CORPORATE GOVERNANCE AND SOCIAL RESPONSIBILITY IN ISLAMIC FINANCIAL INSTITUTIONS

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ABSTRACT

While significant concerns have been invoked on the material aspects of Islamic finance such as financial growth and products sophistication, it is nevertheless observed that equal emphasizes have not been given on the corporate social objectives of Islamic Financial Institutions (IFIs) as part of its ethical framework. In view of scarcity literature on the subject and the essence of social justice in Islamic finance, this paper aims at expanding the normative objective function of IFIs by advocating corporate social responsibility (CSR) via strengthening the corporate governance framework. Ontologically and epistemologically, unlike the western concept of corporate governance which is based on the western business morality that derived from “secular humanist”, this paper suggests that corporate governance in IFIs is founded on the epistemological aspect of Tawhid, Shari’ah and ethics. In the absence of extensive discourse on corporate governance and its roles on CSR, this paper attempts to highlight the importance of corporate governance in stimulating the social function of IFIs within the Islamic ethical dimension paradigm.

Keywords: Corporate governance, CSR and IFIs.
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1.0 Introduction

Contrary to the ideal assumption that Islamic finance is about belief, Shari’ah and ethics, it is observed nevertheless that in actual practice, Islamic finance is more anxious on the legal and mechanistic aspect of Shari’ah compliant\(^1\). At this point, Balz, (2010: 250) views that Islamic finance is now experiencing a “formalist deadlock” where the industry is more concerned with formal adherence to Islamic law instead of promoting Islamic ethical values. This is affirmed by El Gamal, (2006) when he severely criticized the practice of Islamic finance particularly by highlighting the issue of Shari’ah arbitrage. Significant criticisms by numerous scholars about the current practice of Islamic finance have led to series of questions as to the distinctiveness of Islamic finance with its conventional counterparts. Chapra, (2010) and Siddiqi (2007) for instance view that the practice of Islamic finance seems unable to attain its authenticity and share many common similarities with conventional finance.

One of the most important aspects that deserves due attention in Islamic finance is corporate governance and social responsibility. The emergence of CSR in business organization for the past three decades triggers the need of IFIs to be more socially responsible. In view of the moral failure, corporate collapse and lack of ethical values in business organization, CSR outlines the ideal standard of behavior of the firm from social oriented value perspective\(^2\). CSR as its own discipline was developed extensively in the western academia but little is written on the subject from Islamic perspective. Although, CSR is commendable in Islam, its theoretical foundation is actually distinct from the western theory of CSR.

In order to shed light on the essence of corporate governance to promote CSR in IFIs, this paper provides a conceptual framework of corporate governance in IFIs and its functional roles to foster CSR. To achieve this objective, this paper proceeds as follows. The next section briefly discusses corporate governance structure and its functional roles in IFIs. Section three highlights several issues

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* A substantially extended and improved version of a paper presented at the Conference on Ethics in Financial Transactions, University of Melbourne, Melbourne, Australia, 17-18 September 2011.

\(^1\) By 2010, there are about 500 IFIs operating in 75 countries with the total asset of nearly USD1 trillion and within a decade Islamic finance industry is expected to capture half the savings of Muslims world (Asutay, 2010: 41-42).

\(^2\) Dusuki and Dar, (2005: 391-392) highlight four main factors that lead to the emergence and initiative of CSR namely Growing Market Pressure, Regulatory Pressure, Power of Communication and Competitive Advantage. These inherent factors also affect the IFIs to be more socially responsible and in fact as Islamic institutions, the social responsibility is considered as collective religious obligation.
pertaining to criticisms on the roles of IFIs on social justice and the lack of CSR initiatives. Section four deconstructs a corporate governance dimension on CSR in IFIs and to highlight its unique characteristics. Section five discusses the roles of corporate governance towards better CSR practices in IFIs by advocating the pro-active roles of stakeholders, sound monitoring mechanism and transparency via corporate social reporting. The last section then concludes the discussion.

2.0 CSR in IFIs

The trend of CSR is very appealing worldwide. It has been a common practice in the market particularly for listed companies to produce their annual CSR report. Companies with good CSR record enjoy high reputation and able to attract investors especially institutional investors who are very concerned with their ethical investment. In fact, the popularity of Social Responsible Investment (SRI) has boosted the CSR initiatives worldwide. SRI is a form of ethical screen to ensure that the SRI fund does not invest in firms that have poor records of CSR. In the UK, Financial Times Stock Exchange Index introduced the FTSE4 Good Index formulated based on the CSR criteria. This is followed by the US whereby the Dow Jones Stock Exchange introduced its own Sustainability Index. These initiatives obviously indicate positive development on the needs for social dimension in investment and business activities.

Basically, the term CSR has been broadly used to refer the firms’ social obligations on voluntary basis. This is in parallel with definition of CSR by the European Commission (EC) where it refers to “a concept whereby companies integrate social and environmental concern in their business operation and in their interaction with their stakeholder on voluntary basis”. Unlike the definition by the EC which is very narrow, the definition of CSR by the World Business Council for Sustainable Development (WBCSD) extends the framework by not limiting it to voluntary form of CSR. The WBCDS defines CSR as “the commitment of business to contribute to sustainable economic development, working with employee, their families and local community and society at large to improve their quality of life” (WBCSD, 2002: 6). This definition enhances the scope of CSR by including any kinds of initiatives for social purpose whether they are voluntary or obligatory

In the context of IFIs, the Association of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued specific standards on CSR known as Governance Standards No. 7: Corporate Social Responsibility, Conduct and Disclosure for IFIs. The AAOIFI refers CSR as “to all activities carried out by IFIs to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries as individual and institutions” (AAOIFI, 2010). Unlike the WBCDS and the EC, the AAOIFI’s definition further enhances the scope and foundation of CSR. The CSR is considered as not only
part of IFIs contribution to socio-economic development but regarded as religious obligations and ethical consideration inspired by the teaching of al-Quran and al-Sunnah.

