred, only its benefits are to be used for charitable purposes, and it is a voluntary charity characterised by perpetuity. It has a history older than Islam and has existed in ancient Mesopotamia, Greece, Rome as well as pre-Islamic Arab societies (Sadeq, 2002: 139). The Islamic model of *waqf* flourished extensively and influenced the world as a whole. Also, Oxford University has been established by following the Islamic model of *waqf* (Cizakca, 1998: 1231-61; Gaudiosi, 1988: 11).

Prior studies on *waqf* have focused on its history (Cizakca, 1997, 1998, 2004; Kuran, 2001; White, 2006), legal (Sait and Lim, 2006) and socio-economic issues (Kahf, 1992, 1999, 2003; Sadeq, 2002). *Waqf* is often viewed as similar to a traditional charitable organisation. Studies of charitable organizations in profit sector have started exploring the need for reform in various areas to improve stakeholder trust (Brown and Moore, 2001; Connolly and Hyndman, 2013; Ebrahim, 2003; France et al., 2013; Saxton et al., 2014; Torres-Moraga, Pina, et al., 2010; Trussel and Parsons, 2007; Yetman and Yetman, 2004; Zainon et al., 2011). The fact that *Waqf* is not mentioned in Quran and the contribution itself is voluntary, as opposed to Zakah, the need to explore determinants of stakeholder trust in the context of *Waqf* institutions should not be ignored.

In the past century, Government efforts to confiscate *Waqf* properties to generate new sources of public revenue is witnessed. During the 19th century, the reform of *Waqf* system began with the contribution of several Muslim countries like Lebanon, Turkey, Jordan, Sudan, Kuwait and Algeria. Modification of Islamic laws relating to *waqf* has provided greater flexibility in dealing with *waqf* assets. Cash *waqf* was included in the traditional system of *waqf* to provide the opportunity for generating resources from movable properties which were traditionally limited to the immovable properties. The details of the *waqf* laws now in place in Egypt, Morocco, Iran and Turkey, among other countries, speak volumes about the limitations of the traditional system (Kuran, 2001: 890). The failure of public provision and the traditional policy is evident in the general crisis of charitable organisations (Yang et al., 2014).

Sargeant and Lee (2004a) proposes public trust as an essential element in the success of charitable organisations as it not only provides resources, strengthens the commitment to the public, but also offers charities a higher moral tone than other sectors. The failure to maintain public trust could lead to negative consequences, including decreased donations, image damage, diminished autonomy, or even organisational collapse (Yang et al., 2014). The importance of public trust has attracted researchers in the field of accounting to explore disclosure (Hyndman and McMahon, 2010; Irvine and Ryan, 2013), governance and accountability (Dhanani and Connolly, 2012) as a factor of trust in the context of charities operating in developed countries. In the context developing countries' non-profit sector, mechanisms for building donor trust have also been studied (Maliah Sulaiman et al., 2009; Mukherjee and Nath, 2003; Mustafa et al., 2013). However, the concept is yet to be incorporated with *Waqf*. This study is focused on reducing the gap in the literature by introducing a conceptual model that could be used to empirically explore determinants and outcomes of stakeholder trust in *Waqf* institutions.

This study is unique in several aspects. First, the conceptual model itself is unique as it covers components from governance, disclosure, and accountability. Second, the use of commitment-trust theory (Morgan and Hunt, 1994), developed to explore the customer-seller relationship, in exploring stakeholder trust in the context of *Waqf* institutions widens the horizon of the theory itself. Sargeant and Lee (2004a) have already utilised this theory for charitable institutions in the United Kingdom, empirical evidence through the conceptual model developed in the study will increase its validity and generalizability. Third, Islamic accountability (Ibrahim, 2000) and stewardship theory (Davis et al., 1997) are combined with the commitment-trust theory to add several dimensions in the original key mediating variable (KMV) model produced by the theory. It improves the understanding of various stakeholders for *Waqf* institutions and allows the validation of stewardship theory. Policymakers will be able to undertake reform initiatives as the developed model is designed to provide stakeholder perception on the level of trust and commitment they have on *Waqf* institutions and will also indicate factors influencing such perception.

This paper is organised into four sections. First, the concept of *waqf* is briefly discussed. Second, the idea of trust is brought into a picture and discussed in the context of *waqf*. Third, review of related empirical and theoretical literature is provided. In the fourth section, the paper provides a detailed discussion on the development of the conceptual model along of the theoretical outlook and relevant model of trust from prior literature. Finally, the paper concludes with several recommendations for future research and implementation of the developed model in the context of conventional and religious charitable organisations.

2. Overview of *Waqf*

Waqf is often viewed as similar to a conventional charitable organisation. It has a history older than Islam and has existed in ancient Mesopotamia, Greece, Rome as well as pre-Islamic Arab societies (Sadeq, 2002: 139). The Islamic model of *waqf* flourished extensively and influenced the world as a whole. Also, Oxford University has been established by following the Islamic model of *waqf* (Cizakca, 1998: 1231-61; Gaudiosi, 1988: 11).

The institution did not have to be developed from scratch because of various ancient peoples – Persians, Egyptians, Turks, Jews, Byzantines, Romans and others– had developed similar structures (Kuran, 2001: 848). The extent to which Islamic *Waqf* was influenced by these ancient institutions is a question that is still not resolved. While the Roman origins have been rejected, primarily Byzantine, but also Mesopotamian, Sassanid, Jewish and Buddhist influences have been accepted as plausible (Cizakca, 1998: 49).

It is a matter of exploration of a concept that did not arise from Islam and was not mentioned in the Quran still became an influential charitable instrument among Muslims. It can be explained either from the historical or economic point of view. Islam has always been suggested to perform good deeds and engage in charity which was also taught by Prophet Muhammad (PBUH) through many of his charitable acts. The tradition of such charitable acts has led the adoption and embracement of *waqf* in the Islamic economic system. The ability of the continuous fund by *waqf* property to alleviate poverty and deliver public goods and services make is economically significant. Although *waqf* is not explicitly mentioned in Quran, evidence of such charitable deed can be found from the saying of Prophet Muhammad (PBUH). Abu Hurayra narrated from a Ḥādīth:

> *"When one dies, his acts come to an end, except three, regular (recurring charity), knowledge which he has imparted to other or a God fearing (pious) child who makes supplication for him."*

The eternal nature of *waqf* puts it in the position of a recurring charity. *waqf* may not be explicitly mentioned in the Quran as compared to Zakah, but any kinds of the charitable deed are always appreciated in Islam which is reflected in the following verse:

> *"By no means shall ye attain righteousness, unless ye spend (in Allah's Cause) of that which you love; and whatever of good you spend, Allah knows it well."(Surah Al – Imran, 92)*

Several Quranic verses indicate toward the establishment of foundations for religious purposes, but most of them can be interpreted as instructions to pay *Zakāt* for believers. Few Such passages include:

> *"Truly, my Lord enlarges the provision for whom He wills of His slaves, and also restricts (it) for him, and whatsoever you spend of anything (in Allah's Cause), He will replace it. Moreover, He is the Best of providers." (Surah Saba, 30)*

> *"O you who believe! When you (want to) consult the Messenger (Muhammad (PBUH)) in private, spend something in charity before your private consultation. That will be better and purer for you. However, if you find not (the means for it), then verily, Allah is Off-Forgiving, Most Merciful." (Surah Al-Mujadalah, 12)*

Waqf is much older and more established philanthropic vehicle compared to *Zakāt* in Islam (White, 2006). There are four basic differences between *waqf* and *zakāt*. Firstly, *waqf* falls under voluntary contribution, but *Zakāt* is compulsory for a Muslim if he possesses the *nisāb*[1] amount of wealth. Secondly, dedicating one's property to *Waqf* does not fulfil minimum *Zakāt* obligation. Thirdly, *waqf* is classified as *Ṣadaqah-Jarriyah* for which reward are accumulated even after the death of the donor, but *Zakāt* does not offer such recurring rewards. Finally, the perpetual nature of *waqf* ensures a continuous flow of fund for the socio-economic

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[1] *Nisāb* is the minimum amount for a Muslim net worth to be obligated to give *Zakāt* according to Sharīʿah.

development which in the case of *Zakāt* depends on more on the volatile nature of income of the *Zakāt* payer.

3. Literature Review

3.1 The Concept of Trust

The growth of various forms of relationships has put trust in a centre stage. One of the primary reason for the exploration of trust is its ability in establishing co-operative relationships (Handfield and Bechtel, 2002; McQuiston, 1997). Hosmer (1995) has utilised the concept of philosophical ethics to define trust to be the result of a given decision that recognises and protects the rights of other people through the analysis of the ethical principles of analysis. Trust has been conceptualised from different theoretical viewpoints that include transaction cost theory, social exchange theory, agency theory, the resource dependency theory, system theory and attribution theory. Mayer, Davis, & Schoorman (1995) defined trust as the willingness of a trustor to be vulnerable to the actions of a trustee based on the expectation that the trustee will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party.

Past literature has identified two sperate levels of trust, i.e. interpersonal trust, and institutional trust. While institutional trust provides the degree of freedom to disappoint expectations, interpersonal trust belongs to the individual level and include personality traits of a person which could either be trusted or not. Interpersonal trust is often referred to as benevolence trust that relates to the propensity of the trustee to do good for the trustor. As a result, benevolence has been regarded as a critical antecedent of trust between trustor-trustee relationships.

3.2 The Concept of Trust in Islamic Perspective

The word *Amānah* originates from the three letter root verb *Amina*, which means to be in a state of peace, safety, and security. In the noun form, the word becomes *Amn*, which means to be in a state of peace, security, shelter and protection. *Amānah* means trust, reliability, trustworthiness, loyalty, faithfulness, integrity and honesty.

The concept of trust takes a significant role in developing the moral behaviour of a Muslim and several guidelines referring to the importance of trustworthiness in both personal lives and conducting business as emphasised in the following verse:

> *If you trust one another, then let him know who is trusted fulfil his trust, and let him be conscious of God, his Sustainer (AL-Baqarah, 2:283).*

Even before achieving prophethood, all the prophets were the shining examples of trustworthy people in the early Muslim history. Due to his trustworthy trait, Muhammad (PBUH) was called "Al-Amin." Trust demands that if a person is appointed to a certain public position, he should not use it for self-aggrandizement or the benefit of his relatives. The use of public funds for personal purposes is a crime, and the punishment of such act has been described in Quran:

> *Moreover, he who misappropriates shall come on the Date of Judgement with what he misappropriated (Aal-Imran, 3:161).*

Fukuyama (1995) regarded trust as one of the necessary ingredients of social recognition, economic efficiency, and democratic stability. The achievement of a high degree of trust in the relationship between the trustor and the trustee has led toward the accomplishments of early Muslims in the field of religion, economics and social arenas. The level of accountability practised by Prophet Muhammad (PBUH) and his Caliphs are excellent living examples for the concept of trust. The concept of trust and accountability taught and practised by the Prophet Muhammad (PUBH) led to a comprehensive adoption and internalisation of the concept by his companions and subsequent generations (Hasanuzzaman, 1991).

3.3 Integration of Stakeholder Trust and Governance in the context of *Waqf* Institutions

Information asymmetry has always been a problem between managers and principal. Managers are traditionally viewed as opportunistic who need to be controlled by implementing various governance mechanisms which are expected to have an impact on the information disclosure (Akhtaruddin and Haron, 2010; Albassam, 2014; Eng and Mak, 2003; Tsamenyi et al., 2007). This situation is true for both profitable (Kelton and Yang, 2008) and non-profit organisations (Hooper et al., 2008). Ihsan, Ayedh, & Shahul (2006) and Cajee (2008) have highlighted that the *waqf* development in the future will largely depend on the governance of *waqf* institutions.

Alias (2012) stated that the *Waqf* intuitions should be guided by a code of governance and possibly a code of ethics that will help them to understand their role, exercise control over the *waqf* assets and allow them to discharge accountability. In the case of a non-profit religious organisation like *waqf*, a solid governance structure can improve accounting practices and performance toward enhancing accountability (Ramli et al., 2015). However, evidence showing the adoption of an effective code of governance has yet to be found for *waqf* institutions.

Donor trust has a significant role to play in the survival of a charity organisation. Charitable organisations in developed countries have seen a 44 percent increase since 1990, and thus research interest toward the knowledge of what factors influence donor giving behaviour have attracted researchers' attention (Sargeant, 1999; Sargeant et al., 2006; Sargeant and Lee, 2004a, 2004b; Sargeant and Woodliffe, 2007). Investigation toward determining antecedents of trust has yet to make its mark in *waqf* literature. This study is aimed at reducing the gap by providing evidence and statistical proof of factors responsible for enhancing or destroying donor trust in *waqf* institution. The fact that public sector is responsible for managing *waqf* estates make the findings valuable for countries such as Malaysia, Indonesia and Singapore.

The importance of Accountability for *waqf* institution has often been advocated in previous literature (Osman, 2010; Masruki & Shafii, 2013; Ramli et al., 2015; Siraj, 2012). Disclosure and Governance are introduced as means of discharging non-profit accountability toward stakeholders. Ihsan & Ibrahim (2011) provided a framework for *waqf* institution that indicates accountability relationships of *waqf* institution with various stakeholders. The link between accountability and trust has been established by Seal & Vincent-Jones (1997) which is yet to be empirically tested. This study takes the opportunity to determine the significance of accountability in enhancing organisational trust based on donors' perspective.

3.4 Conceptual Models of Stakeholder Trust

An increasing number of studies examine the concept of social capital on trust (Tsujinaka, 2003). As an intangible resource, social capital can be defined as trust, shared norms and networks (Putnam, 1993) within an organisation that encourage organisational development and increases the efficiency of society. Trust is viewed by some scholars (Fukuyama, 1995; Putnam, 1993) as an integral element of social capital while alternatively viewed (Field, 2003; Woolcock, 1998) as one of social capital's products and consequences. Miri (2006) argue that social capital has been created to that extent in which they can create long lasting capacity for dealing with issues faced by stakeholders.

Iqbal and Mirakhor (2004) have discussed the importance of trust in designing an efficient and optimal corporate governance structure of a firm within Islamic economic system. In an Islamic economic system, a firm is expected to behave like other members of the society and managers are deemed to act on behalf of the owner and serve the fiduciary duty to manage the firm for all stakeholders (Iqbal and Mirakhor, 2004). While discussing trust, its link with social capital and importance of an efficient governance structure, it is imperative that we place *waqf* institution as an economic institution and not merely a charitable organisation. Good governance, transparency and accountability are the important institutional aspects that support financial development (Johnson et al., 2002). Similar arguments have been placed for Islamic finance institutions (Abu-Tapanjeh, 2008; Majid et al., 2010; Norazlina and Abdul Rahim, 2011) while only a handful of studies concentrated on the governance structure of *waqf* institutions (Daud et al., 2011; Ramli et al., 2015).

Accounting literature has witnessed the theoretical analysis of long-term relationships that has a root of agency theory. Agency theory and classical contract law make similar assumptions about human behaviour and social institutions (Hunt and Hogler, 1990). Several theoretical models of trust with a wider range of antecedents covering the field of accounting, marketing, operations management, psychology and social science have been introduced in the prior literature. Among the available models of trust, models provided by Mayer et al. (1995); Morgan & Hunt (1994); Seal & Vincent-Jones (1997) are discussed due to their focus on building long term relationship with stakeholders. The use of conventional theoretical models in explaining a phenomenon in Islamic finance is one of the limitations of the study.

There is a growing body of literature on trust that focuses on trust building mechanism. The seminal work by Morgan & Hunt (1994) has provided a model of Trust that has provided new directions in the field of relationship marketing. Morgan & Hunt (1994) have put trust and commitment into the central role which can affect or be affected by several antecedents. The mediating role of trust and commitment played the central role in the model, and thus the model was later named Key Mediating Variable (KMV) Model.

The Key Mediating Variable (KMV) model proposed by Morgan & Hunt (1994) has ten independent variables with trust and commitment as mediators and propensity to leave as dependent variables. KMV model was originally proposed in the relationship marketing literature to get a closer look at the buyer-seller relationship. Trust is conceptualised as confidence in exchange partner's reliability and integrity and is enhanced through communication (Holdford and White, 1997). Shared Values, communication, and opportunistic behaviour are thus considered as outcomes while relationship commitment, cooperation, functional conflict, and uncertainty reduction are considered as outcomes.

Trust is considered to have a direct relationship with commitment. Commitment in the model is defined as enduring desire to maintain a valued relationship and is enhanced when exchange partners perceive that the relationship has a high termination cost, superior benefits and that partners share similar values (Morgan and Hunt, 1994). If the commitment is established, it will lead to higher acquiescence, decrease propensity to leave and increase cooperation. Researchers have utilised the KMV model to explore relationships in the field of relationship marketing and strategic management. Empirical results have proven the significance of the model in understanding the antecedents and outcomes of both trust and commitment (Abosag et al., 2006; Holdford and White, 1997; Sargeant and Woodliffe, 2007).

Sargeant and Lee (2004b) explored the donor-charity relationship in the United Kingdom with the KMV model. This was the first application of KMV model in the non-profit sector. The study identified perceived service quality, shared beliefs, perceived risk, the existence of a personal link to the organisation and trust, drive commitment toward charity giving. Abosag et al. (2006) revealed very interesting differences and few similarities while comparing results from Saudi and British nationals derived by KMV model. Hence, the original KMV model is not deemed appropriate for stakeholders of *Waqf* institutions, and several trust models are introduced improve its applicability.

The second model of trust discussed in the study is developed by Mayer et al. (1995). Mayer et al. (1995) developed an integrated model of organisational trust considering characteristics of the trustor, the trustee and the role of risk. In this conceptual model, ability, benevolence and integrity are perceived to be the factors of trustworthiness which influence risk taking relationships to get the desired outcome. Ability is a group of skills, competencies, and characteristics that enable a party to have influence within some particular domain. Benevolence is the extent to which a trustee is believed to want to do good to the trustor, aside from an egocentric profit motive while the relationship between integrity and trust involves the trustor’s perception that the trustee adheres to a set of principles that the trustor finds acceptable.

Mayer’s model of trust has both mediating and moderating variables. The outcome is measured by the level of commitment made by the stakeholders that are influenced by the risk-taking relationship between supplier and consumer. The risk-taking relationship is affected by the degree of trust which may increase or decrease as a result of the introduction of perceived riskiness of the investment or donation decision. Perceived riskiness play a moderating role and modifies the existing relationship between trust and risk taking relationship. Finally, the level of trust individuals has to another person, organisation or a system can be influenced by ability, benevolence, and integrity. In summary, these three variables are termed as perceived factors of trustworthiness.

The final model introduced in this section is derived from Seal & Vincent-Jones (1997). This model is similar to the previous two models of trust in two aspects. First, it is emphasising the ability of trust in improving long-term relationships which are similar to the idea of relationship commitment in Model 1 by Morgan & Hunt (1994) and risk taking relationships in Model 2 by Mayer et al. (1995). Second, both Model 1 and Model 3 by Seal & Vincent-Jones (1997) emphasised on the ability of disclosure practices in enhancing trust by introducing either the term communication or accounting in their respective models.

The difference can be identified in one single area and that is the introduction of a new variable by Seal and Jones referred as "Accountability." In this conceptual model, long term relations are the central focus which is affected by stakeholders' trust and might be enhanced or undermined by the practice of accounting and contracting. Besides accounting and contracting, accountability plays a significant role in enhancing stakeholder trust. In the context of *waqf* institutions, this factor could play a central role in explaining the level of stakeholder trust for two reasons. Firstly, the voluntary nature of *waqf* donations and secondly, the emphasis on accountability relationships in Islam demonstrated by the Islamic Accountability model introduced by Ibrahim (2000) provides greater importance in the inclusion of the variable in the proposed conceptual model of stakeholder trust for *waqf* institutions.

4. Theoretical Framework

According to the fundamental theory proposed by Morgan & Hunt (1994), maintaining a successful relationship with both individual and organisational levels depend on two aspects. First, relationship commitment and second, trust as these aspects promote cooperative behaviours between relationship partners and encourage them to maintain long-term relationships. The theory was initially tested between automobile retailers and their suppliers. Empirical findings using Key Mediating Variable (KMV) model, provided by Morgan & Hunt (1994), justified the mediating influence of trust in enhancing the commitment of end consumers and thus made a significant contribution to the field of relationship marketing.

The commitment-trust theory proposed by Morgan and Hunt lies on the notion that the propensity to engage in a high-risk situation relies on each party's belief toward the other party in acting for the long run best interest of both parties. It is the most cited theory in relationship marketing (Abosag et al., 2006). Commitment and trust are the distinguishing characteristics of relationships (Blois, 2003). Morgan and Hunt proposed that relationship commitment and trust be key variables for successful relationships because they promote cooperative behaviours between relationship partners and encourage them to maintain long-term relationships (Morgan and Hunt, 1994). They posit that "commitment and trust lead directly to cooperative behaviours that are conducive to relationship marketing success." Veloutsou, Saren, & Tzokas (2002) argued that the commitment – trust theory provide "the foundations of a marketing relationship that can lead to customer retention."