3.0 Critiques over lack of Social Responsibility in IFIs: The ‘Ideal’ and ‘Realities’.

In line with the ideal aspiration of Islamic finance and Islamic economic, IFIs are expected to have two-fold objectives i.e. profit-oriented and social-oriented functions. Good corporate governance with strong ethical consideration will determine the state of initiatives on CSR. Special characteristic of IFIs to comply with Shari’ah rules ethical principles in all their activities requires for a specific kind of governance. As Islamic corporation, IFIs shall avoid any involvement with all kind of Shari’ah prohibitions such as riba (interest), gharar (uncertainty), speculation and maysir (gambling), to stay away from investing in any unlawful activities and to observe the principle of Islamic morality or Islamic ethical code.

In the context of corporate governance in Islam, IFIs are not only required to fulfill their economic functions but also to play significant roles in addressing the socio-economic issues as part of their corporate responsibilities. This foundational dimension is based on the holistic approach of corporate governance whereby its framework is beyond the relationship between the shareholders, BOD, management and stakeholders but to include as to how maintaining the relationship with the God. In this aspect, IFIs require additional framework of Shari’ah and ethical in character to safeguard and maintain not only the relationship with the God but to include correlation with the human being as well as the environment. As such, CSR can be the most appropriate platform and mechanism for IFIs to fulfill their social responsibilities as part of their religious obligation.

While acknowledging the solid and cogent theoretical foundation of CSR in Islam, the reality indicates otherwise where there is lacking of initiative by IFIs to implement CSR as part of their corporate social objectives. The aims of Islamic Economic and Islamic Finance can be summarized into two namely profit-driven and social-oriented objectives. Usmani, (2002: 113) vividly mentions that philosophy of Islamic finance is not only motivated by profit per se but more important to establish distributive justice based on the principle of Shari’ah without any exploitation. He further views that IFIs must fulfill their moral objectives and have social responsibilities. He raises his concerns on the trend of Islamic finance which seems to deviate from its original aspiration.

El Gamal, (2006) severely criticizes the existing practice of Islamic finance by claiming that IFIs have heavily used ruses in their products and services to
circumvent Islamic prohibitions. At this point, he raises the issue of Shari’ah arbitrage that increases the transactional cost which is unnecessary. While Saleem, (2006) posits that Islamic finance is ‘deception’ and ‘charade’, similar connotation by Kuran, (2004) who views that Islamic economic does not have a comprehensive framework for modern economy. Both of them condemn Islamic finance as being manipulative and incompatible with the modern times.

Another worth criticism refers to the system in which Islamic finance operates. It is contended that the current Islamic finance practices are seemed to operate within the classical or Keynesian economics which does not produce any significant implications to current socio-economic conditions. In this aspect, Siddiqi, (2004) points out his concern about the existing practice of Islamic finance in which too much focus and reliance on jurisprudence and little weight given to the scientific aspects of the discipline.

Numerous criticisms on the actual practice of Islamic finance by scholars and practitioners indicate certain irregularities. IFIs are seen to operate within the global financial system and inclined towards the same direction with any other financial institutions. Islamic financial products and services are designed based on profit-motive orientation and lack of socio-economic dimension. The issuance of sukuk (Islamic bond) and other sophisticated products that dominate the market are tailored for economic purpose and not to improve the socio-economic condition of the people at large. Majority of these debt-based financing products now have become the major source of financing for Islamic finance industry which have similar economic and social implications with the conventional financing.

At this juncture, on top of commercial objective, IFIs are also expected to fulfill their social responsibilities as part of their religious and moral obligation. As financial institution, IFIs should play active roles to improve socio-economic condition and these include alleviation of poverty, establishment of equity and justice, socially responsible investment, fostering socio-economic development, fulfillment of broad socio economic development, job creation and stimulation of entrepreneurship, investment in Real Economic Sectors. Asutay, (2008) maintains that the Islamic finance has failed to realize the very reason of its existence in providing socio-economic development for the larger parts of the Muslim world and communities. He further criticizes that IFIs do not serve and engage with communities but rather to serve markets (Asutay, 2010: 43). In fact, the CSR initiatives are rather limited and questionable.

Contrary to the allegation and criticisms on lack of social responsibilities, a study by Farook, (2009) on CSR trends in 29 IFIs from 19 countries however indicates significant improvement of IFIs on the CSR initiative. The report reveals that IFIs have taken numerous and significant social measures towards social
responsibility in various aspects such as charitable activities, social welfare and development, environment, concentration on screening, serving and responsible dealing with customers and employee welfare. Despite the positive trend of CSR in IFIs, there are still many rooms for improvement and enhancement as the public generally unaware or have lack of information on IFIs’ CSR initiative. In fact, the findings in Farook, (2009) can not be considered as conclusive and even do not represent the common CSR practice of Islamic finance industry in view of some significant limitations of the study.

4.0 Ethical Dimension of Corporate Governance on CSR

In Islam, the word ethic is synonym with the term *adab* and *khuluq* (Siddiqui, 1997: 423). These two terms denote good behavior or a standard of conduct to be observed in social interactions or the set of moral principles that distinguish right and wrong (Hasan, 2010). In the holy *al-Quran* the term *khuluq* can be found in Surah al-Qalam verse 4 as Allah says: “And surely you (Prophet Muhammad) have the best form of morals,” and in surah al-Shu’ara verse 137: “There is no other than khuluq of the ancient”. Apart from these, the Prophetic hadith had also made reference to ethics and morality where Aishah reported that that “the Khuluq (Morals) of the Prophet was based upon the Qur’an” and the Prophet says that “I have come to complete the code of moral conduct” (Muslim).