This theory provides a model named Key Mediating Variable (KMV) model with five important antecedents of trust. Both trust and commitment are considered as a mediator in the KMV model. Trust involves one party having confidence in or relying on another party to fulfil its obligations (Morgan and Hunt, 1994). There are two levels of trust, i.e. cognitive trust, and affective trust. Commitment has been seen as the willingness or intention to continue maintaining the relationship in the future (Abosag et al., 2006). Commitment is seen as central because it not only leads to such important outcomes as decreased turnover (Porter et al., 1974), higher motivation (Farrell and Rusbult, 1981) and increased organizational behaviors (Williams and Anderson, 1991), but it also results from such things that can be influenced by the firm as organizational support (Eisenberger et al., 1990). The seminal KMV model has been empirically tested in marketing literature, but worth a greater attention in the context of the non-profit sector due to the significant role both constructs play in establishing and maintaining relationships.

The current study is focused on exploring determinants that could have an impact on donor's trust. The KMV model provided by Morgan and Hunt by Commitment-Trust Theory has proven to be very effective in explaining the buyer-seller relationship, but it requires some adjustments before implementing for the context of Islamic non-profit organisation. Seal & Vincent-Jones (1997) introduced the idea that accountability could be the determinant of trust and long-term commitment. In the context of *Waqf* institutions, Islamic accountability concept introduced by Ibrahim (2000) becomes an appropriate fit. Islamic accountability recognises that human beings are accountable primarily to Allah and secondarily to the *Ummah* for efficient management of properties entrusted to them. *Waqf* estates are donated by *waqif* and are managed by *mutawallis*. The nature of the relationship between *waqif* and *mutawalli* creates a degree of consensus to explore whether the perception of *mutawallis'* accountability assurance toward various stakeholders has any impact on the trust and commitment of donors of *waqf* institutions.

To be accountable to the general public as well as institutional stakeholders, organisations need to be fully transparent by ensuring processes, institutions, and the information is accessible to the related parties, especially to the stakeholders for monitoring purpose (Norazlina and Abdul Rahim, 2011). Accountability is thus interpreted as being, first and foremost, accountability to God through making information freely available (Lewis, 2006). Thus, Islamic accountability puts greater emphasis on effective communication which forms as an antecedent of trust in the KMV model. The inclusion of accountability assurance in the KMV model is thus justified.

Mayer, Davis, & Schoorman (1995) explored a separate dimension and developed a model that consisted of interpersonal traits as antecedents of trust and long-term commitment. Mayer's model allowed the possibility of exploring the ability of board attributes in enhancing trust, which has later been empirically tested in several papers (Jarvenpaa et al., 1998; Mustafa et al., 2013; Yu et al., 2015). In light of stewardship theory, the model provides ways to examine the position of managers in the eyes of principal. Stewardship theory provides an opposite proposition as compared to agency theory, which argues that managerial actions depart from those required to maximise shareholder return in the modern organisation.

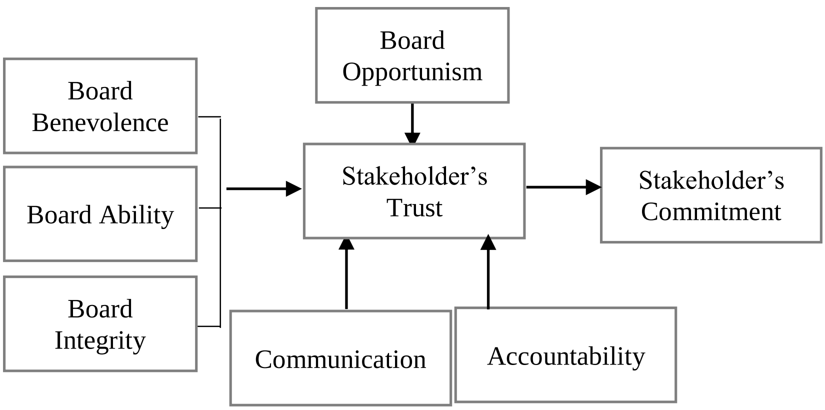
According to Donaldson & Davis (1991), managers are far from being opportunistic shirker and essentially want to do a good job, to be a good steward of the corporate asset. Thus, stewardship theory holds that there is no inherent, general problem among executives. In the context of exploring antecedents of trust in a South-east Asian country, the inclusion of board attributes and board opportunism in the original KMV model extends its measurement ability, and the findings provide a valuable contribution toward the applicability of agency and stewardship theory for *waqf* institutions.

5. Modified Key Mediating Variable (MKMV) Model for *Waqf* Institutions

Three models of trust are discussed in the previous section of the paper. The original KMV model of Morgan & Hunt (1994) provided three determinants (shared value, communication, and opportunistic behaviour) and four outcomes (relationship commitment, cooperation, functional conflict, uncertainty). Mayer et al. (1995) introduced ability, benevolence, integrity as determinants of trust which are being moderated by trustor's propensity and positioned risk taking behaviour as an outcome of trust. Finally, Seal & Vincent-Jones (1997) proposed accountability as an antecedent of trust along with accounting which has already been covered by the original KMV model (communication).

The review of these three models of trusts thus provides seven antecedents of trust and three possible outcomes. To determine the relevance of these variables in the context of *Waqf* institutions, focused group interviews are conducted with experienced *Waqf* administrators. Respondents were asked to rate the importance of selected variables on a five-point Likert scale, ranging from one (strongly disagree) to five (strongly agree). Based on the suggestions of focused group respondents along with the extensive review of related literature, only six determinants of trust are retained with only one outcome variable. These determinants include benevolence, ability, integrity, opportunism, communication, and accountability. Commitment is proposed as a determinant of donor's trust in *waqf* institutions. Following the original KMV model, trust has positioned a mediator between determinants and commitment in the modified model. The modified key mediating variable model in provided in Figure 1.

Figure-1
Model of Stakeholder Trust in *Waqf* Institutions



Benevolence is used as a proxy to measure the perception board members are genuinely interested in the stakeholders' welfare beyond its egocentric profit moves. Five items are included in the questionnaire to measure donors' perception toward the benevolence of board members of public *waqf* institution. Among them, four are adapted from the studies of Bennett & Barkensjo (2005) and Shockley-Zalabak, Ellis, & Winograd (2000). The fifth item was derived from focused group interviews with *waqf* administrators.

Ability refers to the board member's ability and knowledge to provide consistent and desirable performance in fulfilling donors' objectives. In measuring the ability of board, five items are included in the questionnaire. All except one item are adapted from Mayer & Davis (1999). The additional item was included as an outcome of the focused group interview.

Integrity is operationally defined as the donor's perception that the board adheres to a set of principles that the donor finds acceptable. In this study, integrity is used as a proxy for determining the trustfulness of board members in the dealings, timely and accurate information disclosure and ethical behaviour. Among the five items included in the questionnaire to measure integrity, three are adapted from studies of (Mayer & Davis, 1999; Robinson, 1996) and the rest are derived from focused group interviews with *waqf* administrators.

All these three factors are presented as an antecedent of trust in the theoretical model proposed by Mayer et al. (1995) and later on empirically tested studies (Jarvenpaa et al., 1998; Knoll and Gill, 2011; Mustafa et al., 2013; Yu et al., 2015). Based on the findings of prior literature it is expected that higher perception of benevolence, ability, and integrity of *waqf* board members among stakeholders will result in higher perception toward board attributes and have a positive influence on trust. Mustafa et al. (2013) examined the influence of perceived board attributes on perceived disclosure practices and found a significant positive impact in the context of *Zakāt* payer of Nigeria. As such, a similar relationship is conceptualised to investigate the possible association between these two factors for *waqf* institutions in Bangladesh.

Board Opportunism reflects behaviours of others trying to take advantages in disregard of the interest of others. Very often, it is done at the expense of other people's interests which deepens interpersonal conflicts of interest, particularly in cases when violations of promises happen either implicitly or explicitly as part of a job function or commitment (Torres-Moraga, Vasques-Parraga, et al., 2010). Although not present in Mayer's et al. (1995) framework of trust, board opportunism has been found to have a negative influence (Mukherjee and Nath, 2003; Torres-Moraga, Vasques-Parraga, et al., 2010) on trust. Board opportunism is included in the conceptual framework to test a possible association of trust among stakeholders of *waqf* institutions. Stewardship theory has led to the investigation of the association between perception of board attributes and perceived board opportunism as stewards with high benevolence, ability and integrity should not be viewed as opportunistic by the stakeholders.

Disclosure practices are often referred to as communication in prior studies and have been found to be a significant antecedent of trust (Mukherjee and Nath, 2003; Mustafa et al., 2013; Sargeant and Lee, 2004b; Torres-Moraga, Vasques-Parraga, et al., 2010). Communication can be connected to formal and informal information sharing between stakeholders and charitable organisations. Communication seems to play a vital role in the way stakeholders receive a charity's pledge and in how they respond to it (Sargeant and Lee, 2004a). Perceived disclosure practice is included as an antecedent which may have a positive impact on trust among stakeholders.

The final independent variable in the framework is perceived accountability. Accountability was first introduced as a factor by Seal & Vincent-Jones (1997) while looking for the possible influence of accounting practices in developing trust in the public sector organisations of UK and Czech Republic. As the contribution to *waqf* institutions is entirely voluntary, so the degree to which these institutions are being accountable through formal and informal information disclosure to stakeholders can make a significant impact on stakeholder trust. The model is constructed to test the interrelationship between disclosure practices, accountability, and trust.

According to Bennett & Barkensjo (2005), trust involves the belief that the trusted party will not only fulfil the associated obligation, but the fulfilment should fully satisfy the trusting party. Thus, trust is operationally defined as a series of beliefs donors hold regarding the attributes of *waqf* institutions which give assurance that such institutions can be relied upon to manage *waqf* estates in a manner that will fully satisfy its stakeholders. Five items are included in the questionnaire; one is derived from focused group interview, and four are adapted from Mustafa et al. (2013) and Sargeant & Woodliffe (2007).

According to Morgan & Hunt (1994), a critical complement of trust in exchange relationship is commitment. Commitment is operationally defined as the enduring desire to maintain value relationships among registered donors' of *waqf* institution in Bangladesh. Four items are adapted from the study of Bennett and Barkensjo (2005) to measure the perception of donors' commitment toward the public *Waqf* Institution.

The association between trust and commitment has been investigated from several points of views in prior literature. Several authors have utilised the KMV model developed using commitment trust-theory by Morgan & Hunt (1994) while others have utilised the trust model prepared by (Mayer et al., 1995). Although the theoretical model provided by Seal and Vincent-Jones (1997) Jones have not yet been empirically tested, still the introduction of the concept of accountability, have made this model significant and relevant enough for the current study.

In an attempt to verify the applicability of commitment-trust theory, Holdford & White (1997) have found that trust is positively associated with the degree of commitment students have in the pharmacy school of Victoria Commonwealth University. Their findings reveal that trust in faculty and staff reduced uncertainty among students. Reduction of uncertainty increases the possibility to handle conflicts between students and the school that results in greater willingness to cooperate with school.

Sargeant & Woodliffe (2007) have empirically tested the relationship between trust, commitment, and intention of charitable giving in the context of UK and US charitable institutions. They conclude that trust in the selected charitable organisation drives engagement in the context of charitable giving among donors of those institutions. Similar results were found by Chen, Chen, & Yeh, (2014); Morgan & Hunt (1994); Mukherjee & Nath (2003); Wong & Sohal (2002) by using the commitment-trust theory.

Results provided by past literature on the selected variables provide strong statistical evidence. However, most of these variables have been tested in isolation with the introduction of various control variables in the context of profitable and non-profit organisations operating in developed countries. As a result, these findings are not providing any general indication of their ability to influence donor trust for a *Waqf* institution. Empirical evidence provided by the modified key mediating variable model (MKMV) will not only ensure statistical significance of the conceptual model but also contribute to the literature by introducing a new dimension to the *Waqf* literature.

6. Conclusion

Waqf is a historical, charitable instrument that can provide a significant contribution toward the economic development of a country. However, this institution has lost its ability to make an important impact on the economy which has its link toward decreased donation of donors resulting from lack of trust in these establishments. In such a situation, enhancing donor trust through recog*nisāb*le reform initiatives is required for *waqf* institutions around the world. *waqf* institutions, more specifically, *mutawallis* need guidelines for reform initiatives. This study focuses on reducing the gap in *waqf* literature by developing a model concentrating on enhancement in stakeholder trust. The Modified Key Mediating Variable (MKMV) model developed by Commitment-trust theory can determine the significance of governance, accountability, and disclosure in improving trust toward enhancing stakeholder commitment. Several other theories and concepts are utilised such as Islamic Accountability and Stewardship to adjust the model for *waqf* institutions operating in developing countries. It was not possible to provide statistical validation of the developed MKMV model due to its theoretical nature. Future studies on the use of the developed model for *waqf* institution operating in different Muslim and Non-Muslim countries will increase its generalizability. Public *Waqf* administrators will be benefited in designing reform initiatives in enhancing stakeholder trust and increasing the sustainable future for this historic organisation. In turn, *Waqf* institutions will be able to reclaim its rightful place as a practical tool for poverty alleviation.

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Ethical Banking and Islamic Banking: A Comparison of Triodos Bank and Islami Bank Bangladesh Limited

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Abstract

Ethical finance and Islamic finance are the two important topics in the post global financial crisis market environment and in the context of sustainable development goals and circular economy. If Islamic finance is inherently ethical finance, then what remains the difference between the two is an interesting theme for investigation. Islamic finance is governed by universal and divine legal and moral principles and standards related to economic transactions. Contemporary Islamic financial practices are however, strongly criticized for giving precedence to legal forms over ethical substance and for the rising gap between moral ideals and practical realities. Ethical finance is a conscious human effort to reform finance and it embraces environmentally, socially and morally conscious practices. In this paper we select two banks, namely Islami Bank Bangladesh Limited (IBBL) and Triodos Bank. We perceive that the first is an ideal Islamic Bank and the second is an ideal Ethical Bank. We undertake an analysis of the content of balance sheet disclosures of the two banks and try to gauge the similarities and divergences in their business principles and practices. The analysis uncovers that the current practices of IBBL may far exceed other Islamic banks in terms of financial inclusion, microfinance, gender balance, SME financing and green banking while still being financially stable and profitable. However, Triodos Bank has some significant lead over IBBL regarding ethical practices since it only promotes sustainable businesses. If Triodos Bank exceeds IBBL in ethical expectations as we conclude, then it is far ahead of other Islamic banks in such comparison. The implication of our conclusion is that Islamic banking

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needs ethical reform and this can be benchmarked with Triodos Bank's business model. For Islamic banks the correct approach would be to strike the right balance between ethics, moral standards, Sharīʻah compliance and profitability. The Islamic banking model has in-built features to ensure Sharīʻah compliance, and this can be enhanced through adopting sound ethical practices as well as dedicating efforts towards being environment-friendly. The paper attempted to present some considerations which if present in Islamic banks would take them away from the criticism of being only for-profit in motivation. Triodos has balanced its for-profit and not-for-profit motivations letting the later to lead the first.

JEL Classification: G20, G21
KAUJIE Classification: L23, I23
Keywords: ethics, Islamic finance, Islami Bank Bangladesh Limited, Triodos Bank

1. Introduction

The finance industry across the world has expanded exponentially in various degrees across different markets and jurisdictions. Some jurisdictions such as the US witnessed the invention of substantial amount of financial products and instruments including highly-sophisticated derivatives instruments over the past decades. Within the finance industry, some new concepts recently gained momentum, among them, Islamic finance and ethical finance. The concept of ethical finance is probably more recent than Islamic finance and it is increasingly gaining popularity especially in the West. According to Belabes (2013), the 2008 financial crisis incited the debate on the issue of ethics in finance and shifted the focus from being exclusively on returns on capital to incorporate ethics in finance. This view is also shared by Hayat and Malik (2014) who observed that the manifestation of the global financial crisis of 2007–2008 led to an increased interest and appeal in the underlying principles of Islamic finance particularly among those who are concerned with the overall influence of finance on society. Kmeid (2015) asserts that ethical finance sprouted as a result of rising demand across different geographies for ethically-oriented banking products and banks found that a switch to ethical products or environmentally-friendly practices was an added advantage. However, Belabes (2013) argues that in finance, ethics is voluntary and not obligatory as it is a matter of the consent of individuals. Ethics and morals, in contrast to laws, are not enforceable by an authority (Ahmed, 2011). This argument transposes to the development of Islamic financial institutions globally, which until today, is purely voluntary and a matter of individuals' choice to adhere to the Sharīʻah principles in finance.

The emergence of ethical questioning and call for ethics in finance in contemporary times is justifiable especially following the devastating domino-effects of the recent financial crisis. Belabes (2013) discusses that when increasing exchanges in financial markets do not tantamount to « better », but rather goes on to become a significant threat for socio-economic stability to such an extent that some financial experts come forward to advocate the prohibition of certain financial practices, the argument of ethics in finance becomes relevant. In fact, one of the arguments presented as to why the Islamic finance industry was not affected by the financial crisis is the fact that Islamic finance is ethical in the sense that it upholds some prudential rules of finance (for e.g., prohibition of *gharar* and gambling) which are not observed in the conventional finance model. So, can we say then that Islamic finance is the equivalent of ethical finance, or vice versa? Wilson (1997) deliberates that although there are many common elements which are ruled out under both the Islamic finance screening criteria and ethical screening criteria for investment products, the set of ethical criteria for Islamic investors may be very much different from the Western concept of "green" or ethical investments since the underlying moral value systems differ. Nienhaus (2011) argues that Sharī'ah-compliant finance is not per se ethical finance and that most Islamic financial institutions have not reported explicit ethical screening procedures or techniques.

In fact, defining Islamic finance as ethical finance or claiming that being ethical means 'Islamic' is erroneous for they are two different concepts in themselves although some underlying principles may overlap in both. Kmeid (2015) argues that fundamental differences between Islamic business practices derived from religious teaching and ethical practices do not exist. But he believes the former is viewed as unique because ultimately they are based on divine revelation whereas the latter is derived from social values that appeal to humans' consciences to create a moral economic system serving the needs of humanity at large and not only Muslims. In what follows, we will define Islamic finance and ethical finance.

Islamic Finance versus Ethical Finance

The term Islamic finance is commonly understood as a financial service principally implemented to comply with the tenets of Sharī'ah or Islamic law (Gait and Worthington, 2007). Islamic financial products are those which comply with the axioms and rulings of the Sharī'ah and Islamic finance contracts must fulfill two sets of requirements: first, the Sharī'ah conditions and second, the law of the land conditions. The Sharī'ah conditions which govern Islamic financial contracts can be classified in two: (1) general principles of contracting (civil aptitude, consent and legal permissibility); and (2) specific Islamic principles (balance, moral commitment/ethical foundation, Sharīʻah permissibility and realism) (Kahf, 2015). He defined an Islamic bank as a depository institution of financial intermediation specialized in providing financial services in accordance with the tenets of Sharīʻah, especially the moral criteria and prohibition of *Ribā* (interest). The financial intermediary function of an Islamic bank is the same as a conventional bank except for adherence to Sharīʻah principles. Significant differences exist between interest-based banking and Islamic banking as largely discussed by numerous scholars and researches.

Conversely, ethical banking is essentially believed to be a concept which comprises of a banking system that embraces environmentally and socially conscious practices. Wilson (1997) deliberate that ethical investment products is a phenomenon that emerged and developed during the 1970s in response to particular demands for ethical products and ethical finance including finance and investments in environmentally friendly projects as well as companies that go through the moral criteria screening. According to Febea (2012)[1], the role of an ethical bank is: *to work for the common good and ensure the right to receive credit through a bank activity consisting in raising funds and reallocating them in the form of credits for cultural, social and environmental projects*. In other words, ethical banks seek to positively impact development and growth in an economy or state through their financial intermediary function subject to social and environmental concerns. Ethical banks therefore promote social inclusion, sustainable development, development of social economy and social entrepreneurship and support and invest in the third sector, which is explicitly different from the profit-only motive adopted by most commercial banks.

Similarly, Cowton (1994) defined ethical investment as the use of ethical and social criteria in the selection and management of investment portfolios, and opine that ethical investors are not only concerned with the risks and returns features of their portfolios but also give a lot of importance to the characteristics of the companies in which their funds are placed. Therefore, ethically-conscious customers are very much keen to probe into the nature of companies' goods and services, the business location and the way in which business affairs are conducted to ensure they do not violate any ethical, moral or social criteria laid down. Cowton (1994) also distinguished between two strategies for ethical investment: positive and negative. Positive ethical screening would imply being supportive of companies and projects which are acceptable in terms of their products, services, activities or business

[1] FEBEA (the European Federation of Ethical and Alternative Banks and Financiers) issued in 2012 a short booklet on "*What really differentiates ethical banks from traditional banks?*"

methods such as companies involved in pollution control and renewable energy. In contrast, a negative ethical screening entail shunning any investments or financing of companies and projects which engage in unacceptable products or services, or whose activities and business methods are viewed as unethical, for example, gambling, pornography or tobacco or alcohol production and distribution. Negative ethical screening also eliminates military supplies and companies engaged in animal exploitation for cosmetics or fur trade or in factory farming for meat trade (Wilson, 1997).

Belabes (2013) contends that integrating ethics in finance can result to three variants at the input and/or output levels, two of which are:

1. Integrate at the output level some human, social and environmental norms in the functioning of global finance, without affecting the input by prohibiting, for example, usury or stock market speculation that resembles a casino;
2. Integrate at the input level some moral norms such as the prohibition of usury, without affecting the output, i.e. without giving any consideration to criteria which can be human, social, or environmental in nature. For example, two Muslim agents could be using a commercial transaction, via a *Murābaḥah* contract, without bothering if a number of standards, relating to the respect of human rights, social rights and the environment, have been observed at all levels of the chain of production and distribution.

The best approach would be if ethics in finance could be integrated both at the input and output level.

Islamic finance and business is governed by divine principles dating back more than 1400 years ago. It encompasses values such as fairness, equality and morality and the values and ethics rooted in Islamic business makes up its social and moral capital (Kmeid, 2015). In fact, the sources of the Islamic ethical system are the Qur'ān and the Sunnah and thus, the goals of the Islamic system are not essentially materialistic but aim at socio-economic justice and attaining a balance between the material and spiritual needs of humans (Kayode and Ishola, 2012). Kmeid (2015) further contends that, by definition, in an Islamic financial system, concerns about conformity to norms of Islamic ethics prevail over all other concerns and that all transactions must be within the norms of Islamic ethics as established by the Sharī'ah. Therefore, according to Kmeid (2015), the Islamic financial system is, by itself, ethical. Hayat and Malik (2014) also shared the view that Islamic ethics are embedded in Islamic economic thought and finance and that Islamic finance principles emphasize market-based risk sharing of financing which promotes asset and enterprise, deploy finance linked to the real economy and ease redistribution of wealth and opportunity. However, they deliberate that modern Islamic financial practices promotes legal forms over economic substance which has resulted in an expectations gap between theory and practice.

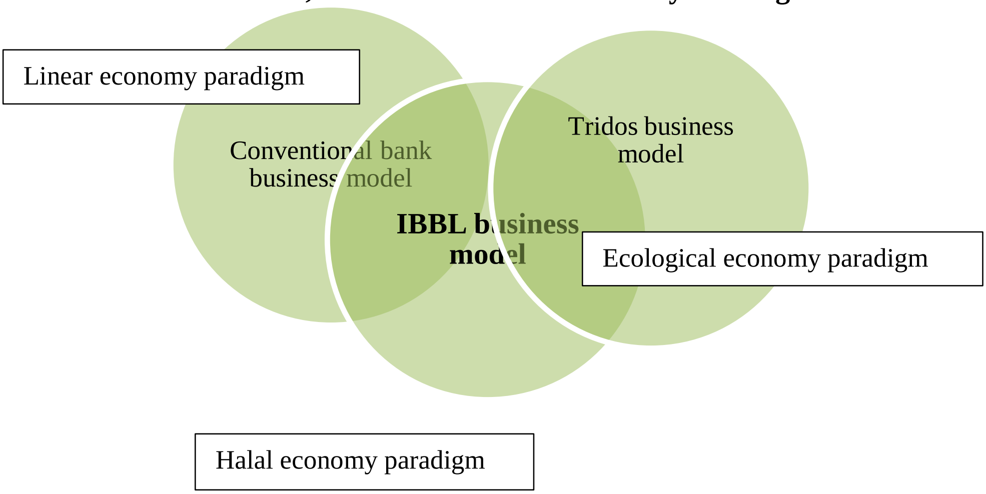
In general, Islamic banks have replicated the profit-only motive of their conventional counterparts, except for adhering to Sharī'ah principles and Halal requirements. Although the message of Islam as well as any other religion is by definition moral, and Sharī'ah in itself calls for ethics, high morals and regulates behavior, there are different standards of Sharī'ah rulings (obligatory فريضة, advisable مندوب, permissible مباح, undesired مكروه and prohibited محرم). From this perspective, Islamic banks have a margin of flexibility in the sense that they refrain completely from the prohibited things, but they may involve in permissible or undesired things[2] if they believe that the economic benefits are greater. For instance, if an Islamic bank has to choose between financing construction of a school or mall, and there is nothing *ḥarām* or unlawful in either project, the Islamic bank will most certainly give preference to the financing which generates more profits at the expense of the other although one of them might actually bring more benefits to society. From the same example, it could also be that respect of labour rights or the environment are not being fully observed, which raises questions pertaining to how ethically-committed the Islamic bank is? This point was highlighted by Kamali (2008:47, cited in Ahmed 2011) that *wajib* and *ḥarām* activities have legal force, but the remaining three activities (advisable مندوب, permissible مباح, undesired مكروه) fall in the domain of morals that cannot be adjudicated in courts. Kamali gave the example of the prohibition of usury or gambling in contrast to Islamic teachings that encourages people not to cause injury to women and elderly or animals. The former are legal obligations while the latter reflect 'the moral underpinnings of Sharī'ah' (Kamali 2008: 49, cited in Ahmed 2011).

Kayode and Ishola (2012) deliberate that in business, because bank managers are agents working in the interests of the owners/shareholders and not the society's interests, this principal-agent relationship may influence the efficacy of ethical standards and therefore, ethics is sometimes marginalized in favor of profit maximization. They, however, conclude that in business it is better being ethical rather than unethical because qualities and values such as mutual trust, integrity, honesty and transparency are indispensable for business success and sustainability. Islamic banks do follow ethics to the extent of complying with Sharī'ah prohibitions

[2] Makruh Tanzihih is the undesired things which are nearer to Mubah, and perpetrators of something Makruh Tanzihih are not liable to punishment and do not incur moral blame.

while ethical banks may be more involved in other areas such as environment and social issues. Such areas have usually received little attention from Islamic banks.

Figure-1
The Linear, Circular and Halal Economy Paradigms



In terms of business paradigms summarized in Figure-1, the market economy is comprised of three premises – Linear Economy, Circular Economy and Halal Economy. The linear paradigm, the economy thrives on resource extraction, use, waste and extract more, use and waste approach. In this conventional paradigm, the environment is not considered as a resource and is rather considered something which is irrelevant in the market driven business equation. On the other hand, the ecological economy paradigm treats the environment as an essential exhaustible resource in itself. In all the religious scriptures including those Islamic, there are significant condemnation of wasteful living. In the theory of Islamic finance these moral tenets are adhered to. The theoretical Islamic business model, although explicitly neither linear nor ecological, it condemns waste and chastises somewhat moderate living. Keeping the interests of the future generations as a pillar of *Maqāṣid* al- Sharīʻah (policy guideposts), the ecological parameters cannot be separated from moderate living and inter-generational justice. This middle of the way living is under constraint of the moral and ethical values. However, when it comes to financing in the practice, the ethical tenets of avoiding waste are subdued by activity's being Halal. In other words, the Halal economy paradigm may converge with the linear paradigm at some level and with the ecological paradigm at another level. An example of its convergence with linear paradigm will be buying a new car because the financing rates have become more attractive, obviously if more is wasted, more will be produced and marketed and more resources extracted at the cost of the environment. The IBBL business model represents this cross-cutting nature into the linear and ecological paradigms. However, the Triodos Bank business model is inherently originated from ecological paradigm. In other words, the not-for-profit motive drives the for-profit-motive in the Triodos Bank model. The for-profit-motive within the range of Halal parameters, is what drives the IBBL business model. That makes the primary difference between the two and fundamental message of our paper.

This paper aims to study the differences and converges between a Ribawi ethical bank and an Islamic bank through a case study of Triodos Bank and Islami Bank Bangladesh Limited (IBBL). The paper contains five sections. Section 2 presents a case study of Islami Bank Bangladesh Limited and highlights some observed practices which are generally not present in other Islamic banks. Section 3 analyses and discusses the banking approach of Triodos Bank. Section 4 consists of recommendations that were reached through a case study of IBBL and Triodos Bank from the perspective of analyzing and exploring the approaches of an Islamic bank versus an ethical bank, and makes some propositions which seek to enhance the Islamic bank model. Lastly, the conclusion section ends this paper.

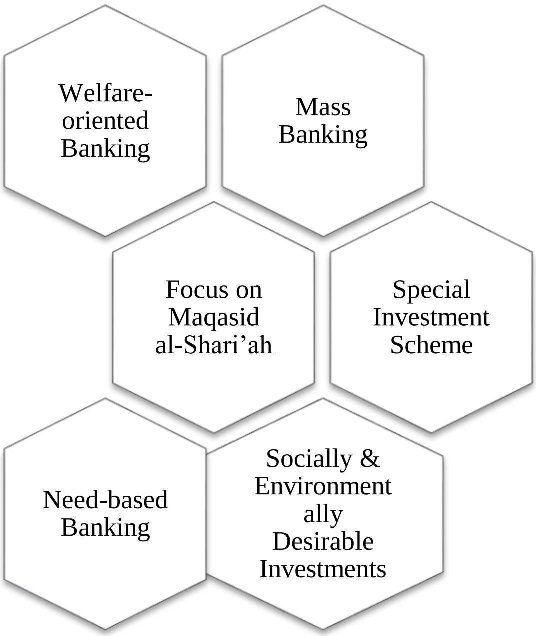
2. Islami Bank Bangladesh Limited (IBBL)

2.1. Company Profile

IBBL, the first Sharīʻah based Bank in South & Southeast Asia, was established on 13 March 1983 as a public limited company and started operation informally through inauguration of its first branch on 30 March 1983. A formal inauguration took place on 12 August 1983 when the first branch of the Bank (its local office located at Motijheel, Dhaka) started its full-fledged banking operations. IBBL has pioneered need based, socially-responsive and development-focused banking through operations and services which are unique by mechanism and objectives. Since inception at the early nineteen eighties, the Bank emerged as the provider of a diversified and wide range of deposit, investment and foreign exchange products coupled with techno based banking devices to people of all strata of the society through inclusive, diverse and cordial services. The establishment of IBBL unveiled a new horizon and ushered a new ray of hope towards realizing a long cherished dream of the people of Bangladesh for conducting their banking and investment transactions in accordance with Sharīʻah. Driven by the core values of equitable distribution and justice in financial activities, IBBL prioritizes welfare banking through diversification of its financing in terms of size, sector and geographical location with emphasis on employment generation for ensuring sustainable development.

As a Bank of the mass people and to deliver its banking services to the maximum number of customers, IBBL has cultivated a vast banking network across the country. As part of its gradual expansion plan to cover important commercial places both in urban and rural areas; the Bank in 2014 successfully opened 8 new branches, increasing the total number of branches to 294 from 286 the previous year. The Corporate Headquarter of the Bank is located in Dhaka. As at 31 December 2014, the Bank's paid up capital was Tk.16,099.99 million, an increase from Tk.80.00 million upon establishment[3]. In its mission to uplift the socio economic conditions in rural areas, IBBL has established the highest number of rural branches among the first generation of private commercial banks.

Figure-2
Unique Features of IBBL



[3] 1 Bangladeshi Taka ≈ 0.013 US Dollar (9 Feb 16); equivalent to approx. US $209.30 million in 2014; US $1.04 million in 1983.

Out of its 294 Branches, 76.19% (224) are located in urban areas and 23.81% (70) are rural branches according to the criteria set by the Bank for determining urban-rural Branch. IBBL also has three subsidiary companies and offshore units, holds membership in several national (Central Sharī'ah Board for Islamic Banks in Bangladesh, Central Sharī'ah Board for Islamic Banks in Bangladesh and others) and international organizations (AAOIFI, IFSB, CIBAFI, IIFM, IIRCA, etc.) as well as equity investments in some companies. IBBL has also received several awards and recognitions worldwide such as ranking among the World's Top 1,000 Banks list in 2012 by The Banker and in 2014, it ranked 970. The Bank also has numerous sponsors, local and foreign, including the Islamic Development Bank, Kuwait Finance House, Islamic Investment and Exchange Corporation (Qatar) and others. Furthermore, IBBL in 2014 obtained the highest rating ("AA+" rating) by the Credit Rating Information and Services Limited (CRISL).

The Bank's core values, commitments and Code of Conduct and Ethical Principles are unique since they are based on Sharī'ah and in their Annual Report, the Bank has taken a very Islamic approach to reporting by citing Quranic verses and Prophetic sayings at the beginning as well as citing the Sharī'ah foundation of ethics (Accountability to Almighty Allah, integrity, principle of vicegerency on the earth, sincerity, piety, righteousness and making one's work perfect, God-fearing conduct in all activities). Although all Islamic banks are based on Islamic principles, they have not adopted such an approach in their annual reports. IBBL has also established the rules of ethical conduct on three levels: 1. self-motivated rules influencing job performance[4]; 2. rules of conduct towards shareholders, managers and fellow employees; and 3. rules of conduct towards those who deal with the institution and its related parties.

2.2. IBBL's Unique Approach to Banking

The Bank's distinctive approach to banking lies not only in the fact that it is an Islamic bank, but also, it aims at making a real difference in the lives of Bangladeshi people. Its mission is to *introduce a welfare oriented banking system* based on Islamic principles as well as work towards financial inclusion particularly in poor rural areas. The Bank has laid down several strategic objectives which it strives to achieve, and the most remarkable ones are:

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[4] The first self-motivated rule stipulated by the Bank is God-fearing state of mind, followed by adherence to the Sharī'ah and implementing its principles. If these two rules are indeed observed, many ethical dilemmas and issues would be minimized, if not eliminated, at work.

- Excellence in serving the cause of least developed community and area;
- Ensure Corporate Social Responsibilities (CSR) through all activities;
- Promote green banking culture and ecological balance;
- Expand need based Retail, SME and Micro financing;
- Ensure lucrative career path, attractive facilities and excellent working environment; and
- Ensure zero tolerance on negligence in compliance with both Sharīʻah and regulatory guidelines.

The Bank is founded on some essentials which are not usually found in contemporary Islamic banking models:

2.2.1 People's Bank

The Chairman of IBBL declares that IBBL belongs to *the* one hundred sixty million people of the country and that it works for people across all strata of the Bangladeshi society irrespective of cast, creed, religion, gender and political standing. The Bank's deposit and investment clients and shareholders include non-Muslims, and a significant proportion of its RDS (Rural Development Scheme) beneficiaries are women and non-Muslims. The MD (Managing Director) declared that 2015 is the 2nd year of the decade of '*Achieving Maqāṣid* al-Sharīʻah, and the aim is to be the 'Bank for all' and make IBBL as the 'Bank of choice' for all families in the country by fulfilling their entire needs.

2.2.2 Dedication to Build a Better 'Bangladesh'

IBBL is dedicated to bring its contribution to the country and its nation through socio-economic and human development. In this regards, IBBL fulfills its responsibilities and obligations towards the country namely: paying corporate taxes on time and remitting Excise duty, tax and VAT to government Exchequer. IBBL is the largest corporate taxpayer in the country's banking sector, and in 2014, it contributed Tk.11,465 (US $149.05) million to the National Exchequer. Such significant contributions certainly make a difference if appropriately distributed.

IBBL is also committed to realize the objectives of Sharīʻah in the aspect of human capital development, and as a result, it recruits the best talent and grooms them into future leaders in the Islamic banking industry through diverse talent development programs.

IBBL has created a vast network across the country, with 450 of its own ATM machines, and more than 4000 shared ATM booths. It has introduced some high-tech banking devices including On-line banking, i-Banking, SMS Banking, phone banking to cater for its clientele. The Bank introduced ATM/Visa Debit Card, Khidmah Credit Card, Hajj Card, Travel Card, Remittance Card, E-commerce (Payment Gateway), IDM (Islami Bank Deposit Machine) to deliver quick and flawless banking services to its large customer base. The Bank's mobile banking service -m Cash- is increasing in popularity day by day and comprises of 154 corporate agents, 32,000 dedicated retail agents and more than 45000 non dedicated retail agents. Therefore, IBBL is contributing to uplift the living standard in the country.

2.2.3 Bank for Humanity and Financial Inclusion

IBBL has founded community-based programs in an attempt to fulfill its mission of implementing Islamic banking for the benefit of humanity in Bangladesh. IBBL has a department for serving social causes (RDS) and social work is deeply rooted in the Bank since its inception. IBBL tried to bring its contribution to the society through CSR activities particularly geared towards education, disaster management, poverty alleviation, health care and creating an environment-friendly society. IBBL also devised some welfare and inclusivity oriented products such as Savings Account for farmers, students, and for different purposes (*Mahr*, Cash *Waqf*, Hajj) to economically empower the lower class of the society. IBBL is on the point of reaching 'Bank of Crore Clients', and has taken various measures and initiatives to reach out to the unbanked population and poorest segments in remote areas.

2.2.4 Corporate Governance, Transparency and Ethics

IBBL is highly committed to the standards of integrity, ethics and compliance. Although all banks, whether Islamic or conventional, are concerned with corporate governance and transparency, IBBL emphasizes a lot on Sharīʻah principles to ensure realization of *Maqāṣid al-* Sharīʻah and transparency in all its activities. The Bank believes that upholding the interest of its customers, employees and regulators significantly influence sustainable growth and the country's development. IBBL adopts the Core Values, Commitments and Code of Conduct and Ethical Principles which are approved by the Board of Directors and circulates it to all employees for acknowledgement and meticulous compliance. All employees are expected at all times to maintain high ethical standards and adequate internal control measures to guard against the occurrence of unethical practices and irregularities.

2.2.5 Commitment to Sharīʻah

IBBL is highly committed to Sharīʻah principles, and it scrutinizes every transaction. For instance, it stipulates that it does not even finance the import of fertilizers to be used in tobacco production. The Bank is striving to bring doubtful income at zero level, and the Sharīʻah department has been equipped with proficient manpower and appropriate logistics to conduct off-site audits and ensure transparency in Sharīʻah compliance. There has also been an increased awareness regarding Sharīʻah compliance among the workforce and clients throughout the year.

2.2.6 IBBL – A Family

IBBL considers its employees as the Bank's most precious asset which plays a vital role in materializing its mission, vision, goals and objectives. A systematic framework has been designed to facilitate the proper development of employees (personal and organizational knowledge, skills and abilities) including succession planning, merit-based hiring, performance appraisal system, promotion, reward & motivation, training and development and grievance management and counseling.

IBBL, as the pioneer of welfare banking in the country, is strongly committed to healthcare, safety and modern working environment for the prosperity and well-being of its employees and has established several employee welfare and fringe benefit schemes. The Bank also implements a human resources accounting system, which helps identify and measure the data about its human resources. It compiles various types of data about its human resources, namely its human resource strength (for e.g., the number of employees in different positions - executive, officer, sub-staff, number of employees per branch for RDS), total workforce by age and gender, employee productivity as well as number of employees who received training programs. As at 2014, 80.2% of IBBL's employees were below 40 years which indicates a young workforce, but out of this, only 3.88% are females (a huge gender disparity). In fact, out of IBBL's total workforce, only 4% is women. However, this figure should be interpreted according to the country's conditions, and since there is high levels of unemployment and poverty, employing more men than women certainly aims to reduce poverty and contribute to strengthening the family unit.

2.2.7 Environment-friendly Banking

Green Banking is consistent with the philosophical basis of the Bank. IBBL is committed to environmental protection, social benefit and human welfare. In 2014, it spent Tk.55,368.53 (US $719.79) million in Green investments, which are provision of financial services to businesses and projects that help prevent deterioration of the environment and/or are environment-friendly. IBBL reported that it is taking the initiative to migrate to full-fledged Green banking operation by December 2015. IBBL has several projects under the green banking concept, for example, green investment (provision of financial services to businesses and projects that help prevent deterioration of the environment as well as those which are not harmful to the environment), climate risk fund (rehabilitation support, tree plantation movement, investments in disaster prone areas), green training and awareness programs and in-house environmental management.

Since Bangladesh is identified as a southern delta which is under serious threat of natural disaster, IBBL as a responsible corporation, has taken some initiatives in this regard. The Bank has been observing a Plantation Program during the rainy season every year since 2003. Each of the RDS members are given one sapling free of cost and in 2014, 723,672 saplings were implanted at a cost of Tk.20.53 (US $0.27) million.

IBBL is continuously striving to reduce consumption of energy, eliminate use of hazardous substances from its processes and minimizing waste generation as well as minimizing paper transactions.

2.2.8 Research & Development (R&D) and Islamic Banking Literacy

As the 1st Sharīʻah based Bank in the region and market leader in banking sector of the country, IBBL felt the need to invest in R&D to have a competent and dynamic human capital. Therefore, in 2011, IBBL started Research and Development activities, strives to bring excellence in Islamic Banking knowledge and devise Sharīʻah compliant innovative products and services which meet the *Maqāṣid al*-Sharīʻah.