In deconstructing the Islamic ethical principles within the realm of economic, Naqvi, (1981: 45-57) advocates four important axioms that specifically reflect its relevancy in determining the rules of economic behavior in a society. The axioms of unity, equilibrium, free will and responsibility are the basis for deriving a set of ethical system and principles that would be appropriate to nurture and guide the economic behavior from Islamic point of view. These divine formulated axioms provide very useful guidelines in identifying and recognizing legitimate ethical principles in economic.

Another construct of ethics to legitimize the ideal Islamic economic behavior refers to the principle of *adl* (justice), *amanah* (trust) and *ihsan* (benevolence). Based on the ethical axioms of unity, equilibrium, free will and responsibility, Islamic ethics must at least have three important characteristics namely the

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3 The concept of unity refers to vertical dimension of Islam whereby man’s life on earth in its entirety relates eternally to God (Naqvi, 1981: 48). While unity depicts the vertical dimension, equilibrium denotes the horizontal dimension of Islam by which it is a binding moral commitment of every individual, institution, corporation or any kind of entities to uphold a delicate balance in all aspects of lives (Naqvi, 1981: 51). The axiom of free will then propagates the concept of natural freedom within certain limitation whereby it emphasizes on the element of balancing between the ‘individual freedom’ and ‘collective freedom’ (Naqvi, 1981: 52). Finally, the concept of ‘amanah’ or responsibility complements the Islamic ethical axioms in which the natural freedom that derived from the free will axiom must be exercised with full responsibility as a vicegerent and trustee of God (Naqvi, 1981: 54).
criterion of adl (justice), amanah (trust) and ihsan (benevolence) (Beekun and Badawi, 2005: 134-135). The first feature of ethics in Islam requires all individual to behave justly to all\(^4\). The managers for instance shall treat equally the employees without discrimination. The concept of amanah then further characterizes Islamic ethics by considering individual as a vicegerent of God and he is accountable to Him\(^5\) in which requires him to be responsible in whatever he does. Finally, the concept of Ihsan represents the core and most important element of Islamic ethics. Unlike justice which is mandatory, Ihsan denotes what is above and beyond mandatory\(^6\). In this regard, Ihsan requires extra caution, effort and good intention where the individual performs good deeds with the realization that Allah is watching him at all times\(^7\). The criterion of ihsan then expects all stakeholders in IFIs regardless of shareholders, managers, board of directors (BOD) and employees to observe the set of Islamic ethical principles which is divinely revealed and clearly stipulated in al Quran and al Sunnah.

4.1 Islamic Corporate Governance Dimension on Social Responsibility

The basis of CSR in modern business organization is founded on several western theoretical foundations and these include Classical View Theory, Social Contract Theory, Instrumental Theory, Legitimacy Theory and Stakeholder Theory\(^8\). This section offers another theoretical foundation of CSR namely Islamic Theory of CSR as formulated based on the underlying principles of al-Quran and al-Sunnah. Khan, (2007) asserts that there should be a distinctive Islamic corporate objective as opposed to the profit and utility maximization based conventional objectives where IFIs should also aim to maximize social welfare function. This can be materialized by involving in community banking, responsible and ethical finance and CSR initiatives (Asutay, 2007).

Unlike theory of CSR from a conventional perspective which is based on secular humanist approach, CSR in Islam is founded on the faith-based approach namely Tawhid, Shari’ah and ethics. In term of epistemology, almost all Islamic

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\(^4\) Allah says in al Quran “Allah commands justice, the doing of good and liberality to kith and kin, and HE forbids all shameful deeds and injustice and rebellion: He instructs you, that ye may receive admonition” (Al Quran, 16: 90).

\(^5\) In al Quran, (8: 27) Allah says “Ye that believe! Betray not that trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you”.

\(^6\) Adl refers to the person’s inner intentions and feelings that should be consistent with the declared words and actions, while Ihsan goes beyond that where it requires words, actions and intention of certain good deeds sincerely realizing he is accountable to Allah (Beekun and Badawi, 2005: 134).

\(^7\) In hadith narrated by Umar, the Prophet explained ihsan as the act of worshiping Allah as though you are seeing Him, and while you see Him not yet truly He sees you (Al Nawawi, 2001).

\(^8\) Garriga and Mele, (2004) classify the theory of CSR into four namely Instrumental Theories, Political Theories, Integrative Theories and Ethical Theories. This section nevertheless further classifies the theory of CSR into Classical View Theory, Social Contract Theory, Instrumental Theory, Legitimacy Theory, Stakeholder Theory, Institutional Theory and Islamic theory.
economists or Muslim jurists agree on the concept of *Tawhid* as one of the philosophical pillars of Islamic economic. Choudhury and Hoque’s model of corporate governance puts the fundamental Islamic epistemology of reference of *Tawhid* as one of its philosophical foundation (Choudury and Hoque, 2004). The *Tawhid* epistemology can only be perfected with *Shari’ah* implementation. In this regard, Islam has laid down numerous principles that relevant for corporate governance such as *maslahah* and *maqasid Shari’ah*. These both principles are considered as the most efficient tools to resolve issues involved in corporate governance such as agency problems and conflict of interest. Finally, the third pillar of corporate governance in Islam namely ethics complements the former two components of *Tawhid* and *Shari’ah*.

The integrated elements of *Tawhid*, *Shari’ah* and ethics have three important characteristics namely the criterion of *adl* (justice), *amanah* (trust) and *ihsan* (benevolence). *Adl* requires all individual to behave justly to all. The managers for instance shall treat equally the employees without discrimination and BOD shall take into consideration a social dimension in the decision making process. The concept of *amanah* then further characterizes Islamic corporate governance by considering individual as a vicegerent of God and he is accountable to Him in which requires him to be responsible in whatever he does. Finally, the concept of *Ihsan* represents the core and most important element of Islamic corporate governance. Unlike justice which is mandatory, *Ihsan* denotes what is above and beyond mandatory (Al Qurtubi, 1966). In this regard, *Ihsan* requires extra caution, effort and good intention where the individual performs good deeds with the realization that Allah is watching him at all times. All of these criterions then expect all stakeholders in IFIs regardless of shareholders, managers, BOD and employees to take into consideration not only the material

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9 Literally *maslahah* means benefit or interest and it is always harmonious with the objectives of the *Shari’ah* i.e. protecting the five essential values of the religion, life, intellect, lineage and property (Al-Ghazali). Al-Shatibi views that *maslahah* concerns with the subsistence of human life, the completion of man’s livelihood and the acquisition of what his emotional and intellectual qualities require of him in absolute sense. As cited in Kamali, (1989).

10 Kamali, (1989) views that the *maqasid Shari’ah* is to educate the individual, to establish justice and to realize *maslahah* to the people.

11 Allah says in al Quran “Allah commands justice, the doing of good and liberality to kith and kin, and HE forbids all shameful deeds and injustice and rebellion: He instructs you, that ye may receive admonition” (Al Quran, 16: 90).

12 In *al Quran*, (8: 27) Allah says “Ye that believe! Betray not that trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you”.

13 *Adl* refers to the person’s inner intentions and feelings that should be consistent with the declared words and actions, while *Ihsan* goes beyond that where it requires words, actions and intention of certain good deeds sincerely realizing he is accountable to Allah (Al-Qurtubi (1966, 10: 165, as cited in Beekun and Badawi, 2005: 134).

14 In *hadith* narrated by Umar, the Prophet explained *ihsan* as the act of worshipping Allah as though you are seeing Him, and while you see Him not yet truly He sees you (Al Nawawi, 2001).
and profit dimension but the socio-economic aspect as well as the environmental issues which are in parallel with the CSR as its own discipline.

For purpose of comparison, table 1 summarizes the distinct characteristics and theoretical frameworks of CSR. This table vividly illustrates the diversities of secular and Islamic Approach of CSR by highlighting their distinct features and different theoretical foundation.

**Table 1: Theory of CSR**

<table>
<thead>
<tr>
<th>Theory</th>
<th>Characteristics</th>
<th>Literatures</th>
<th>Theoretical Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classical view</td>
<td>Social responsibility of business is to increase its profit</td>
<td>Friedman, (1996)</td>
<td>Secular approach;</td>
</tr>
<tr>
<td>Legitimacy</td>
<td>CSR is a response to the environmental pressures involving social, political and economic forces</td>
<td>Deegan, (2000), Suchman, (1995), Tomer, (1994).</td>
<td>Ethical values based on social construct.</td>
</tr>
<tr>
<td>Islamic</td>
<td>CSR is part of the collective religious obligation inspired by the <em>taqwa</em> dimension (God consciousness)</td>
<td>Iqbal and Mirakhor, (2004), Dusuki, (2008), Farook, (2007, 2009) and Aribi, (2009).</td>
<td>Belief, moral and religious obligation. Holistic approach namely belief, moral or ethical and Shari'ah</td>
</tr>
</tbody>
</table>


Table 1 demonstrates the diverse characteristics of theory of CSR from western and Islamic perspectives. The western theories of CSR are founded on the secular approach whereby it emphasizes solely on the physical reality and human rationale. The central motivation of CSR hence is materialistic rather than ethical. On the other hand, Islamic theory considers CSR as part of the collective
religious obligations inspired by the Taqwa dimension derived from the principle of Tawhid. Taqwa dimension is an important factor in motivating the individual to voluntarily contribute in socially responsible activities\textsuperscript{15}. At this point, the theoretical foundation of CSR in Islam is based on the holistic approach by combining moral, ethical, Shari’ah and belief. Implementing CSR is one of the ways to achieve Taqwa and fulfilling duty as vicegerent of Allah to achieve “al faalah” or success in the world and the hereafter.

In conclusion thereof, there are similarities as well as fundamental differences of CSR from western and Islamic perspectives. The theoretical foundation of CSR in Islam is inspired by the Taqwa dimension that derived from the epistemology of Tawhid. This holistic approach requires IFIs to perform their social responsibilities as part of collective religious obligations towards all of stakeholders. With this solid foundation, CSR should be one of the main priorities of IFIs and should be embedded as corporate culture so as to epitomize the duty of fulfilling maqasid Shari’ah.

4.2 CSR Framework in IFIs

Despite positive development of CSR and widespread of academic interest, its theoretical framework is still elusive. Dusuki and Dar, (2007: 253) highlight the scope of CSR framework into four main areas of CSR namely from the environmental dimension, the human resource dimension, the philanthropic dimension and the human rights dimension. These four dimensional perspectives provide foundational basis to formulate CSR framework in IFIs. Another conceptual dimension on CSR categorizes social accountabilities into four layers of responsibilities namely economic, ethical, legal and discretionary. Figure 1 demonstrates these layers of responsibilities in the form of pyramid indicating the most and the least level of accountabilities.

\textsuperscript{15} Taqwa means harmonizing and integrating material well being and moral-spiritual values that determine their fate in the world and hereafter (Hasan, 2002, as cited in Dusuki, 2008). Taqwa denotes other important Islamic principles of human dignity, free will, equality and rights and trust and responsibility.
The economic framework views CSR as a mechanism to provide returns and to maximize the shareholders wealth. The legal dimension places CSR as a regulatory requirement within the ambit of economic objectives. The ethical category on the other hand considers CSR as a vehicle to materialize the moral aspects of business. The discretionary or philanthropy dimension puts CSR as a pragmatic tool to contribute to the society through social activities and community investment.