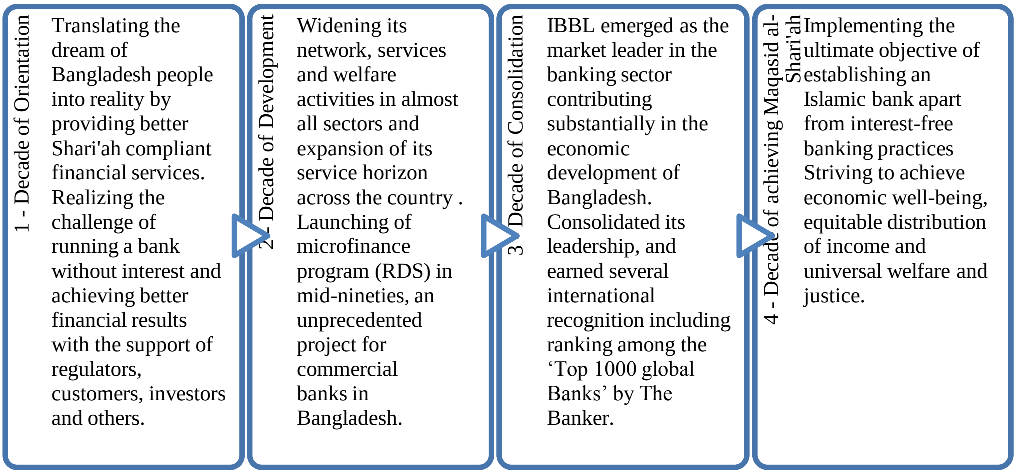
One of the objectives of IBBL is Islamic banking literacy and the Bank, over the years, has been continuously trying to eliminate misconceptions and present the Islamic banking model. IBBL plays an important role in empowering fellow banks towards promoting Islamic banking and humanizing the banking sector through establishing a welfare-oriented financing culture.

2.3. IBBL’s Experiment with Islamic Banking: Between Theory And Practice

IBBL has a rich history of 33 years, which according to its MD, can be classified into four decades of notable achievements, steady growth and performance as illustrated in Figure 3.

Figure-3

IBBL's Practice with Islamic Banking over Four Decades



IBBL's MD commented on their objective for this fourth decade, and quoted Saleh Kamel, Chairman of General Council for Islamic Banks and Financial institutions (CIBAFI) in the 35th annual conference of the Islamic Development Bank in Azerbaijan in 2012, "... Over the past decades, academic researchers and Islamic banking practitioners and Sharīʻah specialists have emphasized more on the modes and mechanism of Islamic Banking. We undoubtedly gained success in pursuing interest-free transactions and Sharīʻah-compliant procedures. But the inherent strength of the Islamic Banking and the *Maqāṣid* or the objectivity of this system like justice in wealth distribution, mass welfare and emancipation from economic slavery, were not received due importance in the works of professional Bankers and Sharīʻah experts as much as it was needed."

IBBL's experiment with Islamic banking and commemorating its three decades of achievements through carefully planned goals and objectives, certainly projects us with an outlook of an ideal theory for the next era of Islamic banking. There is presently a gap between Islamic banking theory and contemporary practice for most Islamic banks.[5] However, in the case of IBBL, we notice that the practice seems to

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[5] Elgari (2005) noticed with concern that a closer look at the contemporary reality of Islamic banks reveal that their development did not converge towards the theory developed by its founders nor was it similar to the thought of those Sharīʻah scholars, but in fact, the Islamic bank charted for itself a clearly different path. According to him, Islamic banks are increasingly relying on *Tawarruq* including on the

be aligned with the theory, and even more so, since they are now emphasizing on achieving the *Maqāṣid* al-Sharīʻah for the next decade, starting from 2013.

2.4. Operational Structure, Product Diversity and Other Significant Notes

2.4.1 Corporate Structure

The Board consists of 15 non-executive members, one-third (5 persons) of which are independent directors excluding the ex-officio MD. What is of noticeable interest in the corporate structure of IBBL is the constituents of its Sharīʻah Supervisory Committee. Surprisingly, in contrast to other Islamic banks, IBBL has a relatively larger Sharīʻah Supervisory Committee consisting of 12 members, including the Chairman, Vice Chairman and Secretary, which is excellent from a Sharīʻah governance perspective.

Sharīʻah Supervisory Committee (SSC)

As per Islamic Banking Guidelines issued by Bangladesh Bank, IBBL formed an independent SSC which gives opinions and guidelines to ensure Sharīʻah compliance in all activities of the Bank. The Committee conducted Sharīʻah inspections in 286 branches through *Muraqibs* during 2014 to ensure that the implementation of and/or compliance with Sharīʻah principles, or detect shortcomings (if any) that occurred in the Bank's branches. The SSC Report discloses that although all investments and transactions executed by IBBL were in accordance with Sharīʻah principles, some exceptions were however observed at the implementation level as per the Sharīʻah inspection report. Therefore, we can say that the SSC is independent in its decision-making and authority.

The IBBL Sharīʻah Supervisory Committee

- Consists of 12 members;
- Is governed by a by-law approved by the Board of Directors;
- Representatives attend different meetings of the Bank, like Board of Directors, Executive Committee, Audit Committee, Risk Management Committee, and Annual Business Development Conferences to give opinions and oversee the activities of the Bank from Sharīʻah perspective;
- Evaluates performance of the officials in terms of their Sharīʻah compliance;

funding side to mobilize deposits which is a visible divergence from the Islamic bank model portrayed by the founders and falsifies the theory of Islamic finance.

- Held 10 (ten) Sharīʻah Committee meetings in 2014;
- Attended 8 (eight) Seminars organized by the management of the Bank on the eve of inauguration of new branches and 18 (eighteen) Sharīʻah Awareness programs arranged by the Head Office and different zones.

2.4.2 Products & Services Offered

IBBL has various products and services to mobilize deposits and provide financing.

Deposit Products

IBBL successfully mobilized Tk.560,696 (US $7289) million from 9,587,458 depositors as at 31 December 2014, registering a growth of Tk.87,555 (US $1138) million (19 %) over the previous year. For the same period, the total number of depositors increased to 9,587,458, a 12% growth over 2013, and historical trends of deposit mobilization show that the Bank doubles its deposit base in every 4 years. The Bank has a wide array of diversified deposit products which currently stands at 24. IBBL uses two Islamic structures: *Wadīʻah* and *Muḍārabah*. The *Wadīʻah* structure is used for current accounts, while all savings accounts are based on *Muḍārabah*. In 2014, IBBL's deposit mix largely comprises of *Muḍārabah* deposits (89.65%, of which *Muḍārabah* savings account single-handedly totals 32.4%) and the remaining 10.35% are cost-free deposits (*Wadīʻah* current accounts made up 4.69% of IBBL's deposit mix).

Wadīʻah Accounts

IBBL's current account works under the principle of *Wadīʻah*. The Bank defines the operation of the *Wadīʻah* account as follows: *The Bank commits to refund money deposited in these Accounts on the demand of customers. On the other hand, the Bank takes permission from customers that the Bank may utilize their money*. However, this should be rather known as a *qarḍ* since the Bank is utilizing these funds with prior permission of its depositors, and similar to any other current accounts, withdrawals can be entertained at any time, depositors' capital are guaranteed and they do not earn any profits.

Muḍārabah Accounts

IBBL invests the *Muḍārabah* funds and distributes a minimum of 65% of investment-income earned through their deployment (as per weightage assigned to each type of *Muḍārabah* deposit) among the *Muḍārabah* depositors after the closing of the year, implying that the profit-loss sharing ratio is not fixed. In 2014, IBBL paid 71.48% of investment income earned through *Muḍārabah* funds' deployment, and some *Muḍārabah* deposits earned an additional rate over this rate derived as per weightage. *Muḍārabah* depositors share only incomes derived from investments where their funds were used. The Bank pays profits to *Muḍārabah* depositors at provisional rates on half-yearly/yearly basis considering overall projected growth, performance and profitability of the Bank during the year. The final profit rates for any accounting year are declared after finalizing the Sharī'ah inspection report and certifying the investment income of the Bank by the statutory auditors.

General Investment

The Bank's Total General Investment increased to Tk.463,475 (US $6025) million in 2014. Its Investment Policy is to invest on profit-loss sharing basis in accordance with the tenets and principles of Sharī'ah. IBBL's motive is not only profits, but its investment policy rather emphasizes on achieving social goals and objectives in creating employment opportunities. The following modes are used for investment: sale-based contracts (*Murābaḥah, Bay' Istijrar*, *Bay'-Mu'ajjal*, *Salam*, *Istiṣnā'* and *Bay'-As-Sarf*), sharing-based contracts (*Muḍārabah* and *Mushārakah*) and *Ijārah*-based (Hire Purchase under Shirkatul Milk).

SMEs and Micro-Investment Activities

IBBL has adopted a comprehensive SME Investment Policy, and disbursed Tk.24,981 (US $324.75) crore[6] to SMEs in 2014 which is 106% of annual target of Tk.23,500 (US $305.5) crore. SME investment outstanding as at 31 December 2014 is Tk. 20,112 (US $261.46) crore which is 42% of Bank's total general investment. The Bank holds the highest position in financing SMEs in the country with 15% market share (on the basis of outstanding position). The SME Investment scheme of IBBL singlehandedly created about 800,000 jobs in Bangladesh.

Furthermore, IBBL has 16 Special Investment Schemes targeting different groups of people particularly fulfilling finance needs of under privileged and neglected segments of the population. IBBL also launched a microfinance program for rural areas under the appellation "Rural Development Scheme (RDS)" in 1995 to cater to the investment needs of the agriculture and rural sector and create employment opportunities and increase income of the rural people with a view to alleviate

[6] A crore is a unit in the Indian numbering system equal to ten million (10,000,000).

poverty, and recently, the "Urban Poor Development Scheme (UPDS)" in May 2012 for extending micro-investment facilities in urban poor areas. The RDS is operated in 221 branches across the country, while UPDS is present in 23 urban branches.

IBBL also promotes non-financial (welfare) programs under several schemes in the areas of Education, Training, Health, Relief & Rehabilitation and Environment.

Welfare oriented products

The IBBL offers a set of unique welfare oriented deposit and investment schemes including:

i. *Muḍārabah* Hajj Savings
ii. *Muḍārabah* Special Savings (Pension)
iii. *Muḍārabah* Muhor Savings
iv. *Muḍārabah Waqf* Cash Deposit
v. *Muḍārabah* NRB Savings Bond
vi. Students *Muḍārabah* Savings
vii. *Muḍārabah* Farmers Savings
viii. Transport Investment Scheme
ix. Small Business Investment Scheme
x. Agricultural Implement Investment Scheme
xi. Women Entrepreneurs Investment Scheme.

2.4.3 Basel Framework

IBBL follows the guidelines issued by Bangladesh Bank on Risk Based Capital Adequacy (RBCA) for Banks and Supervisory Review Process under Basel II framework. Recently, the Central Bank issued comprehensive guidelines for Basel III with an implementation phase from 2015 to 2019, and IBBL is taking appropriate measures to start implementing the Basel III framework. The Capital Adequacy Ratio in 2014 was 12.83%. IBBL also had a Tier-I capital ratio of 9.25% (which is well above the 6% required by Basel III). Figure 4 illustrates some main information about IBBL's Capital Adequacy position.

From IBBL's Basel II Compliance disclosures, we note that *Muḍārabah* Accounts are simply treated as deposits accounts and do not appear in the computation of Tier 1 and Tier 2 Capital. Interestingly, IBBL does not maintain a Profit Equalization Reserve (PER) and an Investment Risk Reserve (IRR), and as a result, the profits paid to depositors dropped dangerously in 2014 for all deposit products except for the *Muḍārabah* Foreign Currency deposits (the profit rate was maintained at 1.66%). For instance, the profit rate paid on *Muḍārabah* Savings Account in 2014 decreased to 4.90% from 6.30% in 2013. In contrast, IBBL maintains a dividend equalization account (DEA) for its shareholders which totaled Tk.32 (US $0.416) million end of 2014. One of the probable reasons might be because the Statutory reserve is a legal requirement[7] and once this is fulfilled, IBBL might consider setting up a PER for its depositors to mitigate withdrawal risk.

Figure-4
IBBL's Capital Adequacy Ratios

Tier 1 Capital

- As per the guidelines of Bangladesh Bank, Tier-1 Capital of IBBL consists of: (i) Fully Paid-up Capital, (ii) Statutory Reserve, (iii) General Reserve, (iv) Non-Repayable Share Premium Account, (v) Retained Earnings, (vi) Dividend Equalization Account, (vii) Minority Interest in Subsidiaries, and (viii) Non-Cumulative irredeemable Preference Share.

Tier 2 Capital

- Tier-2 Capital consists of applicable amount of (i) General Provision (against Unclassified Investments, Off-Balance Sheet exposure & Off-Shore Banking Units), (ii) Assets Revaluation Reserves up to 50%, (iii) Revaluation Reserve for Securities up to 50%, (iv) Subordinated Debt (Mudaraba Perpetual Bond) (up to max. 30% of eligible Tier-I capital), (v) Revaluation Reserve for equity instruments up to 10%, and (vi) All Other Preference Shares.

RATIOS	31 Dec 2014	Bangladesh Bank Benchmark
Tier 1 CAR	9.25%	5%
Tier 2 CAR	3.58%	-
TOTAL Capital Adequacy Ratio (CAR)	12.83%	10%

2.4.4 Risk Management

IBBL faces the same risks that any normal bank faces. It has formed 6 core risk management committees to effectively manage the 6 core risks and has designed and

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[7] As per section 24 of the Bank Company Act, 1991 as amended, at least 20% or more of the net profit before tax is transferred to statutory reserve every year until the balance of the reserve equates with the paid-up capital.

implemented its own Risk Management Guidelines in accordance with the guidelines prescribed by the Central Bank. The major core risk management committees are: Investment Risk Management Committee, Foreign Exchange Risk Management Committee, Information & Communication Technology Risk Management Committee, Money Laundering Risk Management Committee, Internal Control and Compliance Risk Management Committee and Asset Liability Committee. Being an Islamic bank, IBBL is also exposed to some additional risks unique to Islamic banks, and implements certain measures to mitigate them as explained in Figure 5.

Figure-5
Risk Management of specific Islamic Banking Risks

Risk	Management
Fiduciary Risk	In the case of mixing of funds (*Muḍārabah* Depositors' funds with the Bank's own funds), the Bank ensures that the bases for asset, revenue, expenses and profit allocations are established, applied and reported in a manner consistent with the Bank's fiduciary responsibilities.
Displaced Commercial Risk	The Bank may decide to waive their rights to part or its entire *Muḍārib* share of profits in order to satisfy and retain its fund providers and dissuade them from withdrawing their funds. IBBL's Asset liability management committee (ALCO) regularly meets to assess the fiduciary risk, rate of return risk and displaced commercial risk.
Sharīʻah Compliance Risk	IBBL is operating in a mixed economic system. The independent Sharīʻah Board oversees the Bank's day-to-day transactions and doubtful transactions are declared as suspended.
Liquidity risk for lack of non-structured Islamic financial market	IBBL has limited scope for placement of funds with the desired return from the market in times of surplus liquidity as well as limited scope in receiving Sharīʻah compliant funds at the time of liquidity crisis. However, IBBL remains vigilant – it did not face any liquidity crisis in the past and strives to ensure it remains so.

2.4.5 Social Responsibility

In addition to all its activities, IBBL is committed to social responsibility towards its stakeholders as well as to the communities in which it is established. CSR was an in-built mechanism of IBBL since its inception. IBBL since its establishment started its charitable activities through creation of '*Ṣadaqah Tahbil'* which was later converted into a full-fledged foundation in 1991. Moreover, IBBL has also established a Corporate Social Affairs Department (CSAD) in 2009 in compliance with the instruction of the Central Bank. IBBL's CSR program seeks to achieve the 3 Ps: People, Planet and Profit. In 2014, IBBL spent around Tk.524.52 (US $6.82) million as CSR expenditure in various sectors such as disaster management, education, health, sports, and environment, amongst others.

2.4.6 Financial Statement Preparation

The consolidated and separate financial statements of the Bank have been prepared basically as per provisions of the "Guidelines for Islamic Banking" issued by Bangladesh Bank and in accordance with rules applicable in Bangladesh and Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) since it is a member of that organization. However, in case of differences between the Standards, the guidelines and circulars issued by Bangladesh Bank prevail.

2.4.7 Treatment of Unlawful Revenue, Income and Gains

- Doubtful Income

  Doubtful incomes arising out of shortcomings in compliance with Sharī'ah principles for investments as per the Sharī'ah Supervisory Committee report are included in the Bank's investment income and corporate taxes are paid on it accordingly, whether these amounts are realized or not. However, it is not distributed to depositors or shareholders of the Bank, and the amount net of corporate tax is transferred to an account entitled 'Doubtful Income account'. The realized amounts of doubtful income are then given to charity.

- Penalty Fees

  IBBL charges fees on overdue payments under the sale-modes, and although the total amount is not included in investment income and kept separately, it is considered for taxes. The net realized amount of these fees and charges are expended for charitable purposes.

- Interest Income

  Any interest income received from balances held with foreign banks and from foreign currency clearing account with the Central Bank is not credited to income and given to charity net of corporate income taxes.

The previous practice of IBBL was to treat doubtful income on temporary basis and create provisions as per the decision of its Sharī'ah Supervisory Committee and only realized amounts net of corporate taxes were transferred and utilized for charitable purposes. However, starting from 2014, IBBL will maintain a separate account after payment of corporate income tax for doubtful income whether these incomes have been realized or not. Accordingly, in 2014, the amount of doubtful income net of corporate tax was transferred to ‘Doubtful Income account’ as a charge in profit & loss account under the sub-heading ‘Other Provisions’.

2.4.8 *Zakāh*

IBBL additionally pays Zakat at the rate of 2.58% (instead of 2.50% since its financial statements follows Gregorian Year) on the closing balances of Share Premium, Statutory Reserve, General Reserve and Dividend Equalization Accounts as per guidelines of the Sharīʻah Supervisory Committee and Bangladesh Bank. Zakat is charged in the Profit & Loss Account of the Bank as per “Guidelines for Islamic Banking” issued by Bangladesh Bank. However, there was no disclosure as how this amount was spent. IBBL does not pay *Zakāh* on Paid-up Capital and Deposits because it is the responsibility of the Shareholders and Depositors respectively.

3. Triodos Bank

3.1 Company Profile

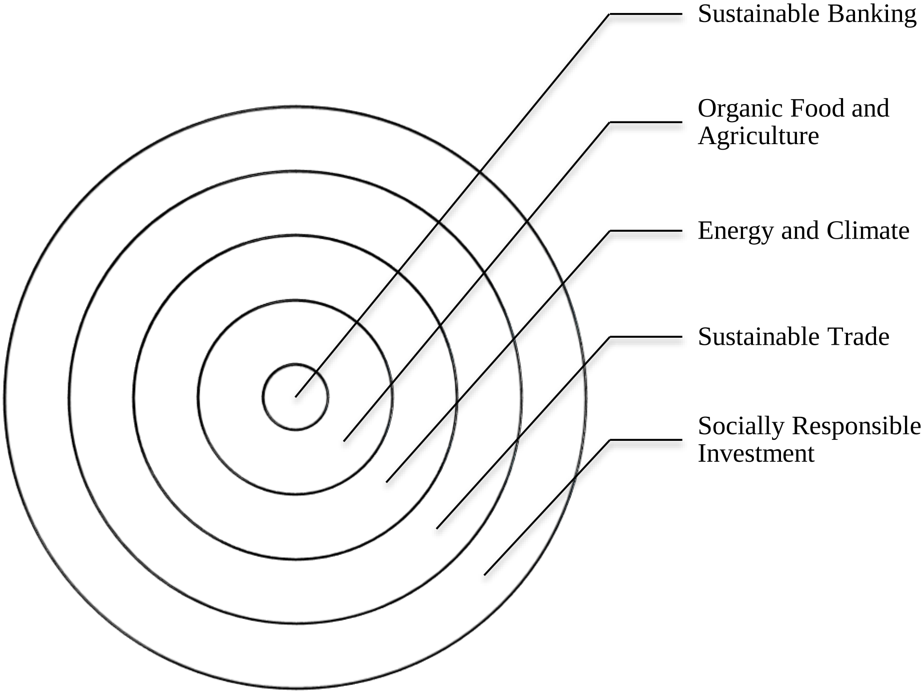
Triodos Bank, a European bank, is one of the world’s leading sustainable banks. Founded in the Netherlands in 1980 where its head office is presently, Triodos Bank has opened branches in Belgium, Spain, the United Kingdom and Germany. It uses money to work for positive social, environmental and cultural change by offering a comprehensive range of banking services that includes saving, investing, asset management, private banking, payment services and lending with the support of depositors and investors who want to encourage socially responsible business and a sustainable society. The Bank’s philosophy is built upon the responsibility to help bridge the gap between economic development and the interests of people and the environment which is undertaken in three different ways – by providing sustainable services, developing new and innovative products and engaging in public debate about the benefits and challenges of socially responsible business and sustainable banking. The 1960s and 1970s growing understanding of the need for sustainable economic development, and particularly awareness of the problems faced by ethical businesses dealing with conventional financial institutions motivated a small group of people to establish the Triodos Foundation in 1971 to support innovative projects and companies. In 1968, a study group, consisting of Adriaan Deking Dura (an economist), Dieter Brüll (a professor in tax law), Lex Bos (a management consultant) and Rudolf Mees (a banker) deliberated on how money can be managed sustainably. When Triodos Foundation was first established in 1971, gifts and loans were used to support innovative projects and companies. Since this proved a viable project, the bank's founders created a fully-fledged sustainable bank. In 1980, Triodos Bank NV is established with EUR 540,000 in start-up share capital and a full banking license from the Dutch Central Bank and started operation in Netherlands. In 1990, the Bank launched the first green fund in Europe, Biogrond Beleggingsfonds followed by the Wind Fund and Green Investment Fund later. The Triodos Sustainable Trade Fund, a fund providing trade finance to certified organic and fair trade producers in developing countries and emerging markets, was launched in 2008. In 2009, Triodos won the Financial Times Sustainable Bank of the Year Award at the International Sustainable Banking Conference in London for its leadership and innovation in integrating sustainability in all its activities.

The Bank's founders believe that it is crucial that its mission and identity is protected, and thus, all Triodos Bank shares are held in trust by SAAT (the Foundation for the Administration of Triodos Bank Shares). SAAT then issues depository receipts for Triodos Bank shares to the public and institutions. Depository receipts embody the economic aspects of Triodos Bank shares but its voting rights remain solely with SAAT. The Board of SAAT's voting decisions are guided by Triodos Bank's goals and mission, its business interests, and the interests of the depository receipt holders. Depository receipts are not listed on any stock exchange. Triodos also has an International Remuneration and Nomination policy and practices a remuneration system based on the principle that income is generated by the joint efforts of all co-workers.

3.2 Triodos's Unique Approach to Banking

Triodos Bank's ambition is to promote human dignity, environmental conservation and focus on people's quality of life in general. To fulfill its vision, mission and ambition, the Bank has undertaken a responsible approach to business, transparency and using money more consciously through financing projects that benefit both people and the environment, and that are financially sustainable.

Figure-6
Triodos Bank Business-Lines and Expertise



3.2.1 3P's Approach - People, Planet and Profit and a Reference Point

Triodos Bank is founded on the concept of banking to make a positive impact and the belief that economic activities can and should have a positive impact on society, the environment and culture – a concept the Bank coined as 'sustainable banking'.

Triodos wants to be viewed as a reference point and be recognized internationally in terms of sustainable banking and development. Therefore, it promotes public debate on issues such as quality of life, corporate social responsibility and sustainable banking. Through hosting and participating in such events, Triodos creates awareness about itself, and its identity, mission and objective which further strengthens the Triodos Bank brand and reputation.

3.2.2 Sustainable Business Model

Triodos claims to have a simple business model, whereby they only lend money collected from savers and investors to entrepreneurs they know well. They claim that they only work in the real economy and don't invest in complex financial instruments, for their own benefit, which brings high returns but which also carry greater risk. For the management of the Bank, such an old-fashioned approach is a blessing in disguise because it enables the Bank to remain solid and stable in times of global financial crisis, and sustain its rapid growth.

The Bank also gives a lot of importance to product innovation, competitive pricing and quality of service to better serve its customers as the latter not only wants sustainable products and services, but also competitive prices and a professional service.

3.2.3 Positively 100% Sustainable

The sustainable banking business model of Triodos implies firstly, offering products and services that directly promote sustainability. Although Triodos is ethical in the sense that it does not lend to people and businesses causing harm to other people, society and the environment, it has taken a self-consciously positive approach to finance by lending only to organizations that contribute to a more sustainable society. However, the Bank is built on the belief that money plays a leading role in sustainable banking because using money consciously means investing in a sustainable economy, which in turn helps to create a society that enjoys a better quality of life. The Bank's innovation includes the development of 'ordinary' banking products which meet Triodos Bank criteria, such as 100% biodegradable debit and credit cards and savings accounts and fixed term deposits that allow customers to donate interest, and Point of Sale machines using Forest Stewardship Council (FSC) paper.

3.2.4 Total Transparency

The Bank claims that they strongly believe sustainable banking depends on trust, and therefore, they publish details of every single organization which they lend to, thereby enabling their savers and investors to trace the use of their funds. Triodos also publishes all details related to Corporate Governance on its website as well as minutes of the Triodos Bank Annual General Meeting (AGM) and the Meeting of Depository Receipt Holders of the Foundation for the Administration of Triodos Bank Shares.

3.2.5 Lending Process

Triodos believes that money has the potential to create lasting, positive change, and therefore, it has accordingly structured its lending process which is as follows:

- Identify sustainable sectors where the Bank can help projects to innovate and businesses to emerge and develop;
- Select projects which will bring real and meaningful benefits for the wider community - for which creating cultural, social and environmental added value is as important as meeting commercial and financial targets;
- Closely consider the motivations of the people involved in a loan application;
- Ensure each selected project meets absolute criteria which measures the potential negative impact of an organization's activity on people and the environment; and
- Finance clearly defined assets, activities or projects within each organization.

3.2.6 Utilization and Deployment of Funds

The Bank scrutinizes every loan application and considers its implications to ensure that it meets its overall objectives. The Bank identifies and finances projects that combine added cultural, social or environmental value with financial credibility within different sectors. It has classified its operations within three main streams: nature and the environment, culture and society, and social business.

The Bank has also devised an absolute criterion for which lending will not be provided. It does not lend to consumers, businesses and projects that are directly involved for more than 5% of its activities in non-sustainable products and services or non-sustainable working processes. Triodos ensures that, to the best of its knowledge, all the following activities are excluded, which it classifies under three headings: non-sustainable products and services (comprising fur industry, gambling, environmentally hazardous substances, pornography, tobacco, weapons and nuclear energy), non-sustainable working processes (including intensive agricultural production without concern for animal welfare and environment, corruption, financially supporting dictatorial regimes, animal experiment, genetic engineering, etc.) and other non-sustainable products and processes.

Figure-7
Triodos Lending Sectors' Positive Screening

Nature and the Environment

- Finance sustainable environmental businesses and initiatives and refer to certification from respected bodies (such as SKAL, Biogarantie and the Soil Association) to guide decisions about organic food and farming loan applications. Areas considered for lending include:
  - Organic farming (for e.g., arable, dairy, meat, poultry, forestry, horticulture)
  - Organic Food (for e.g., shops, butcheries, food processing, restaurants)
  - Renewable energy (for e.g., wind, solar, hydro, biomass)
  - Eco-development (for e.g., shared workplaces, property development, nature development)
  - Environmental technologies (for e.g., recycling, transport).

Culture and Society

- Finance businesses and initiatives that help people to develop and act as free and responsible citizens. Lending applications are considered in:
  - Education (for e.g., Schools, Training and conferences centres)
  - Childcare (for e.g., day care centres, kindergartens)
  - Healthcare (for e.g., medical centres, therapeutic farms, care for elderly people, hospices)
  - Art & Culture (for e.g., visual arts, performing arts, cultural centres, film & media)
  - Philosophy of life (for e.g., meditation centres, religious and spiritual groups)
  - Community projects (for e.g., social services, migrant integration, community buildings)

Social Business

- Businesses whose key objectives are to add value to society and, or the environment.
- The Bank refers to respected fair trade labels recognised by the Financial Labelling Organisation (FLO), an international fair trade organisation, much as it does with its work in the organics sector.
  - Retail non-food (for e.g., toys, books, clothing)
  - Manufacturing (for e.g., printers, publishing)
  - Professional Services (for e.g., consultancy, research, building contractors)
  - Recreation (for e.g., parks, camping sites, eco-tourism)
  - Housing (for e.g., housing associations)
  - Fair Trade (for e.g., fair trade shops, wholesale trading)
  - Development cooperation (for e.g., microfinance, certified FLO products, certified organic products).

3.2.7 Monitoring Use of Funds

Triodos focuses lending to SMEs and charities to maintain close relation with people who run the organization and track use of the funds. The Bank also tries to make loans for specific purposes, such as purchase of assets, to ensure funds are indeed being used for the approved purpose. It may also lend to large companies which may not be primarily involved in generating positive social and environmental added value, but which operate certain crucial activities which are directly connected to sustainable sectors or activities provided they do not contradict the Bank's core mission.

3.2.8 Working Culture

Triodos Bank's working culture is open and transparent. The Bank depends on its human power to achieve its mission. Employees are involved in developing the organization's mission, and co-operation is encouraged within and between departments. All employees attend regular weekly meetings and new ones are provided a comprehensive induction into the Bank's way of working. The Bank has a training programme that involves individual and group sessions and includes specialized courses focusing on the development of personal and professional skills.

Triodos also has its own Academy that offers courses and seminars on management development and visionary leadership, as well as co-worker seminars on the values at the heart of the bank. Triodos also confers some distinctive benefits to its employees, for e.g., in the Netherlands, employees can buy two weeks' extra holiday and they can work on part-time basis. It also offers exceptional secondary terms of employment such as attractive allowance for bicycles in the Netherlands, as well as contributing to an employee's moving expenses if he/she wants to live closer to the office.

3.2.9 Social and Environment Reporting

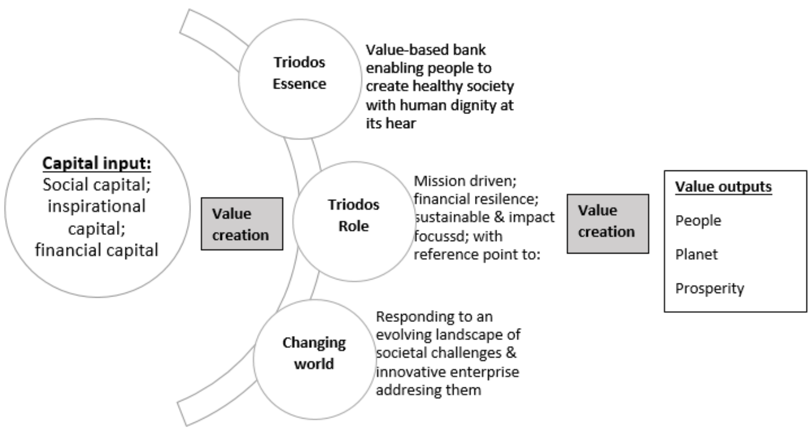
Triodos has a unique approach of disclosing in its Annual report certain social and environmental issues (social such as the number of employees at year end, employees' turnover, women as percentage of management team, ratio between the highest and the lowest salary; environment such as emission of CO2 and CO2 compensation). The Annual report 2014 includes a section on Co-worker Report and Environmental Report. In 2014, Triodos Bank employed 541 women (53.2%) and

476 men (46.8%); with women's share in management positions remaining unchanged at 40%.

3.3Business Model and Corporate Structure

Triodos business model is based on value creation, that is, transforming capital inputs (for e.g., skills and entrepreneurship of the people within the organization and money from customers, via our core products and services) into value outputs (making a positive contribution to the development of a healthy society).

Figure-8
Triodos Business Model



Source: Adapted from Triodos Website

Triodos has adopted the following measures to ensure financial viability: *(1) Offer fair (but not inflated) interest rates to savers; (2) Aim for reasonable long-term returns for investors both in Triodos Bank and its funds; (3) Use deposits to lend to sustainable entrepreneurs working in the real economy; (4) Aim at a healthy balance between loans and deposits; and (5) Maintain healthy levels of capital, well above regulatory requirements to ensure long-term resilience.*

3.3.1 Supervisory Board

Triodos Bank has a Supervisory Board, whose task consists of monitoring the Bank's business operations and advising and assisting its Executive Board to benefit its business interests. The Supervisory Board new members are appointed by the Annual General Meeting, based on recommendations from the Supervisory Board.

3.3.2 Risk Management

Triodos Bank uses a Three-Lines-of-Defense model of risk management which ensures that each employee is fully aware of their responsibilities in the management of risk, irrespective of whether their role is in a commercial, policy-making or control function. The Bank has a solid and robust risk management policy clearly detailed in its Annual Report.

In its Annual Report 2014, Triodos Bank disclosed that it already complies with the capital and liquidity requirements of Basel III which will be compulsory as from 2019. The Bank's strategy is to be strongly capitalized and it aims for a regulatory solvency ratio of approximately 14%, well above its own internal economic capital requirements. Triodos also gives importance to the quality of capital and almost 100% of its solvency comes from equity. In 2014, the Solvency (BIS ratio) was 19.0% while the Leverage ratio was 8.8%.

3.3.3 Corporate Governance

The corporate governance structure of Triodos reflects and protects its mission and meets all relevant legal obligations. It complies with the Dutch Corporate Governance Code, the Dutch Banking Code and the Corporate Governance Code and Banking Code Statement 2014. The Bank closely monitors and continuously reviews its corporate governance performance and reports it in its annual report. The Bank also gives high importance to gender diversity, and the Supervisory Board seats are not held by more than 70% by either gender. During 2014, five Supervisory Board members were male (approx.70%), and two female (approx. 30%).

4. What Islamic Banks Can Learn?

Although Islamic banks are viewed as ethical banks, studying the practice of some Islamic banks and an ethical bank suggest that there are some gaps which make Islamic banks ethical in some perspective, but not in its fullest sense. There are many social and environmental issues which are given the highest consideration in ethical banking, but unfortunately, very few Islamic banks pay attention to these. IBBL is one of the rare Islamic banks (although there might be others) whose banking model incorporates extra ethical banking concepts in terms of environmental and social issues. In what follows, we will first list down the convergences and divergences between IBBL and Triodos (Table 1 and 2) as well as some lessons that Islamic banks can learn from both of these banks (Table 3).

Table-1
Convergences between IBBL and Triodos

Convergences
Environmentally-friendly banking / green banking and sustainable practices – 3P's approach (People, Planet and Profit)
SME Financing
Risk Management
Corporate Governance and Enhanced Transparency
Corporate Social Responsibility
Working Culture
Integrated reporting (financial and risk reporting plus ESG disclosures)
Voluntary internal regulation – (Shariah Board in IBBL, Supervisory Board in Triodos)

Table-2
Divergences between IBBL and Triodos

	Divergences	
	IBBL	**TRIODOS**
Type of Banking	Sharīʻah compliant	Interest-based
	Need-based, socially-responsive and development-focused banking	
	Welfare-oriented banking: people's bank, bank for humanity and financial inclusion	Sustainable banking
	Core values (Trust in Almighty Allah, Adherence to the spirit of Islamic Sharīʻah) and commitments (Sharīʻah directives)	Ethical lending criteria (positive and negative screening) in utilization and deployment of funds and monitoring of funds
Annual Reporting and Financial Statement Preparation	An Islamic approach to reporting (cites Quranic verses and Prophetic sayings as well as the Sharīʻah foundation of ethics - Accountability to Almighty Allah, integrity, principle of vicegerency on the earth, sincerity, piety, righteousness and making one's work perfect, God-fearing conduct in all activities.)	• A conventional approach to reporting • Social and Environment reporting
	Research and Development and Islamic Banking literacy	Triodos Academy
	Basel II (2015 annual report)	Basel III
	Unique IB risks	Normal risks –shuns investments in risky and complex financial instruments
	Treatment of doubtful income and *Zakāh*	-
	Sharīʻah Supervisory Committee	Supervisory Board
Others		Higher gender diversity

Table-3
Lessons to learn from

IBBL	TRIODOS
Financial Inclusion, Micro- and SME Financing	Sustainable Banking
PSIAs Accounts: strong framework for proper management and deployment of funds	Financing criteria and monitoring use of funds
• Working Culture and employee welfare (training and development and grievance management and counseling) • Human resources accounting system	• Working Culture • Gender equality and diversity
Environment-friendly banking: • Green investment: provision of financial services to businesses and projects that help prevent deterioration of the environment as well as those which are not harmful to the environment • Climate risk fund: rehabilitation support, tree plantation movement, investments in disaster prone areas, green training and awareness programs • In-house environmental management (green office guide)	Integrated Reporting (financial and risk reporting plus voluntary ESG reporting)
Commitment to Sharīʻah and Sharīʻah Governance - SSC fees and expenses disclosed	
R&D And Islamic Banking Literacy	

The following are some principles and approaches, which if implemented by Islamic banks will positively impact the sector and pave the door to a new theory of Islamic banking.

4.1. Financial Inclusion, Micro- and SME Financing

Few Islamic banks provide microfinancing and even fewer pay attention to financial inclusion of society’s lower segments. Instead, Islamic banks have private and exclusive banking departments for the rich and elite class of the society providing high net worth individuals personalized service (in many instances, each client has a Relationship Manager assigned to serve him/her exclusively at all times), flawless and efficient transaction execution combined with a world of privileges and facilities with privacy and confidentiality. Although it is not prohibited for Islamic banks to undertake such transactions, it becomes preoccupying when they completely ignore the financing needs of the middle-class and entrepreneurs and wipe out small savers and the ‘unbankable’ segment.

We are not trying to portray ideals, and the fact that an Islamic bank remains an institution owned by its shareholders whose objective is to make profits for its shareholders is not overlooked. The Islamic bank, as any individual would do with his/her own money, can make profits and even maximize profits for its shareholders, but within the boundaries of the Sharīʻah. But, as any other institution in society, the Islamic bank has certain commitments to society, which it can easily undertake at no extra cost. For example, it can easily set up a department for microfinancing, provide deposits products for low savers and channel these deposits together with funds from other sources to financing micro-financing needs. The objective is not to make the Islamic bank a charitable institution – Islam has in place other institutions for that namely, *Qarḍ* , *Zakāh*, *Awqāf*, forbearance and *Ṣadaqah* – but, to promote financial inclusion. IBBL has implemented RDS in 1995 which caters for the investment needs of the agricultural and rural sector, creates employment and alleviates poverty as well as an Urban Poor Development Scheme (UPDS) in 2012 to extend micro-investment facilities among the urban poor.

Although all countries are different with their own demographic factors, there is still scope for microfinancing and SME financing. Islamic banks should promote financial inclusion, instead of excluding people from financial services based upon income and wealth factors. The decision of providing financing is based on credit risk assessments, and despite some classes are viewed as riskier than others, this should not be a cause of their exclusion from Islamic banking services. Islamic banks can potentially build a robust and successful department for microfinancing and SMEs, and in some instances, *Waqf* and *Zakāh* funds can be used as funding. For instance, cash *waqf* made for the purpose of providing *qarḍ* to the poor or microfinancing can be administered by the Islamic bank as an agent against a fee, and in return, the Islamic bank is also giving back to society.

4.2. Sustainable Banking and Integrated Reporting

Islamic banks can infuse the concepts of sustainable banking as well as environment and society-reporting as practiced by Triodos and IBBL. Although Triodos is more advanced than IBBL in terms of sustainable banking, IBBL has started implementing green banking, which means that other Islamic banks can do it as well. Islamic banks could also at a later stage report on social and environmental issues as done by Triodos. This would be a very positive innovation and customers can actually monitor the bank's impact on the environment and society and choose to bank with the most sustainable one. An interesting discovery is the implementation of an 'In-house Environmental Management' by IBBL and it even has a Green Office Guide which it follows in its day-to-day office operations to minimize and reduce carbon emissions, achieve more efficient use of resources and reduction of waste, save energy and money, and help improve working environment. Islamic banks can adopt such an environment-friendly approach and encourage their employees to observe sustainable practices especially in terms of water and energy management and paper consumption.

Disclosures offered in the annual reports of Islamic financial institutions are evolving through time. Most traditional financial disclosures are supplemented by regulatory requirements like Basel 2 Pillar 3 disclosures about balance sheet and off-balance sheet risks and to certain extent also about governance. Obviously, from historical records we know about the *Maqāṣid*, society's ideals that shall serve as guideposts for policy making, that include sustainability of cultural and religious values, protecting the interests of future generations, human dignity and self-respect, intellectual development and access to wealth and material resources. These elements need to constitute the disclosures of Islamic financial institutions as well as non-banking businesses in an integrated manner instead of merely relying on financial and risk reporting as required by regulators. The global regulatory models are traditionally fit and designed for the linear business model. However, we know that the sustainable development goals (SDGs) try to change the overall approach and integrated reporting may eventually become the norm of practice. At present, integrated reporting is not standardized and is adopted voluntarily by some institutions. In the Islamic finance practices, it is reduced to compliance of form with the Sharī'ah. When we look at the IBBL disclosures these are evolving in an integrated manner – the disclosures over and above regulatory requirements is significant and visible. Same is the case of Triodos Bank disclosures which are integrated covering financial and risk aspects but simultaneously, also covering environmental, social and governance (ESG) issues.

Triodos Bank and IBBL both practice somewhat radical transparency. In the Islamic banks' funding sources, we have share-holders' equity, equity of holders of profit sharing investment accounts (PSIAs), equity of *Sukūk* -holders, and the lent money of current account holders. This presents a unique governance challenge, particularly in terms of protecting the PSIA holders' interests as they are the weakest party (not being guaranteed not being managing). The standards of the Islamic Financial Services Board (IFSB), particularly concerning market discipline give significant attention to better disclosures to protect PSIAs. The IBBL has significant PSIAs and offer significant disclosures in this regard. In this regard an important learning opportunity is offered by the disclosures of the Triodos Bank and IBBL.