Social responsibilities of typical financial institutions include exercising care in the use of funds, providing security guarantees to depositors, deposited, showing concerns for social needs and environment, allowing access to finance, know the customer, fighting money laundering and protecting financial privacy (Zeegers, 2001, 153-157 and Decker, 2004: 715). With the different nature of business and unique features, CSR framework in IFIs extends beyond those aspects where it consists of mandatory and recommended forms of social responsibilities as illustrated in table 2. The mandatory form of CSR is considered as religious obligatory while the recommended form of CSR as commendable and voluntary.
Table 2: CSR Frameworks

<table>
<thead>
<tr>
<th>Mandatory Forms</th>
<th>Recommended Forms</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Screening Clients for <em>Shari’ah</em> compliance</td>
<td>• Qardh al Hasan (Benevolent Loan)</td>
</tr>
<tr>
<td>• Responsible Dealing with Clients</td>
<td>• Reduction of Adverse Impact on Environment</td>
</tr>
<tr>
<td>• Earning and Expenditure Prohibited by <em>Shari’ah</em></td>
<td>• Social, development and environment based Investment Quotas</td>
</tr>
<tr>
<td>• Employee Welfare</td>
<td>• Customer Service</td>
</tr>
<tr>
<td>• <em>Zakah</em> (Obligatory Tax)</td>
<td>• Micro, Small Business and Social Savings and Investments</td>
</tr>
<tr>
<td></td>
<td>• Charitable Activities</td>
</tr>
<tr>
<td></td>
<td>• <em>Waqf</em> (Endowment) Management</td>
</tr>
</tbody>
</table>


As Islamic institutions, IFIs are obligated to operate their business and operations based on the *Shari’ah* principles and these include screening clients for *Shari’ah* compliance, responsible dealing with clients, to ensure that income, earning, and expenditure free from prohibited elements, employees’ welfare and payment of *zakah*. These are mandatory forms of CSR for IFIs as stipulated in *al Quran* and *al sunnah* which can not be compromised at all. Basically, the recommended forms of CSR are not compulsory for IFIs and the list is not exhaustive and its framework can be in many forms as long as they comply with *Shari’ah* principles and Islamic ethical values. Islam nevertheless strongly encourages and commends any efforts for socio-economic justice. In this aspect, IFIs are recommended to provide benevolent loan for the needy, to invest in adverse impact on environment project, to give priority for social, development and environment based investment, to have standard customer service, to participate in microfinance and SME investment, to increase charitable activities and *waqf* contribution.

5.0 Roles of Corporate Governance in IFIs towards Better CSR

Basically, there are various social and economic factors involved in the formation of corporate awareness on the importance of CSR. Besides economic development status, cultural values, legal system and religious practice, corporate governance is also one of the determinant factors that contribute to better management of CSR (Farook and Lanis, 2005: 336). Stronger corporate governance through sound and proper governance framework will surely result greater accountability and transparency. The accountability then nurtures corporate awareness and responsibilities upon a large number of stakeholders. With these sense of responsibilities finally will stimulate the corporate desire to
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contribute to the society in order to improve socio-economic condition of the community on top of IFIs duty to protect the rights and interest of shareholders.

From theoretical perspective regardless the agency theory or the stakeholders theory or even the stewardship theory, corporate governance is expected to function as a mechanism to reduce cost of business, to resolve agency issues and to mitigate any potential conflict of interest in the firm. In addition to that corporate governance is also considered essential as a key factor in shaping the IFIs direction towards active engagement on CSR. In fact, CSR may play its function to boost financial performance and to improve corporate image in the community. At this point, the empirical evidence reveals that CSR has positive relationship with corporate performance. For instance, an extensive study conducted by Pava and Krausz, (1996) on 21 empirical studies from 1972-1992 further affirmed positive association between CSR performance and corporate financial performance. At this point, issues on financial return shall not be the reason or excuse for IFIs to be actively involved in CSR initiatives. This study vividly proves that CSR has not only improved the financial performance but also portrayed good corporate image.

With an understanding that CSR has positive association with corporate financial performance, this paper suggests that corporate governance plays very imperative roles to foster and to stimulate CSR initiatives in IFIs. The extent of corporate governance practice in IFIs reflects the commitment of the companies to protect the interest and rights of all stakeholders by taking social and economic aspects into consideration. From the viewpoint of corporate governance, the state of CSR practices in IFIs is strongly influenced by the way they are directed, controlled, monitored and supervised. At this juncture, this paper makes five prepositions that pro-active roles of stakeholders, organizational structure, ownership structure, monitoring mechanism and corporate social reporting are the most important factors to determine and influence the level of CSR practices in IFIs.

5.1 Pro-Active Roles of Stakeholders

Generally, from typical corporate structure’s perspective, there are four types of stakeholders namely business stakeholder, social stakeholders and financial stakeholders (Aerts, et al, 2004). Another classification refers stakeholders into internal and external. This paper reconciles these two classifications by categorizing internal stakeholders as business stakeholders and financial stakeholders and external stakeholders such as mainstream media, regulatory

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16 Haniffa and Cooke, (2005) view that CSR reporting is significantly associated with multiple directorships and foreign ownership factors.
authorities and non-governmental organizations (NGOs) as external stakeholders. Since external stakeholders do not have direct commercial interest in the company as in the case of internal stakeholders, they will normally be more inclined towards CSR initiatives.

The stakeholders’ theory of corporate governance enhances the scope of stakeholders as described above. In this regard, Freeman (1984: 46) defines stakeholders as ‘any group or individual who can affect or is affected by the achievement of the organization’s objectives’. Although, this definition expands the definition of stakeholders to include internal and external stakeholders, key participants of corporate governance in IFIs mainly refer to internal stakeholders such as employees, managers, BOD, Shari’ah board and shareholders. The external stakeholders namely customer, consumer, regulators and investors act as a pressure group to encourage CSR. External pressure from NGOs, consumers, suppliers and media is important to affect the CSR initiatives from outside. As organizations independent from government and have no direct interest with IFIs, NGOs through campaigns and direct or indirect influence to community as well as investment communities may provide significant impact on corporate social activities.