4.3. Financing Criteria

Triodos Bank has very concise and detailed lending criteria. In a 4-page document available on its website[8], Triodos clearly details to whom it lends, and to whom it does not. Triodos only lends to organizations that contribute to a more sustainable society. Although this is somewhat restrictive in itself, because it implies that if you

[8] https://www.triodos.com/downloads/425586/lending-criteria.pdf

are not directly involved in a sustainable business you might be excluded (for e.g., if you are not involved in organic food or farming), the lending criteria developed by Triodos is very useful, and can be developed by Islamic banks in an attempt to foster a more systematic approach to financing. The non-compliant areas of financing for Islamic banks include gambling, alcohol (consumption), swine and related products, conventional financial services, entertainment (adult), tobacco, weapons and defense, and any other activity prohibited by Sharīʻah. Triodos goes a step forward by including to the list: fur industry, environmentally hazardous substances, intensive agricultural production, corruption, dictatorial regimes, animal experiment, genetic engineering, breach of legislations, codes of conduct or conventions related to the environment, labour rights amongst others as well as anything which is not viewed as sustainable[9]. As an ethical bank, Triodos also lends money deliberately for specific purposes such as financing assets to ensure monitoring of funds. In this sense, Islamic banks can develop a concise and well-laid out criteria for financing which meets Sharīʻah principles and *Maqāṣid* al-Sharīʻah and avoid providing cash to customers whereby the monitoring of funds is lost[10].

4.4. PSIAs Accounts and Unique Structure of Funds

IBBL's deposit mix largely comprises of *Muḍārabah* deposits. Although it faces some unique risk such as fiduciary risk and displaced commercial risk associated with the nature of deposits, IBBL is still highly successful in mobilizing deposits through the *Muḍārabah* structure and provides attractive returns to its depositors. In some jurisdictions, PSIAs are not allowed since they pose threats to financial stability. However, since IBBL has successfully been able to mobilize deposits through *Muḍārabah* and manage it expertly, other Islamic banks can do the same provided a strong framework is built for proper management and deployment of these funds. For example, although the principal amount is not guaranteed by Islamic banks and the *Rabb al-māl* (in this case, the depositors) bears the loss, if any, in *Muḍārabah*, this is not an absolute principle since Islamic banks will be responsible in case of misconduct, negligence or breach of contract on its part. We have now the concept of Protected Capital, which means that the principal amount is not

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[9] From the Sharīʻah perspective, some of these are prohibited, while others are controversial. For e.g., financing the fur industry is opinionated, whereas there is no Sharīʻah issue regarding intensive agricultural production. Genetic engineering is a scientifically controversial issue, and some Sharīʻah scholars have not taken a position until science confirms one. In contrast, it is not permissible for Islamic banks to finance environmentally hazardous substances, animal experiment, breach of legislation, codes of conduct or conventions (particularly violation of fundamental child labour rights, forced labour, etc.) if such facts are proved and established.

[10] In *Tawarruq* transactions, it is difficult to trace and monitor the purpose of funds since cash is provided to customers.

guaranteed, but the principal is invested in financing secured by collaterals which may be liquidated in case of default. Islamic banks also try to invest in low-risk financing to protect both the bank and its depositors, which is true also in the case of IBBL[11]. IBBL, despite being highly successful in microfinancing and SME financing resorted to *Murābaḥah* instruments and *Ijārah*, instead of *Muḍārabah* and *Mushārakah* due to the inherently high risk elements and several impediments. Therefore, Islamic banks cannot be criticized of not using *Muḍārabah* and *Mushārakah* instruments on the financing side because they are financial intermediaries, acting on behalf of their depositors and shareholders and are bound by Sharīʻah principles and the *Wakālah* contract to act in a responsible manner.

The capital structure of Triodos Bank is also innovative as its Depository Receipts constitute significant source of funds. The IBBL is one of the pioneering banks which has significantly innovated by introducing *Muḍārabah Perpetual Bonds* in 2007 as perpetual profit sharing certificates and the instrument was introduced much earlier than the Basel 3 additional tier-1 perpetual bonds. Triodos Bank works for a purpose which is to make responsible business ventures successful. In theory, an Islamic bank too has a purpose as the primary focus of its stakeholders, and in this sense, the owners are not as profit sensitive as the owners of conventional banks. In practice, however, this again goes back to the concerns the paradigms. The Triodos Bank and IBBL are however, newer experiments and perhaps we need more time to determine the longer-term motivations of different types of fund owners.

4.5. Working Culture

The practical experiences of Triodos Bank and IBBL evidence that Islamic banks as well can implement conducive working environment, ensure gender equality in terms of remuneration and opportunities, and work towards overall employee welfare. Any company's greatest asset is its workforce, and Islamic banks first and

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[11] In 1984, the bank made 28.95% of its total investment under the *Mushārakah* mode which was reduced to 3.54% in 1994 (Alam, 2000), and in 2014 amounted to only 0.6%. In fact, Alam commented on IBBL as follows: "*as regards the overall investment position of the Islami Bank Bangladesh it may be concluded that, since the beginning of banking activities the bank has not invested any amount in any project on the Muḍārabah mode of investment*" and confirmed that *Muḍārabah* and *Mushārakah* were only applied on the funding side and not financing side. "*While interviewing officers in the investment department it was informed that in order to, make investment under Mushārakah mode of investment honest and sincere entrepreneurs are required. They experienced a hard time in many cases while introduced financing under the Mushārakah mode. In most cases it was found that although the entrepreneur is an honest person he lacks in sufficient equity capital. The bank has not concentrated much in financing small and cottage industry owners in rural Bangladesh. The bank has not invested yet under the Muḍārabah mode of investment while it is one the main mode of investment of Islamic banks. It needs a lot of care and the investment under this mode costs much to administer and supervise the loan.*"

foremost should be guided by Sharīʻah morals and values to promote and enhance employee welfare as well as provide a safe and healthy working environment. Islamic banks can devise a systematic framework to facilitate the proper development of employees and implement a human resources accounting system, to easily identify and measure data about its human resources as practiced by IBBL. Islamic banks should set the example, once they are well-established, by providing attractive remuneration packages and benefits to their employees. For instance, in the Netherlands Triodos employees can buy two weeks' extra holiday and the Bank also contributes to an employee's moving expenses if he/she wants to live closer to the office. IBBL also confers some distinctive benefits to its employees, such as burial expenses, recreation program, scholarships for education of meritorious wards of employees, cash prizes and certificate of merit to meritorious wards of bank employees, etc.

The IBBL is sensitive to the ideal of gender-balance and it is reflected in several places of their disclosures, which is lesser common among other Islamic banks. However, due to the dominant culture of Bangladesh where women don't have equal access to educational and professional opportunities, there may not be a sizable woman work force in IBBL. Triodos is a European Bank and in Europe, obviously, there are more opportunities for women to work in banks. We avoid discussing demographic issues with respect to whether the European culture as such can be compared with the culture in Bangladesh. Obviously, cultural differences will affect relative visibility of women in the workforce. What is important is that this by itself shall be part of disclosures and that is what IBBL and Triodos Bank actually share, indeed a good sign with respect to aspirations of SDGs.

4.6. Commitment to Sharīʻah and Sharīʻah Governance

IBBL has a rather exceptional Sharīʻah Board. Most Sharīʻah Boards consist of 3-5 members including the Secretary. IBBL has a rather large Sharīʻah Board size which is excellent from a Sharīʻah governance perspective. The Annual Report also contains appropriate disclosures regarding the SSC fees and expenses as well as rates of fees for attending different meetings. IBBL also ensures that the Sharīʻah Secretariat has qualified manpower and necessary logistics to undertake off-site Sharīʻah audits. The SSC Report highlights some remarks and recommendations which suggest its true independence from IBBL's management and Board of Directors, for e.g., the observations of some shortcomings at the implementation level of investments and transactions executed by IBBL, and that it is necessary to provide more Sharīʻah training to employees and strengthening of different steps to improve Sharīʻah Compliance such as motivational programs, administrative measures and intensive supervision by management. IBBL has a high level of transparency and commitment to Sharīʻah which all contributes to its good Sharīʻah governance which other Islamic banks can learn from in an attempt to improve their Sharīʻah governance structure.

Voluntary internal regulation is another institutional aspect of convergence between the two banks. In Triodos Bank Supervisory Board and in Islamic banks, the Shariah Board ensure voluntary supervision. These voluntarily internal supervisions add a new layer of governance structure to supplement the external regulation based on Basel and IFSB requirements. In Europe, there is a rising trend of the circular economy paradigm, and the regulatory authorities must be growingly supporting integrated reporting like Triodos Bank does. In the SDG implementation process regulators are perhaps going to encourage such an approach, and if pursued, the beneficiaries would also be Islamic banks and their clients.

4.7. R&D and Islamic Banking Literacy

IBBL spends on R&D activities, and Islamic banks can significantly increase their competitiveness in the market if they undertake such activities. R&D activities are vital for product development and devising Sharīʻah compliant innovative products and services which simultaneously meet market needs.

Islamic banking and financial literacy is also very important, especially in new and emerging markets. Islamic banks should consider embarking on some well-structured ongoing projects in view of promoting Islamic banking and finance awareness to the general public and creating an Islamic financial literacy. An Islamic financially literate population is primordial so that people can make responsible and informed decisions especially in a world of complex financial products as well as to eliminate misconceptions about Islamic finance. Once the Islamic bank is well-established, it can contemplate on launching its own Academy as undertaken by Triodos and offer courses and seminars on Islamic finance to train its own employees and interns on a first instance which can be extended to other audiences later.

5. Conclusion

This paper is an attempt to explore the similarities and divergences between an Islamic bank and an ethical bank through an in-depth case study of Islami Bank Bangladesh Limited and Triodos Bank. The analysis uncovered that the current practices of IBBL by far exceeds other Islamic banks in terms of financial inclusion, microfinance, SME financing and green banking while still being financially stable and profitable. However, Triodos Bank has some upper hand over IBBL regarding some ethical practices since it promotes mainly sustainable businesses. The correct approach would be to strike the right balance between ethics, morals, Sharīʻah compliance and profitability. Belabes (2013) argues that the challenge for religious, ethical and socially responsible finance is not the race against conventional finance by offering more competitive products, but by tackling the issue of human purpose devoid of which finance would be meaningless. It is man who gives value to finance and not vice-versa. As a result, religious, ethical and socially responsible finance should be viewed and dealt with as a resource, an opportunity and a strength instead of a constraint or weakness.

Islamic banks are financial intermediary institutions, not charitable institutions, and yet, they can significantly make a positive contribution in society if they observe Sharīʻah compliance and Islamic ethics and values in fulfilling their objective and mission as well as incorporate social and environmental concerns in their day-to-day business. Kayode and Ishola (2012) opine that Islamic finance is an ethical system based on religious values and its fundamental requirement is that all transactions should be linked to real economic activities. They argue that for Islamic banking and finance to positively contribute towards economic development, the system should be adopted and faithfully implemented in its entirety. The Islamic banking model has in-built features to ensure Sharīʻah compliance, and this can be enhanced through adopting sound ethical practices as well as dedicate efforts towards being environment-friendly. Islamic banks as institutions which follow Sharīʻah principles, although are not altruistic or non-for-profit organizations, can impact the society positively through creating employment, financial inclusion, and contribute to development of the country. Although some believe that ethics and profits are valid business objectives that are complementary, rather than substitutes, there are no empirical evidence to suggest or validate the claim that a trade-off actually exists between the two (Kayode and Ishola, 2012). However, from a macro-perspective, for the long-term stability and healthy growth of the sector, in case of conflicts between ethics and profits, ethical concerns should prevail.

The paper presented some elements which if present in Islamic banks would take them away from the forever criticism of being profit-only-motivated or profit-maximizing organizations. Some of the elements which would be required in an ideal Islamic bank are: promoting financial inclusion, micro- and SME financing, sustainable banking practices and reporting, well-detailed Sharīʻah-compliant and ethical financing criteria, diligent management of PSIAs Accounts, promote an organizational working culture, commitment to Sharīʻah and Sharīʻah Governance, and R&D activities and promoting Islamic banking literacy. IBBL has been very successful in its unique approach to Islamic banking, but the one-size fits all approach is utopian. All markets are not alike, and therefore, Islamic banks should give due consideration to market conditions and demographic factors before choosing the best approach under specific circumstances.

Moreover, judging whether banking practices are ethical or not necessitates an examination of the effect of transactions on morality and welfare (Ahmed, 2011). These kinds of ethical issues usually crop up when transactions or products are structured to be legally-compliant but have negative impacts on welfare or morality, the simple example of which are products which encourages borrowing through multitudes of attractive privileges and benefits. In the case of the Islamic finance sector too, if Islamic financial institutions give preference to the legality of transactions but which can lead to unethical outcomes, there is the need for a mechanism or authority which will ensure Islamic banking practices remain ethical within the moral teachings of Islam. Kamali (2008) states that although courts looked only into legal issues, the market controller (*muhtasib*) in ancient times had the power to intervene in the market and stop immoral practices. In contemporary times, should Islamic banks and Islamic financial institutions prove to be inefficient in observing Islamic ethics and morals of doing business, regulators can intervene in the market and issue binding laws and/or guidelines promoting ethical behavior for the welfare of the sector and society.

APPENDIX

Summary of Key Elements of the Institutions

BANK	IBBL	Triodos
Vision	• To establish Islamic Banking through introduction of a welfare oriented banking system and also ensure equity and justice in all economic activities, achieve balanced growth and equitable development through diversified investment operations particularly in the priority sectors and less developed areas of the country; and • To encourage the socio-economic development and financial services to the low-income community particularly in the rural areas.	• The Bank exists because it believes that people have the freedom to develop themselves, have equal rights and are responsible for the consequences of their economic actions on society and the planet. It only lends to and invests in organisations that contribute to a more sustainable society. Triodos Bank's approach takes account of people, planet and profit to deliver a positive return over the long term. This people-oriented, environmental and financial approach is expressed in the Bank's name itself. Triodos – 'Tri hodos' – translated from Ancient Greek means 'three-way'.
Mission	• To always strive to achieve superior financial performance, be considered a leading Islami Bank by reputation and performance; • To establish and maintain modern banking techniques, to ensure soundness and development of the financial system based on Islamic Principles and to become a strong and efficient organization with highly motivated professionals, working for the benefit of people, based on accountability, transparency and integrity to ensure stability of the financial systems; and • To encourage savings in the form of direct investment as well as encouraging investment particularly in projects, which are more likely to lead to higher employment.	• To help create a society that promotes people's quality of life and that has human dignity at its core; • To enable individuals, institutions and businesses to use money more consciously in ways that benefit people and the environment, and promote sustainable development; • To offer customers sustainable financial products and high quality service.
Core Values	• Trust in Almighty Allah • Adherence to the spirit of Islamic Sharīʻah • Honesty & Integrity • Transparency & Accountability • Welfare Driven • Equity & Justice • Environment Consciousness • Customers Focus • Respect for all • Discipline & Cooperation	• Entrepreneurship • Excellence • Sustainability • Transparency
	Commitments • Sharīʻah directives • Regulators • Shareholders • Society • Customers • Employees • Environment	**Business principles** • Promote sustainable development • Respect and obey the law • Respect human rights • Respect the environment • Be accountable • Continuous improvement

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Corporate Social Responsibility of Islamic Banks in Malaysia: Arising Issues

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Abstract

Corporate social responsibility (CSR) term has rapidly developed and is no longer a strange concept among business communities. As part of business entities and concurrently guided by Sharīʻah principles, Islamic banks face even more expectations in performing CSR as Islamic financial institutions. On top of that, although Malaysia is at the vanguard in the development of Islamic finance especially in Islamic banking industry, there is a lack of discussion on issues pertaining CSR applications of Islamic banks. Using interview data with top management executives and supported by observations and document reviews, this study attempts to disclose arising issues regarding CSR applications of Islamic banks in Malaysia. It was found that there are significant issues that need to be addressed in order to ensure the efficiency of Islamic banks CSR applications especially regarding corporate social responsibility disclosure (CSRD), CSR department and CSR fund.

JEL Classification: G30, P43
KAUJIE Classification: L33
Keywords: Corporate social responsibility, Islamic banks, Malaysia, top management

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1. Introduction

Undeniably, many contemporary discussions of corporate social responsibility (CSR) have largely been based on a Western direction (Di Bella & Al-Fayoumi, 2016). CSR idea was originally introduced by an American economist in 1950s and until recently has evolved as a comprehensive term that refers to anything good which is done by a corporation in order to have a positive and productive impact on its various stakeholders. Generally, CSR focuses on what an organization does that affects the society in which it exists (Stoner, Freeman, & Gilbert, 1995). It is important to recognize that all types of business apply CSR initiatives to further their relationships with their customers, their employees and their community at large (McAlister, Ferrel, & Ferrel, 2005). In this light, fundamentally, all of the world's top multinationals engage in CSR in some form and there is almost no country in which business have not taken up the challenge of CSR in some way (Matten, 2006), since social responsibility of corporate institutions and how they respond to the welfare expectations of society are important concerns in modern business (Aribi & Arun, 2015).

CSR also is not alien to Islamic banks. In fact, the majority of Islamic banks worldwide are sensitive to CSR, and this is parallel with the goal of their establishment as institutions with moral and profit making motives (Haron & Wan Azmi, 2009). Unsurprisingly, there are significant number of studies on the CSR of Islamic banks are found in past literature (see Adnan, 2012, 2015; Aribi, 2009; Aribi & Arun, 2015; Dusuki, 2005, 2008; Dusuki & Dar, 2005, 2007; Farook, 2007, 2008; Hassan & Abdul Latiff, 2009; Yusuf & Bahari, 2011). However, none of them disclosed any arising issues regarding CSR applications of Islamic banks especially in Malaysia. It is imperative to disclose the issues in order to understand the hurdles faced by Islamic banks in implementing CSR and further find solutions for that. Thus, the purpose of this study is to uncover arising issues pertaining CSR applications of Islamic banks in Malaysia.

The rest of this paper is organized as follows: Section 2 reviews of previous studies, Section 3 explains on research methodology. The findings are discussed in Section 4. Section 5 concludes the paper.

2. Literature Review

Many Islamic banking scholars claim that although Islamic banks execute mostly the same functions as conventional banks, they do this in clearly different ways (Ahmad, 2000; Iqbal & Molyneux, 2005; Marvyn K. Lewis & Algoud, 2001;

Warde, 2000). The most important features of Islamic banking and finance which makes it different and unique from its conventional counterpart are, firstly, Islamic banking strives for a just, fair and balanced society as envisioned by the Islamic economics. Secondly, Islamic banking is constructed upon the principle of brotherhood and cooperation which stands for a system of equity-sharing, risk-sharing and stake-taking. Thirdly, as a system grounded on ethical and moral framework of the Sharīʻah, Islamic banking is also characterised by ethical norms and social (Dusuki, 2006). Fourthly, Islamic banking is community oriented and entrepreneur-friendly, emphasising productivity and the physical expansion of economic production and services. Finally, Islamic banking operates within limits that ensure stability in the value of money and that reduce destabilizing speculations (Dusuki, 2011).

These characteristics somehow imply the relevance and significance of CSR as a globally accepted practice to Islamic banks. Islamic banking system has an intrinsic dimension that promotes social responsibility, as it resides within a financial trajectory underpinned by the forces of Sharīʻah injunctions. These Sharīʻah injunctions intertwine Islamic financial transactions with genuine concern for ethically and socially responsible activities and at the same time prohibiting involvement in illegal activities or those which are detrimental to social and environmental well-being (Dusuki, 2006).

Hence, while the virtues of Islam have always advocated social responsibility, the challenge to Islamic banking communities lies in its application. For Islamic banks, good CSR practises should have already been embedded in all aspects of their operations. Indeed, Islamic banking should endeavour to be the epicentre in the financial galaxy of promoting good CSR practises (Dusuki & Dar, 2007).

While Islamic banking industry has progressed to become an increasingly considerable segment within the global financial market, it has been renowned as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim region and offers an extensive range of financial products and services (Dusuki, 2008). The basic differences between Islamic banking and conventional banking, is not only in the ways they perform their businesses, but also in terms of all the values which guide Islamic banking whole operations and outlook (Dusuki, 2008).

These values which prevail within the scope of Sharīʻah (Islamic law) are expressed not only in the details of its transactions, but also in the width of its role in society. This requires the internalisation of principles of Islamic financial transactions, in its form, spirit and substance. By doing so, it symbolizes the objectives of Sharīʻah in promoting both economic and social welfare. In other words, as a Sharīʻah-based firm, Islamic banks need to fulfil social obligations that go beyond the conventional capitalist worldview aimed at only maximising profits (Dusuki, 2008). Clearly, Islamic banks operations are based on Sharīʻah and must depart further from conventional banks that are intensely profit motivated. Thus, the concept of brotherhood, social obligations, justice and fairness would be the goals of Islamic banks (Masruki, Ibrahim, & Azizan, 2010).

Nevertheless, there are reasons to believe that the demand for Islamic banks to consider social objectives may indeed prove to be an illusion. This is because a mass of literature in Islamic banking only focuses on commercial and economic aspects of Islamic banking while social issues with respect to its practices normally occupies a back seat in the discussion (Dusuki, 2008). This is particularly true when some literature even go further to assert that Islamic banks are no different from other commercial banks except in complying with Sharīʻah legal prescriptions pertaining to product offering (El-Gamal, El-Komi, Karlan, & Osman, 2014; Ismail, 2002). This view posits that Islamic banks are a typical commercial entity which has a sole responsibility of carrying out business in a manner consistent with Islamic law while social welfare objectives are to be fulfilled by other bodies such as the government (Marvyn K. Lewis & Algoud, 2001).