Basically, CSR is considered as voluntary in which regulatory authorities do not interfere or pass any specific legislation to make CSR mandatory. Nevertheless, regulators may play their role in stimulating the CSR initiative and provide regulatory frameworks for its implementation and practice. Although CSR is a voluntary practice, the recent development shows that regulation is necessary to boost its practices especially pertaining to workers rights and environmental issues. Indeed, McBarnet, (2009: 27) views that sound regulatory framework can provide systematic and significant impact on CSR practices. In certain jurisdiction, regulatory authorities promote CSR through indirect regulation such as tort law to extend the legal enforceability of CSR issues and contract law to give the CSR standards, the weight of obligation (McBarnet, 2009: 31). For instance, in the UK, the government uses the disclosure tool to foster CSR practices whereby companies are required to disclose their initiative in relation with investment decisions and social, environmental and ethical considerations.

In line with the nature of corporate governance framework which is involving the internal organ of governance such as managers, and employees, Kolk and Pinse, (2010: 18) view that CSR is likely to be integrated in the firms’ CSR policies pertaining to internal aspects such as employee conditions and ethical behaviour of managers and employees. They further opine that corporate governance would put much less emphasis on the external framework of CSR such as environmental and community issues (Kolk and Pinse, 2010: 19). The external framework of CSR is normally influenced not from the internal stakeholders but
coming from outside stakeholders such as investors that concern with the socio-economic and environmental issues. These external stakeholders could potentially boost the CSR initiatives as the companies would try to attract these kinds of investors.

In the case of IFIs, the internal stakeholders refer to the same organ of governance in typical companies’ structure and these include employees, managers, BOD and shareholders. Additional stakeholder which is prevalent and unique in the IFIs corporate structure refers to the institution of Shari’ah board. In the meantime, external stakeholders may play the same roles as in other kinds of corporation to act as a pressure group and to provide appropriate framework for the CSR practices.

Since CSR is relatively new area to IFIs, it is hard to find a comprehensive study on the extent of CSR practices. Some studies although not comprehensive, provide certain interesting findings on the stakeholders’ perception upon CSR. A study conducted by Dusuki and Dar, (2007: 261) on 1500 respondents consist of seven different stakeholders namely customers, depositors, local communities, employees, branch managers, regulators and Shari’ah advisors revealed that stakeholders of IFIs have positive views on CSR and in fact they considered it as one of the most important criteria in their banking selection decisions. In addition, senior manager’s personal values and management policy and initiatives are also amongst the important factors to determine the extent of CSR practices in IFIs.

Any effort and endeavor on CSR initiatives adheres most to its key players within the corporate governance structure of the organization. This raises an issue as to the need for integrated approach for such purpose. At this point, several key participants of corporate governance either external such as regulatory and supervisory authorities or internal as in the case of BOD, shareholders, managers, employees and Shari’ah board are considered very important. Their responsibilities to promote, to implement, to practice and to enforce CSR are summarized in table 3.
Table 3: Key Participants of CSR

<table>
<thead>
<tr>
<th>Stakeholders</th>
<th>Functional Roles</th>
</tr>
</thead>
</table>
| Regulatory Authority    | To set regulatory framework for sound and proper code of ethics  
                          - Code of ethics on corporate governance for general usage                                         |
| Supervisory Authority   | To supervise, monitor and enforce the implementation of code of ethics  
                          - Enforcement of the code of ethics                                                      |
| Shareholders            | To ensure that all investments and business activities are Shari’ah and ethically permissible  
                          - Incentive for ethical achievement                                                       |
| Shari’ah Board          | To ensure Shari’ah and ethical compliance  
                          - Assist the BOD to come out with Code of Ethics  
                          - Emphasize on ethics in the process of issuing Shari’ah rulings                        |
| BOD                     | To set the IFIs direction and policies on ethics  
                          - Code of Ethics for internal usage  
                          - Ethics as a basis of decision making                                                  |
| Management              | To implement set of ethical policies set by the BOD  
                          - Organizing ethics training  
                          - Module for ethics programme  
                          - Enforcement of ethics                                                               |
| Employees               | To practice and comply with the code of ethics  
                          - Ethics as a culture                                                                   |
| Community               | Pressure Group to encourage CSR  
                          - External pressure from NGOs, consumers, suppliers and media.                          |

Table 3 simply demonstrates each stakeholder’s integrated function in relation with CSR in IFIs. The regulatory authorities play a key role in promulgating a set of law or code of ethics on corporate governance. To complement this function, the supervisory authorities have duty to supervise and monitor the implementation of this code of ethics effectiveness of corporate governance system and to check its. Shareholders have responsibilities to ensure that all business transactions and investment activities are conducted in ethical way. The BOD has responsibility to specify the code of conduct and standard of appropriate behavior for internal usage\(^{17}\). Unlike the BOD, the management has fiduciary duty to implement the ethical policies and strategies set by the BOD while the employees, to practice and observe every aspect of ethics as stipulated in the code of ethics.

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\(^{17}\) BOD that meets frequently is more likely to discharge their duties because more time can be devoted to monitoring issues such as conflicts of interest and management supervision. On the other hand, BOD that rarely meets may have no time to do the same and in fact may lead to only rubberstamp the management plans.
To further illustrate the stakeholders’ responsibilities to foster CSR in IFIs, table 4 highlight CSR frameworks in seven areas. All stakeholders particularly BOD, shareholders, managers, employees and *Shari’ah* board have their own functions to implement and foster CSR. For this purpose, it is important to have integrated governance policy and framework on the implementation of CSR. Continuous and effective interaction between the stakeholders will surely lead to increasing societal awareness and concern upon any issues pertaining to CSR.

**Table 4: CSR Framework and Stakeholders Responsibilities**

<table>
<thead>
<tr>
<th>CSR Framework</th>
<th>Implementation</th>
<th>Main Stakeholder Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Welfare</td>
<td>Equal Opportunities, Training and Developments, Employee’s benefit, Indemnity and Pension, Workplace environment</td>
<td>BOD</td>
</tr>
<tr>
<td>Community</td>
<td>Community Investment, Education Support, Health Support, Qardh al Hasan, Social Activities Support</td>
<td>BOD, BOD, BOD, BOD</td>
</tr>
<tr>
<td>Philanthropy</td>
<td>Charity and donation, Zakah, Waqf Management</td>
<td>Shari’ah Board, Shari’ah Board</td>
</tr>
<tr>
<td>Product and Services</td>
<td>Quality of the products and Services, Micro, Small Business and Social Savings and Investments</td>
<td>Shari’ah Board</td>
</tr>
<tr>
<td>Customer</td>
<td>Consumer-friendly products and services, Customer satisfaction</td>
<td>Managers, Employees</td>
</tr>
<tr>
<td>Environmental Issue</td>
<td>Support of environmental initiative, Reduction of Adverse Impact on Environment, Social, development and environment based Investment Quotas</td>
<td>BOD, BOD, BOD</td>
</tr>
<tr>
<td><em>Shari’ah</em> Issue</td>
<td>Screening Clients for <em>Shari’ah</em> compliance, Maqasid <em>Shari’ah</em> as the Main Consideration</td>
<td>Shari’ah Board, Shari’ah Board</td>
</tr>
</tbody>
</table>

Table 4 summarizes the CSR frameworks applicable to IFIs and the main actors to implement and boost CSR initiatives. In relation with the roles of corporate governance, this section explains separately the functions of internal stakeholders and as to how they can foster the implementation of CSR. Although, the external stakeholders are also important to influence CSR from outsides, in the context of corporate governance in IFIs, this paper views that the

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18 There are 500 verses in al Quran, relate to environmental issues. Allah says “ do not mischief on the earth, after it has been set in order, and invoke Him with fear and hope, Surely Allah’s mercy is ever near unto the good-doers” *Al Quran, (7: 6).*
5.2 Organizational Structure

The existence of *Shari’ah* board within the internal corporate governance structure shall be the advantage for IFIs to further promote the implementation of CSR. *Shari’ah* board is also expected to take into consideration the moral and social objectives. A study conducted by Farook and Lanis, (2007: 240) reveals that the existence of *Shari’ah* board is one of the significant factors to foster CSR disclosure practice. The study finds that *Shari’ah* board which consists of interdisciplinary memberships, doctorate qualification and international repute results in greater supervision and monitoring and hence showing higher level of CSR disclosure. Based on this finding, the study suggests four main factors that lead to positive association between the existence of *Shari’ah* board and CSR practices. *Shari’ah* board with more board members, cross memberships, secular educational qualifications and reputable scholars are found to be more proactive to influence IFIs on CSR.

As the highest authority in IFIs, the BOD has responsibilities to design corporate strategies by considering the interest of all stakeholders and this includes influencing the company’s social obligation. At this point, board structure and composition is one of the factors that may determine the extent of CSR initiatives in IFIs. Board with more independent directors is presumed to have better monitoring and supervision of company’s activities and action of managers. On the other hand, board with more executive directors and insider directors is considered less effective. Outside directors provides more resources, legitimacy and information which is important to stimulate the CSR initiatives (Ayuso and Argandona, 2007: 8) in IFIs\(^\text{19}\).

Moreover, board diversity with different gender, ethnicity, experiences and cultural background can also be significant influential factors to promote CSR (Ayuso and Argandona, 2007). A study conducted by Ibrahim and Angelidis, (1994) reveals that female directors are more sensitive to CSR. This is affirmed by other studies such as Coffey and Wang, (1998), Williams, 2003 and Webb, (2004)\(^\text{20}\). In fact, non-shareholder stakeholders in the BOD such as academic, politicians and retired government officer are also found to be more keen to

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\(^\text{19}\) Several studies affirmed the positive correlation between outside directors and CSR. Ibrahim and Angelidis, (1994) found that outside directors are tend to be more in favor with the social activities and company’s initiatives on community, environment and social needs. Zahra, et. al., (1993) and Johnson and Greening, (1999) revealed that firm with outside directors are more socially responsible. This is affirmed by Webb, (2004).

\(^\text{20}\) It is also found that the UK-based companies with female board members have good practice of corporate governance as compared to the companies with all male directors (IFC and Hawkamah, 2008: 32).
Corporate Governance and Social Responsibility in Islamic Financial Institutions

protect not only the interest of shareholders but to take into consideration social responsibilities\textsuperscript{21}.