Supposedly, Islamic banks should play an active role in executing their social responsibilities because of their status as financial institutions fulfilling a collective religious obligation and their exemplary position as financial intermediaries (Farook, 2007) and simultaneously are considered as acknowledged legal entities in Islam which consequently, are accountable for CSR (Wan Jusoh, Ibrahim, & Mohd. Napiah, 2015). Moreover, the CSR practices in Islamic banks should not only be based on collective religious obligation (*farḍ kifāyah*) and obtain a positive corporate image, but can be considered as a method to alleviate poverty and achieve the true economic goals of Islam (Yusuf & Bahari, 2011). Usmani (2002) asserts that the philosophy behind Islamic banking was "aimed at establishing distributive justice free from all sorts of exploitation". Moreover, the notion of social responsibility and justice has been part and parcel of Islamic society for more than 14 centuries and according to Islamic principles, business transactions can never be separated from the moral objectives of the society.

Dusuki (2005) stresses that Islamic banks should adopt CSR policies in their operations and decision-making in order to reap comparative advantage in competing with conventional banks, especially in dual-systems co-existing together like the case of Malaysia. He further explicates that by effectively and efficiently being involved in CSR activities, Islamic banks may inevitably generate valuable resources in terms of reputation, long term standing, and loyalty from various stakeholders (Dusuki, 2005). In addition, Islamic banks are expected to show a higher level of social responsibility than their conventional counterparts do since they are ultimately based on Sharīʻah. Therefore, the need for Islamic banks to be seriously engaged with CSR activities is crucial by carefully strategizing CSR initiatives and incorporating them into their corporate strategy, planning and marketing (Dusuki, 2005). However, none of previous studies really discusses any arising issues on CSR applications of Islamic banks especially in Malaysia thus far. Hence, disclosing arising issues on CSR applications is significant to ensure effective and efficient CSR implementation by Islamic banks.

3. Research Methodology

Research methodology is a crucial aspect of any research work and is vital for the success of research. The choice of an inappropriate method will have serious implications for a research project, regardless how good the objectives of the study might be. The research design of this study will cover a few matters namely, selection of research instruments, design of research instrument, selection of Islamic banks, research participants, data collection and data analysis techniques.

3.1. Selection of Research Instrument

Interview method is a useful data collection method to obtain information on the issues of interest to the researcher when qualitative data is required (Sekaran, 1992). Since the research objective is to disclose arising issues regarding CSR applications of Islamic banks in Malaysia, this study employed the semi-structured face-to-face interview, which contained both qualitative and quantitative data. Face-to-face interview gives advantages to the researchers in getting higher response rate and data that are more accurate. Furthermore, the interviewer can note specific reactions by participants during interview and people will usually respond with good gesture and provide accurate responses when approached in person (Awang, 2010).

On the other hand, semi-structured interview[1] technique is chosen for this research because it allows the researcher enough flexibility to re-word the question to fit into the interview (Denscombe, 2010). Other advantages of doing semi-

[1] "Semi-structured interview" which is also known as semi-standardized interview refers to one that contains structured and unstructured sections with standardized and open-ended questions (see Walliman, 2006).

structured interviews are that questions may be reordered during the interview and the interviewer may add or delete probes to interview between subsequent subjects (Berg, 2007). These enable the interviewer to capture unexpected issues and information (Barbour & Schostak, 2005). This technique suits the nature of this study, which is exploratory in nature and is a prelude to a larger and more comprehensive investigation. An interview script containing a list of questions was prepared prior to the interview process, with four major sections: participant's background, CSR concept, main CSR applications and common CSR applications.

Since CSR applications in this study cover almost all spectrums of Islamic banks activities and initiatives, data collected from interviews alone sometimes is not really enough to represent the comprehensive CSR applications of an Islamic bank. Hence, data collected from observations and document review are also employed to support the data given by the research participants whenever necessary. Furthermore, the data from both observation and document review can be used for qualitative research (Flick, 2006).

This data triangulation method was employed in order to enhance the rigorousness and robustness of the study. "Triangulation" which is also known as "multiple methods" means gathering and analysing data from more than one source to gain a fuller perspective on the investigated situation. Triangulation is one of the most popular validation strategies and able to enhance the rigorousness of findings as it converge upon a particular finding by using different sorts of data and data-gathering strategies. Each set of data or each strategic finding on its own might not be strong enough to support the finding. However, when these different "strands" are taken together, there is stronger evidence for the finding (see Creswell, 2007; Daymon & Holloway, 2002; Flick, 2006; Lacey & Luff, 2001; Richards, 2005; Shank, 2006; Silverman, 2005).

3.2. Selection of Islamic Banks

All 16 Islamic banks in Malaysia has been selected in this study based on "corporate culture" justification as it is found from previous studies that corporate culture does affect CSR activities of an organization significantly (see Ali, Frynas, & Mahmood, 2017; James, 2011; Katamba, 2010; Übius & Alas, 2009). They are Bank Islam Malaysia Berhad (BIMB) (2014), Bank Muamalat Malaysia Berhad (BMMB) (2014), CIMB Islamic Bank Berhad (CIMB Islamic) (2014), Maybank Islamic Berhad (Maybank Islamic) (2014), RHB Islamic Bank Berhad (RHB Islamic) (2014), Public Islamic Bank Berhad (Public Islamic) (2014), Hong Leong Islamic Bank Berhad (Hong Leong Islamic) (2014), Alliance Islamic Bank Berhad

(Alliance Islamic) (2014), AmIslamic Bank Berhad (AmIslamic) (2014), Affin Islamic Bank Berhad (Affin Islamic) (2014), Al-Rajhi Banking and Investment Corporation (Malaysia) Berhad (Al Rajhi) (2014), Kuwait Finance House (Malaysia) Berhad (KFH) (2014), Asian Finance Bank Berhad (Asian Finance) (2014), HSBC Amanah Malaysia Berhad (HSBC Amanah) (2014), OCBC Al-Amin Bank Berhad (OCBC Al-Amin) (2014), and Standard Chartered Saadiq Berhad (Standard Chartered Saadiq) (2014). Fundamentally, the 16 Islamic banks existed in Malaysia can be divided into four types. There are standalone local Islamic banks,[2] local Islamic subsidiaries,[3] standalone foreign Islamic banks,[4] and foreign Islamic subsidiaries.[5] Indisputably, each of them has its own corporate culture that is different from one and another that possibly affect their understanding and implementation of CSR differently. Based on that consideration, all 16 Islamic banks has been selected in this study.

Thus, the data in this study was collected from the whole population of Islamic banks without using the sampling technique. The method used in this study can be considered as "census" where all of the cases in a population have been surveyed (see Walliman, 2006). Although a census is a very costly and time-consuming project, it has been done in order to enhance the applicability of the findings. Moreover, all the 16 Islamic banks have fulfilled the most essential criteria of studied organizations i.e. relevant to the research problem and could be accessed by the researcher (Rubin & Rubin, 2012).

3.3. Research Participants

There were three groups of personnel selected as research participants in this study i.e. Chief Executive Officer (CEO)/Managing Director (MD), Head of Sharīʿah (HOS), and Head of Corporate Communications (HCC). Since CSR involves all kind of activities, programmes or initiatives of Islamic banks, the selection of CEO/MD as research participants is significant, as they normally know everything from top to bottom of their institutions. Whereas, the selection of HOS was done based on their essential role in ensuring all activities within their institutions is Sharīʿah-compliant. The selection of HCC on the other hand was made because there are the one who are directly involved in performing CSR activities or programmes of their organizations.

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[2] The standalone local Islamic banks are BIMB and BMMB.

[3] The local Islamic subsidiaries are CIMB Islamic, Maybank Islamic, RHB Islamic, Public Islamic, Hong Leong Islamic, Alliance Islamic, AmIslamic, and Affin Islamic.

[4] The standalone foreign Islamic banks are Al-Rajhi, KFH, and Asian Finance.

[5] The foreign Islamic subsidiaries are HSBC Amanah, OCBC Al-Amin, and Standard Chartered Saadiq.

The total number of research participants in this study is 34. The researcher interviewed 32 participants individually face-to-face. However, the remaining two participants were just able to give written feedback due to their time constraints. The research participants comprised of six CEOs/MDs, 14 HOS, six HCC, and 8 from other positions. All research participants were from the central region, i.e. Kuala Lumpur because all headquarters of Islamic banks are located in this region.

Overall, good responses were received from the interviews. Useful and valuable comments, suggestions, and recommendations were obtained. The interviews ranged from 30 to 90 minutes. The conversations during face-to-face interviews were recorded using an audio recorder except only one participant reluctant to be recorded because of personal reason. Table 1 provides a breakdown of research participants by position, institution, and working experience.

On the other hand, the observation work was carried out since 13th April 2012 when the pilot study started until the last day of interview on 10th September 2014. Among Islamic banks' CSR activities that have been observed for this research were community activity,[6] employee activity,[7] and environmental activity.[8] In terms of document review, other than annual reports and websites, any media used to disclose the Islamic banks CSR activities such as media release, internal and external bulletin were utilized to support the interview data. This is because, document review could be used as a complementary technique as a means of triangulating the data collection technique (Mohd Tobi, 2012) which in this case is the interview technique.

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[6] Among the activities were religious Talk by Imam Muda Hassan titled "Dunia di Tanganku, Syurgadi Hatiku" to Universiti Teknologi MARA (Terengganu) staff on 5 September 2013, and "Islamic Property – Islamic Financial Management Workshop" to Universiti Teknologi MARA (Terengganu) staff and students on 21 August 2014. All those CSR activities were done by Bank Islam Malaysia Berhad.

[7] Among the activities were *Zuhr* congregational prayer with Muslim staff performed by Bank Muamalat Malaysia Berhad, Menara Bumiputra, Kuala Lumpur on 3 July 2014 and religious talk to Muslim staff during *Ramaìén* which was performed by Kuwait Finance House, Menara Prestige, Kuala Lumpur on 10 July 2014.

[8] Among the activities or initiatives were beach cleaning at Pantai Teluk Gadung, Dungun, Terengganu on 13 April 2012 which was initiated by Bank Islam Malaysia Berhad, saving electricity notice initiated by CIMB, Menara Bumiputra-Commerce, Kuala Lumpur observed on 20 June 2014, "Go Green Program – Toner Recycle Bin" which is a joined programme between RHB and HP observed on 10 September 2014.

Table-1
List of Research Participants

Research Participant (RP) No.	Group	Islamic Bank (IB)	Years in Banking Sector	Years in Current Position
RP1	Chief Executive Officer/Managing Director	IB5	15 years and above	6-10 years
RP2		IB7	5 - less than 10 years	1-5 years
RP3		IB8	15 years and above	6-10 years
RP4		IB9	15 years and above	1-5 years
RP5		IB16	15 years and above	1-5 years
RP6		IB15	15 years and above	1-5 years
RP7	Head of Sharīʻah	IB1	5 - less than 10 years	1-5 years
RP8		IB2	10 - less than 15 years	Less than 1 year
RP9		IB3	5 - less than 10 years	1-5 years
RP10		IB4	10 - less than 15 years	6 -10 years
RP11		IB6	10 - less than 15 years	1-5 years
RP12		IB8	15 years and above	6 - 10 years
RP13		IB9	5 - less than 10 years	1 - 5 years
RP14		IB10	5 - less than 10 years	Less than 1 year
RP15		IB11	15 years and above	1-5 years
RP16		IB12	5 - less than 10 years	1-5 years
RP17		IB13	15 years and above	1 - 5 years
RP18		IB14	15 years and above	1 - 5 years
RP19		IB15	15 years and above	More than 10 years
RP20		IB16	5 - less than 10 years	1 - 5 years
RP21	Head of Corporate Communications	IB2	15 years and above	1 - 5 years
RP22		IB7	5 - less than 10 years	Less than 1 year
RP23		IB8	15 years and above	1 - 5 years
RP24		IB11	10 - less than 15 years	1 -5 years
RP25		IB13	15 years and above	6 - 10 years
RP26		IB16	15 years and above	1 - 5 years
	Others			
RP27	Chief Operating Officer	IB2	15 years and above	6 - 10 years
RP28	Group CSR Manager	IB4	15 years and above	1 - 5 years
RP29	Sharīʻah Executive	IB5	5 - less than 10 years	1 - 5 years
RP30	Deputy Manager, Corporate Responsibility	IB6	5 - less than 10 years	6 - 10 years
RP31	Head of Section, Wakaf Management & Secretariat	IB7	15 years and above	1 - 5 years
RP32	Group Head of Corporate Affairs	IB9	5 - less than 10 years	1 - 5 years
RP33	Senior Manager	IB14	15 years and above	1 - 5 years
RP34	Senior Manager, Corporate Communications (Group)	IB14	15 years and above	More than 10 years

4. Findings and Discussion

After conducting interview sessions with the research participants and analyzing the Islamic banks CSRD, it was found that there are various ways of disclosing their CSR programmes. BIMB, BMMB, Affin Islamic, and Hong Leong Islamic have their independent annual reports to disclose their CSR programmes. Whereas, Maybank Islamic, CIMB Islamic, Public Islamic, Alliance Islamic, AmIslamic, RHB Islamic, Al Rajhi, Asian Finance, KFH, HSBC Amanah, Standard Chartered Saadiq, and OCBC Al-Amin just have independent financial statement. Their CSR programmes are disclosed, either through their "Group Annual Reports" and/or "Sustainability Reports"[9] or official websites.

It is understandable that the primary reasons behind the consolidated reports are cost efficiency and avoiding redundancy, since everything is leveraged by the Group (RP3). Nevertheless, for many foreign Islamic banks and local Islamic subsidiaries that consolidate their annual reports with their group annual reports, their existence is almost invisible. Normally, the conventional entities are predominant in what has been highlighted in the consolidated reports and sometimes the CSR explanation is very general in nature. In fact, there is one Islamic bank that does not have any annual report, except financial statements. The CSR activities of that bank could only be retrieved via its "Media Centre" website link. These new discoveries in agreement with Farook's et al. (2011) finding which showed that the majority of Islamic banks disclose significantly less than expected, with apparent differences in the levels of disclosure. These scenarios directly or indirectly give an unhealthy impression to the stakeholders involved. Thus, it is recommended that all Islamic banks disclose their CSR programmes regularly especially their social activities in their annual reports.

It seems that without some form of regulatory intervention, reliance on voluntary disclosure alone is unlikely to result in either a high quality disclosure or sufficient levels of disclosure. The result of the current study is consistent with that of Mallin's et al. (2014) who found that Islamic banks pay less attention to the voluntary CSR disclosure. Therefore, it is suggested that all Islamic banks need to ensure that their existence is acknowledged and their contributions are counted by disclosing whatever CSR programmes involved or initiated in whatever medium they have especially in the annual report. This finding supports Nik Ahmad's et al. (2003) contention that making CSR disclosures mandatory would force companies to report on their CSR performance. They would also benefit stakeholders by making annual

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[9] There are six Islamic subsidiaries in which their Groups have dedicated "Corporate Sustainability Report" or "Corporate Responsibility Report" to disclose their CSR programmes. They are Maybank Islamic, CIMB Islamic, RHB Islamic, KFH, HSBC Amanah, and Standard Chartered Saadiq.

reports more consistent and comparable (Nik Ahmad et al., 2003), and would enable them to significantly assess the non-financial impacts of CSR activities (see Ackers & Eccles, 2015).

Furthermore, the principle of full disclosure is closely related to the concept of CSR in Islam (see Lewis, 2001). Full disclosure does not mean that Islamic banks need to disclose everything, which of course is impractical. It means disclosing any information deemed relevant and that should be rightfully given to the stakeholders to facilitate their economic and religious decision-making. The implication of this position is that Islamic banks should disclose all information necessary to advise the stakeholders about their operations, even if such information would work against the institution itself (see Muwazir, Muhamad, & Noordin, 2006). It is because, as representative organizations, Islamic financial institutions are responsible to disclose their compliance with the principles and laws of Islam to stakeholders (Farook, 2007).

Another important finding from the analysis is not all Islamic banks in Malaysia have their own CSR division or department. There are nine Islamic banks that have their own CSR division i.e. BIMB, BMMB, Maybank Islamic, CIMB Islamic, RHB Islamic, Al Rajhi Bank, KFH, OCBC Al-Amin, and Asian Finance. On the other hand, the CSR matters of the other seven banks are managed under their Group Corporate Affairs or Corporate Communications Department. The absence of independent CSR division in an Islamic bank implies the absence of autonomy for the bank to conduct its CSR programmes. Thus, it is suggested that all Islamic banks need to have their own CSR department. Other than giving them more freedom, the existence of independent the CSR department will also encourage Islamic banks to initiate their own CSR programme rather than follow whatever CSR programmes initiated by their Group. Simultaneously, this development will give more advantages to the Islamic banks themselves.

In terms of CSR funding, it was found from the interviews conducted that generally charitable activities are funded from two types of fund i.e. *zakāh* fund[10] and CSR fund.[11] However, not all Islamic banks have both funds. In fact, there are Islamic banks which have none. In the case of *zakāh* fund, not all Islamic banks pay *zakāh* (RP1; RP3; RP6; RP8; RP12; RP14; RP15; RP19; RP23; RP24; RP27; RP29) and not all Islamic banks that pay *zakāh* retain certain portions or get back certain

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[10] *Zakāh* fund normally is a fund consisted of certain portions of corporate *zakāh* that are retained by the bank for self *zakāh* distribution and/or certain portions that are given back by certain State Religious Council which is normally not more than 3/8 of the total *zakāh* amount.

[11] CSR fund is a special fund allocated by the bank or by the bank's Group for its CSR activities.

portions from State Religious Councils for their self-*zakāh* distribution (RP13; RP20; RP25). Similarly, in the case of CSR fund, not all Islamic banks allocate a special budget for their CSR programmes annually especially for certain local Islamic subsidiaries or foreign Islamic banks that need to apply for their CSR budget from their Groups annually or on an ad-hoc basis (RP1; RP21; RP27; RP14). Therefore, in order to ensure all Islamic banks are able to perform their charitable activities annually, CSR fund should be established in all Islamic banks.

5. Conclusion and Recommendation

This study attempts to disclose arising issues on CSR applications of Islamic banks in Malaysia through interviews, observations and document reviews. The findings of the study revealed that firstly, all Islamic banks in Malaysia are aware of the importance of CSR. However, the majority of them have not properly disclosed it in their annual reports. Secondly, the absence of independent CSR division in an Islamic bank implies the absence of autonomy for the bank to conduct its CSR programmes. Thirdly, all Islamic banks should establish CSR fund to ensure the continuity of their charitable activities. It seems that without some form of regulatory intervention, reliance on voluntary action alone is unlikely to result in efficient and effective CSR applications. Thus, a special CSR framework for Islamic banks in Malaysia would be a practical suggestion to resolve the issues by including them in that framework.

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Key Points from Conference Communique

The 11th International Conference of Islamic Economics and Finance (ICIEF) held in Kuala Lumpur, Malaysia from 11 to 13 October 2016

At the end of the conference, the participants issued **Kuala Lumpur Declaration** (Communique of the 11th IClEF), it emphasized:

- The need for development of a consistent theory of Islamic economics and finance to strengthen the practices of Islamic finance.
- The Conference agreed that another area of emphasis should be policy-oriented research in the fields of Islamic economics and finance.
- The Conference participants noted the need for further consolidation, coordination and streamlining efforts in teaching and research in Islamic economics and finance.
- The Conference also agreed that there must be a balance between growth strategies and equity considerations.
- A genuine risk sharing system that is rooted in Islamic economic philosophy must be developed to replace the existing risk transfer/risk shifting system that has caused much concern and destruction in many communities.
- The conference noted that the 12th ICIEF will be held in March/April 2018 in Makkah al-Mukarramah hosted by the Umm al-Qura University and co-organized with IRTI and IAIE.

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CUMULATIVE INDEX OF PAPERS

CUMULATIVE INDEX OF PAPERS PUBLISHED IN PREVIOUS ISSUES OF *ISLAMIC ECONOMIC STUDIES*

Vol. 1, No. 1, Rajab 1414H (December 1993)
Articles
Towards an Islamic Stock Market, 1-20.
Mohamed Ali Al-Qari
Financial Intermediation in the Framework of Shariah, 21-35.
Hussein Hamed Hassan
Islamic Banking in Sudan's Rural Sector, 37-55.
Mohamed Uthman Khaleefa
Discussion Papers
Potential Islamic Certificates for Resource Mobilization, 57-69.
Mohamed El-Hennawi
Agenda for a New Strategy of Equity Financing by the Islamic Development Bank, 71-88.
D. M. Qureshi

Vol. 1, No. 2, Muharram 1415H (June 1994)
Articles
Is Equity-Financed Budget Deficit Stable in an Interest Free Economy? 1-14.
M. Aynul Hasan and *Ahmed Naeem Siddiqui*
Contemporary Practices of Islamic Financing Techniques, 15-52.
Ausaf Ahmad
Discussion Papers
Financing & Investment in *Awqaf* Projects:A Non-technical Introduction, 55-62.
Mohammad Anas Zarqa
Limitation on the Use of *Zakah* Funds in Financing Socioeconomic Infrastructure, 63-78.
Shawki Ismail Shehata
Al-Muqaradah Bonds as the Basis of Profit-Sharing, 79-102.
Walid Khayrullah

Vol. 2, No. 1, Rajab 1415H (December 1994)
Articles
Islamic Banking: State of the Art, 1-33.
Ziauddin Ahmad
Comparative Economics of Some Islamic Financing Techniques, 35-68.
M. Fahim Khan
Discussion Papers
Progress of Islamic Banking: The Aspirations and the Realities, 71-80.
Sami Hasan Homoud
Concept of Time in Islamic Economics, 81-102.
Ridha Saadallah
Development of Islamic Financial Instruments, 103-115.
Rodney Wilson

Vol. 2, No. 2, Muharram 1416H (June 1995)
Articles
Growth of Public Expenditure and Bureaucracy in Kuwait, 1-14.
Fuad Abdullah Al-Omar
Fiscal Reform in Muslim Countries with Special Reference to Pakistan, 15-34.
Munawar 1qbal
Resource Mobilization for Government Expenditures through Islamic Modes of Contract: The Case of Iran, 35-58.
Iraj Toutounchian
Discussion Papers
An Overview of Public Borrowing in Early Islamic History, 61-78.
Muhammad Nejatullah Siddiqi
Public Sector Resource Mobilization in Islam, 79-107.
Mahmoud A. Gulaid

Vol. 3, No. 1, Rajab 1416H (December 1995)
Articles
Islamic Securities in Muslim Countries' Stock Markets and an Assessment of the Need for an Islamic Secondary Market, 1-37.
Abdul Rahman Yousri Ahmed
Demand for and Supply of Mark-up and PLS Funds in Islamic Banking: Some Alternative Explanations, 39-77.
Tariqullah Khan
Towards an Islamic Stock Exchange in a Transitional Stage, 79-112.
Ahmad Abdel Fattah El-Ashkar
Discussion Papers
The Interest Rate and the Islamic Banking, 115-122.
H. Shajari and *M Kamalzadeh*
The New Role of the Muslim Business University Students in the Development of Entrepreneurship and Small and Medium Industries in Malaysia, 123-134.
Saad Al-Harran

Vol. 3, No. 2, Muharram 1417H (June 1996)
Article
Rules for Beneficial Privatization: Practical Implications of Economic Analysis, 1-32.
William J. Baumol
Discussion Papers
Privatization in the Gulf Cooperation Council (GCC) Countries: The Need and the Process, 35-56.
Fuad Abdullah AI-Omar
Towards an Islamic Approach for Environmental Balance, 57-77.
Muhammad Ramzan Akhtar

Vol. 4, No. 1, Rajab 1417H (December 1996)
Articles
Monetary Management in an Islamic Economy, 1-34.
Muhammad Umer Chapra
Cost of Capital and Investment in a Non-interest Economy, 35-46.
Abbas Mirakhor
Discussion Paper
Competition and Other External Determinants of the Profitability of Islamic Banks, 49-64.
Sudin Haron

Vol. 4, No. 2, Muharram 1418H (May 1997)
Article
The Dimensions of an Islamic Economic Model, 1-24.
Syed Nawab Haider Naqvi
Discussion Papers
Indirect Instruments of Monetary Control in an Islamic Financial System, 27-65.
Nurun N. Choudhry and *Abbas Mirakhor*
Istisna' Financing of Infrastructure Projects, 67-74.
Muhammad Anas Zarqa
The Use of Assets *Ijara* Bonds for Bridging the Budget Gap, 75-92.
Monzer Kahf

Vol. 5, Nos.1 & 2, Rajab 1418H & Muharram 1419H (November 1997 & April 1998)
Article
The Survival of Islamic Banking: A Micro-evolutionary Perspective, 1-19.
Mahmoud A. EI-Gamal
Discussion Papers
Performance Auditing for Islamic Banks, 23-55.
Muhammad Akram Khan
Capital Adequacy Norms for Islamic Financial Institutions, 37-55.
Mohammed Obaidullah

Vol. 6, No. 1, Rajab 1419H (November 1998)
Articles
The Malaysian Economic Experience and Its Relevance for the OIC Member Countries, 1-42.
Mohamed Ariff
Awqaf in History and Its Implications for Modem Islamic Economies, 43-70.
Murat Cizakca
Discussion Paper
Financial Engineering with Islamic Options, 73-103.
Mohammed Obaidullah

Vol. 6, No. 2, Muharram 1420H (May 1999)
Article
Risk and Profitability Measures in Islamic Banks: The Case of Two Sudanese Banks, 1-24.
Abdel-Hamid M. Bashir
Discussion Paper
The Design of Instruments for Government Finance in an Islamic Economy, 27-43.
Nadeemul Haque and *Abbas Mirakhor*

Vol. 7, Nos. 1 & 2, Rajab 1420H & Muharram 1421H (Oct.'99 & Apr.'2000)
Article
Islamic Quasi Equity (Debt) Instruments and the Challenges of Balance Sheet Hedging: An Exploratory Analysis, 1-32.
Tariqullah Khan
Discussion Papers
Challenges and Opportunities for Islamic Banking and Finance in the West: The UK Experience, 35-59.
Rodney Wilson
Towards an Objective Measure of Gharar in Exchange, 61-102.
Sami Al-Suwailem

Vol. 8, No. 1, Rajab 1421H (October 2000)
Article
Elimination of Poverty: Challenges and Islamic Strategies, 1-16.
Ismail Siragedlin
Discussion Paper
Globalization of Financial Markets and Islamic Financial Institutions, 19-67.
M. Ali Khan

Vol. 8, No. 2, Muharram 1422H (April 2000)
Articles
Islamic and Conventional Banking in the Nineties: A Comparative Study, 1-27.
Munawar Iqbal
An Economic Explication of the Prohibition of *Gharar* in Classical Islamic Jurisprudence, 29-58.
Mahmoud A. El-Gamal
Discussion Paper
Interest and the Modern Economy, 61-74.
Arshad Zaman and *Asad Zaman*

Vol. 9, No. 1, Rajab 1422H
(September 2001)
Article
Islamic Economic Thought and the New Global Economy, 1-16.
M.Umer Chapra

Discussion Paper
Financial Globalization and Islamic Financial Institutions: The Topics Revisited, 19-38.
Masudul Alam Choudhury

Vol. 9, No. 2, Muharram 1423H
(March 2002)
Article
The 1997-98 Financial Crisis in Malaysia: Causes, Response and Results, 1-16.
Zubair Hasan

Discussion Paper
Financing Microenterprises: An Analytical Study of Islamic Microfinance Institutions, 27-64.
Habib Ahmed

Vol. 10, No. 1, Rajab 1423H
(September 2002)
Article
Financing Build, Operate and Transfer (BOT) Projects: The Case of Islamic Instruments, 1-36.
Tariqullah Khan

Discussion Paper
Islam and Development Revisited with Evidences from Malaysia, 39-74.
Ataul Huq Pramanik

Vol. 10, No. 2, Muharram 1424H
(March 2003)
Article
Credit Risk in Islamic Banking and Finance
Mohamed Ali Elgari, 1-25.

Discussion Papers
Zakah Accounting and Auditing: Principles and Experience in Pakistan, 29-43.
Muhammad Akram Khan

The 1997-98 Financial Crisis in Malaysia: Causes, Response and Results – A Rejoinder, 45-53.
Zubair Hasan

Vol. 11, No. 1, Rajab 1424H
(September 2003)
Articles
Dividend Signaling Hypothesis and Short-term Asset Concentration of Islamic Interest Free Banking, 1-30.
M. Kabir Hassan
Determinants of Profitability in Islamic Banks: Some Evidence from the Middle East, 31-57.
Abdel-Hameed M. Bashir

Vol. 11, No. 2, Muharram 1425H
(March 2004)
Articles
Remedy for Banking Crises: What Chicago and Islam have in common, 1-22.
Valeriano F .García,Vvicente Fretes Cibils and *Rodolfo Maino*
Stakeholders Model of Governance in Islamic Economic System, 41-63.
Zamir Iqbal and *Abbas Mirakhor*

Vol. 12, No. 1, Rajab 1425H (August 2004)
Articles
Efficiency in Islamic Banking: An Empirical Analysis of Eighteen Banks, 1-19.
Donsyah Yudistira

Ethical Investment: Empirical Evidence from FTSE Islamic Index, 21-40.
Khalid Hussein

Vol. 12, No. 2, and Vol. 13, No. 1, Muharram and Rajab 1426H (February & August 2005)
Articles
The Case for Universal Banking as a Component of Islamic Banking, 1-65.
Mabid Ali Al-Jarhi

Impact of Ethical Screening on Investment Performance: The Case of The Dow Jones Islamic Index, 69-97.
Abul Hassan, Antonios Antoniou, and *D Krishna Paudyal*

Vol. 13, No. 2, Muharram 1427H (February 2006)
Articles
Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art, 1-48.
Mohammad Nejatullah Siddiqi
The X-Efficiency in Islamic Banks, 49-77.
M. Kabir Hassan
Islamic Law, Adaptability and Financial Development, 79-101.
Habib Ahmed

Vol. 14, No. 1 & 2
(Aug. 2006 & Jan. 2007)
Articles
Financial Distress and Bank Failure: Lessons from Ihlas Finans Turkey, 1-52.
Salman Syed Ali
The Efficiency of Islamic Banking Industry: A Non-Parametric Analysis with Non-Discretionary Input Variable, 53-87.
Fadzlan Sufian

Vol. 15, No. 1, Rajab 1428H (July 2007)
Articles
Theory of the Firm: An Islamic Perspective, 1-30.
Toseef Azid, Mehmet Asutay and *Umar Burki*
On Corporate Social Responsibility of Islamic Financial Institutions, 31-46
Sayd Farook
Shariah Compliant Equity Investments: An Assessment of Current Screening Norms, 47-76
M. H. Khatkhatay and Shariq Nisar

Vol. 15, No. 2, Muharram 1429H (January, 2008)
Articles
Sukuk Market: Innovations and Challenges
Muhammad Al-Bashir Muhammad Al-Amine
Cost, Revenue and Profit Efficiency of Islamic Vs. Conventional Banks: International Evidence Using Data Envelopment Analysis
Mohammed Khaled I. Bader, Shamsher Mohamad, Mohamed Ariff and Taufiq Hassan

Vol. 16, No.1 & 2, Rajab, 1429H & Muharram 1430H (August 2008 & January 2009)
Articles
Ethics and Economics: An Islamic Perspective, 1-21
M. Umer Chapra
Madaris Education and Human Capital Development with Special Reference to Pakistan, 23-53
Mohammad Ayub
Islamic Finance – Undergraduate Education, 55-78
Sayyid Tahir
Islamic Finance Education at the Graduate Level: Current State and Challenges, 79-104
Zubair Hasan

Vol. 17, No. 2, Muharram 1431H (January 2010)
Articles
Faith-Based Ethical Investing: The Case of Dow Jones Islamic Index, 1-32.
M. Kabir Hassan and Eric Girard
Islamic Finance in Europe: The Regulatory Challenge, 33-54
Ahmed Belouafi and Abderrazak Belabes
Contemporary Islamic Financing Modes: Between Contract Technicalities and Shariah Objectives, 55-75
Abdulazeem Abozaid

Vol. 17, No.1 Rajab, 1430H (2009)
Articles
Shariah Position on Ensuring the Presence of Capital in Joint Equity Based Financing, 7-20
Muhammad Abdurrahman Sadique
The Impact of Demographic Variables on Libyan Retail Consumers' Attitudes Towards Islamic Methods of Finance, 21-34
Alsadek Hesain A. Gait
A Shariah Compliance Review on Investment Linked *takaful* in Malaysia, 35-50
Azman Mohd Noor

Vol. 18, No. 1 & 2, Rajab, 1431H & Muharram 1432H (June 2010 & January, 2011)
Articles
Solvency of *Takaful* Fund: A Case of Subordinated *Qard,* 1-16
Abdussalam Ismail Onagun
The Process of Shariah Assurance in the Product Offering: Some Important Notes for Indonesian and Malaysian Islamic Banking Practice, 17-43
Agus Triyanta and Rusni Hassan
The Effect of Market Power on Stability and Performance of Islamic and Conventional Banks, 45-81
Ali Mirzaei

Vol. 19, No.1, Rajab 1432H (June 2011)
Articles
Certain Legal and Administrative Measures for the Revival and Better Management of *Awqaf*, 1-32
Syed Khalid Rashid
Profit Sharing Investment Accounts--Measurement and Control of Displaced Commercial Risk (DCR) in Islamic Finance, 33-50
V Sundararajan
Risk Management Assessment Systems: An Application to Islamic Banks, 51-70
Habib Ahmed

Vol. 19, No.2, Muharram 1433H (December 2011)
Articles
Role of Finance in Achieving *Maqasid* Al-Shariah, 1-18
Abdul Rahman Yousri Ahmad
Comprehensive Human Development: Realities and Aspirations, 19-49
Siddig Abdulmageed Salih
Decision Making Tools for Resource Allocation based on *Maqasid* Al-Shariah, 51-68
Moussa Larbani & Mustafa Mohammed
Introducing an Islamic Human Development Index (I-HDI) to Measure Development in OIC Countries, 69-95
MB Hendrie Anto

Vol. 20, No.1, Rajab 1433H (June 2012)
Articles
Islamic Banking in the Middle-East and North-Africa (MENA) Region, 1-44
Salman Syed Ali
Measuring Operational Risk Exposures in Islamic Banking: A Proposed Measurement Approach, 45-86
Hylmun Izhar
Leverage Risk, Financial Crisis and Stock Returns: A Comparison among Islamic Conventional and Socially Responsible Stocks, 87-143
Vaishnavi Bhatt and Jahangir Sultan

Vol. 20, No.2, Muharram 1434H (December 2012)
Articles
Targeting and Socio-Economic Impact of Microfinance: A Case Study of Pakistan, 1-28
Nasim Shah Shirazi
Dual Banking and Financial Contagion, 29-54
Mahmoud Sami Nabi
The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries, 55-120
Mahmoud Mohieldin, Zamir Iqbal, Ahmed Rostom & Xiaochen Fu

Vol. 21, No.1, Rajab 1434H (June 2013)
Articles
Redefining Islamic Economics as a New Economic Paradigm, 1-34
Necati Aydin
Why is Growth of Islamic Microfinance Lower than its Conventional Counterparts in Indonesia?, 35-62
Dian Masyita & Habib Ahmed
State of Liquidity Management in Islamic Financial Institutions, 63-98
Salman Syed Ali

Vol. 21, No.2, Muharram 1435H (November 2013)
Articles
Fiscal and Monetary Policies in Islamic Economics: Contours of an Institutional Framework, 1-22
Sayyid Tahir
Are Islamic Banks Sufficiently Diversified? An Empirical Analysis of Eight Islamic Banks in Malaysia, 23-54
M Ali Chatti, Sandrine Kablan and Ouidad Yousfi
Trade and Human Development in OIC Countries: A Panel Data Analysis, 55-70
Zarinah Hamid and Ruzita Mohd Amin
Economic and Financial Crises in Fifteenth-Century Egypt: Lessons from the History, 71-94
Abdul Azim Islahi

Vol. 22, No.1, Rajab 1435H (May 2014)
Articles
Understanding Development in an Islamic Framework, 1-36
Hossein Askari, Zamir Iqbal, Noureddine Krichene & Abbas Mirakhor
Islamic Finance in the United Kingdom: Factors Behind its Development and Growth, 37-78
Ahmed Belouafi & Abdelkader Chachi
Integrating Zakat and Waqf into the Poverty Reduction Strategy of the IDB Member Countries, 79-108
Nasim Shah Shirazi
An Attempt to Develop Shariah Compliant Liquidity Management Instruments for the Financier of Last Resort: The Case of Qatar, 109-138
Monzer Kahf & Cherin R Hamadi
Efficiency Measure of Insurance v/s *Takaful* Firms Using DEA Approach: A Case of Pakistan, 139-158
Attiquzzafar Khan & Uzma Noreen
An Empirical Study of Islamic Equity as a Better Alternative during Crisis Using Multivariate GARCH DCC, 159-184
Syed Aun Rizvi & Shaista Arshad
Public Sector Funding and Debt Management: A Case for GDP-Linked *Sukuk*, 185-216
Abdou DIAW, Obiyathulla Ismath Bacha & Ahcene Lahsasna
Portfolio Determination of A Zero-Interest Financial System Entity, 217-232
Shafi A. Khaled & A. Wahhab Khandker

Vol. 22, No.2, Muharram 1436 (Nov 2014)
Articles
Maqāṣid al-Sharīʿah: Are We Measuring The Immeasurable? 1-32
Rafi Amir-Ud-Din
Non-Monetary Poverty Measurement in Malaysia: A *Maqāṣid* al-Sharīʿah Approach, 33-46
Mohamed Saladin Abdul Rasool & Ariffin Mohd Salleh
A Structural Model for Human Development, Does *Maqāṣid* al-Sharīʿah Matter! 47-64
Medhi Mili
Socio-Economic Philosophy of Conventional and Islamic Economics: Articulating Hayat-e-Tayyaba Index (HTI) on the Basis of *Maqāṣid* al-Sharīʿah, 65-98
Muhammad Mubashir Mukhtar, et al
Islamic Wealth Management and the Pursuit of Positive-Sum Solutions, 99-124
Mohammad Omar Farooq

Vol. 23, No.2, Muharram 1437 (Nov 2015)
Articles
"The Genesis of Islamic Economics" Revisited, 1-28
Abdul Azim Islahi
Instability of Interest Bearing Debt Finance and the Islamic Finance Alternative, 29-84
Mughees Shaukat & Datuk Othman Alhabshi
Risk Sharing and Shared Prosperity in Islamic Finance, 85-115
Nabil Maghrebi & Abbas Mirakhor

Vol. 23, No.1, Rajab 1436 (May 2015)
Articles
Tradable Inventory Certificates: A Proposed New Liquidity Instrument, 1-32
Monzer Kahf & Mahah Mujeeb Khan
Product Development and *Maqāṣid* in Islamic Finance: Towards a Balanced Methodology, 33-72
Muhammad Al-Bashir Al-Amine
Assessing Socio-Economic Development based on *Maqāṣid* al-Sharīʿah Principles: Normative Frameworks, Methods and Implementation in Indonesia, 73-100
Rahmatina Kasri & Habib Ahmed
Enhancing Intra-Trade in OIC Member Countries Through T-SDRs, 101-124
M S Nabi, Rami A Kafi, Imed Drine & Sami Al-Suwailem

Vol. 24, No.1, Sha'ban 1437 (June 2016)
Articles
An Evaluation of Islamic Monetary Policy Instruments Introduced in Some Selected OIC Member Countries, 1-47
Md. Abdul Awwal Sarker
Research Trends on *Zakāh* in Western Literature, 49-76
Ahmed Belouafi & Abderrazak Belabes
Critical Review of the Tools of *Ijtihād* Used in Islamic Finance, 77-94
Abdulazeem Abozaid
An Assessment of Journal Quality in the Discipline of Islamic Economics, 95-114
M Nahar Mohd Arshad

Vol. 24, No.2, Rabi' I 1438 (Dec 2016)
Articles
An Economic Theory of Islamic Finance Regulation, 1-44
Mabid Ali M. M. Al-Jarhi
The Relation between Return and Volatility in ETFs Traded in Borsa Istanbul: Is there any Difference between Islamic and Conventional ETFs?, 45-76
M. Kabir Hassan, Selim Kayhana & Tayfur Bayatb,
Sharīʻah and SRI Portfolio Performance in the UK: Effect of Oil Price Decline, 77-103
Nur Dhani Hendranastiti & Mehmet Asutay

TRANSLITERATION TABLE

Arabic Consonants

- Initial, unexpressed medial and final:

ء	’	د	d	ض	d	ك	k
ب	b	ذ	dh	ط	t	ل	l
ت	t	ر	r	ظ	z	م	m
ث	th	ز	z	ع	[	ن	n
ج	j	س	s	غ	gh	هـ	h
ح	h	ش	sh	ف	f	و	w
خ	kh	ص	s	ق	q	ي	y

- Vowels, diphthongs, etc.

Short	َ	a	ِ	i	ُ	u
Long	أ	a	ي	i	و	u
Diphthongs	ؤ	aw	ئ	ay		

Notes To Contributors

1. The papers submitted to *IES* should make some noticeable contribution to Islamic economics, either theoretical or applied, or discuss an economic issue from an Islamic perspective.
2. Submission of a paper will be held to imply that it contains original unpublished work and is not being submitted for publication elsewhere.
3. Since *IES* sends all papers for review, electronic copies should be submitted in MS word format in a form suitable for sending anonymously to the reviewers. Authors should give their official and e-mail addresses and telephone/fax numbers at which they can be contacted.
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5. All papers should have an introductory section in which the objectives and methodology of the article are explained and a final section, which summarizes the main points, discussed and the conclusions reached.
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7. Detailed derivations of the main mathematical results reported in the text should be submitted separately. These will not be published.
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9. Articles: Al-Qari, Mohamed Ali (1993), "Towards an Islamic Stock Market", *Islamic Economic Studies*, Vol. 1, No. 1; Books: Khan, A. R. (1993), *Financial Intermediation*, New York: Springer Publishers. Page references to works referred to in the text should take the following form: Al-Qari (1993:17). Citations within the text should follow Harvard APA style.
10. The verses of the Qur'ān quoted should carry *surah* number and *ayah* number as (3:20).
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