While the existing studies and empirical evidence vividly indicate that board diversity is one of the key factors to influence CSR initiatives, the practice in IFIs seems to show otherwise. The board room of IFIs particularly in GCC countries is still male territory. Even though female directors are expected to be more sensitive to social responsibilities and in fact more meticulous in making decision, the existing practices demonstrate that the board room is still dominated by male directors. A study by International Finance Corporation (IFC), the private sector arm of the World Bank Group and Hawkamah, the Institute for Corporate Governance reveals that majority of banks in the Middle East and North Africa region indicated that they do not have a single female board member. The finding on this is further illustrated in table 5.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
Number of Women on the Board (74 Banks: IFIs and Conventional Banks) & Percentage \\
\hline
2 to 5 & 1.50% \\
\hline
1 & 20.90% \\
\hline
0 & 77.60% \\
\hline
\end{tabular}
\caption{Number of Women on the Board.}
\end{table}


Table 5 demonstrates the finding on the number of women on the board of 74 banks in 11 countries namely Morocco, Tunisia, Egypt, Jordan, Lebanon, West Bank and Gaza, Bahrain, Kuwait, Oman, Saudi Arabia and the UAE. The study by IFC and Hawkamah evidences that only 1.5% of banks out of 74 have two to five female board members and 20.90% have one female board member. Majority of banks (78%) indicated that they have no female board member. As can be clearly seen through the figures, the board diversity in term of gender has not been a common practice yet by IFIs and even conventional banks in the Middle East and North Africa. This is perhaps amongst others contributed by cultural background and social condition of the society in the Arab world. Considering to the importance of board diversity and equal opportunities regardless of gender, races and religion, the existing practice of having male directors only in the board room of IFIs should be changed and transformed towards more dynamic and open corporate governance practice.

5.3 Ownership Structure

Ownership structure is of critical importance to the effectiveness of corporate governance. Generally, there are two types of ownership structures namely

\textsuperscript{21} Kassinis and Vafeas, (2002) found the firm with non-shareholder stakeholders was unlikely to violate the environmental laws.
insider ownership or managerial ownership and block holder’s ownership or institutional ownership. Based on the nature of the managerial ownership which is owned by individual, IFIs are likely to operate on excessive profit-motive orientation and thus may lead to lack of CSR. On the other hand, in the case of block holder’s ownership or institutional ownership such as such employees’ provident fund, pension fund or government linked company, IFIs are likely to invest not only in business that may provide higher returns but also may contribute to socio-economic, community and environment. This is affirmed by a study on 86 Malaysia companies in Ghazali, (2007) which reveals that government ownership have significantly influenced the CSR disclosure practice. This is because IFIs with block holder’s ownership have responsibilities to satisfy and to protect rights and interest of a large number of individuals such as tax payers and pensioners.

In the context of IFIs, the deposit structure also one of the factors that influence the CSR practices in IFIs. Farook and Lanis, (2007: 231) suggest that the size of Investment Account Holders (IAH) fund in IFIs is one of the determining factors upon the level of CSR practices. The percentage of CSR initiatives are larger to IFIs that having significant IAH funds as compared to those having small amount of IAH funds. This is because the IFIs with large amount of IAH funds have to prove to investors including shareholders and depositors particularly IAH as a quasi shareholders on the credibility and social functional roles of IFIs towards community.

5.4 Monitoring Mechanism

Having a sound framework of corporate governance to foster CSR is meaningless without support of proper monitoring and supervisory mechanism. Corporate governance committee within the internal structure of corporate governance in IFIs is necessary for purpose of supervision and monitoring CSR practices. In this regard, the IFSB Guiding Principles on Corporate Governance recommends the establishment of corporate governance committee in IFIs for purpose of governance monitoring and supervision. This corporate governance committee will specifically monitor the IFIs’ compliance with their governance policies and initiate any effort to improve them.

On top of corporate governance committee, it is also good practice for IFIs to dedicate specific staff or CSR manager to deal with any CSR initiatives including monitoring and supervision. In the US for instance, the practice of appointing dedicated CSR managers or ethic officers is becoming popular (Mcbarnett, 2009: 2). Although, it is not a common practice in IFIs to appoint specific officer or CSR

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22 It is also contended that the company size has significant impact on social disclosure practice.
manager to in charge CSR matters, such initiative is expected to positively influence the CSR activities. The CSR manager will be able to allocate ample time and necessary efforts to plan, initiate and monitor any CSR initiatives in IFIs.

In view of the uniqueness of corporate governance structure in IFIs, the institutionalization of Shari’ah board offers another important mechanism to monitor, supervise and even to foster CSR practices. Shari’ah board can play a role as hisba23 institution during the pre-modern Muslim societies but dresses with new approach and strategy in modern Muslim societies. At this point, the institution of the Shari’ah board is an important organ of corporate governance in IFIs to function as the muhtasib (ombudsman) or internal supervisory authority on the aspect of Shari’ah and CSR practices.

Despite the significance of Shari’ah board to supervise and monitor the CSR initiatives and implementation, the existing practice evidences that majority of Shari’ah scholars are unable to locate ample time for such responsibilities. As a result, Shari’ah board is more concerned on the legal mechanistic of fiqh in issuing Shari’ah pronouncements rather than taken into consideration their implication to socio-economic condition including CSR. The release of “Shari’ah Scholars-A Network Analytic Perspective” issued by the Funds-at-Work provides the extent of current Shari’ah board practices in IFIs. The survey in 2008 reveals that out of 94 scholars in 467 IFIs in 19 countries, only 20 of them are heavily utilized where they represent 339 board positions equaling 17 board positions per scholar. This figure is increased in 2009 where it shows that the top 10 listed Shari’ah scholars have monopolized more than 58% out of 956 Shari’ah board positions in 271 organizations in 22 countries. The recent analysis in 2010 further evidences that the top 10 scholars hold 67% out of 1054 board positions in 291 IFIs in 24 countries.

This paper summarizes and illustrates the board and chairman positions of top ten Shari’ah scholars in these three separate reports in table 6.

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23 A term used by the classical Muslim jurists to describe the function carried out by the state or appropriate Islamic authority to regulate the market place for purpose of maintaining social justice.
Table 6: Board and Chairman Positions of Top Ten Shari’ah Scholars

<table>
<thead>
<tr>
<th>Shari’ah Scholar</th>
<th>Data as of 31.12.2008</th>
<th>Data as of 10.10.2009</th>
<th>Data as of 12.04.2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>467 Board Positions in 19 Countries</td>
<td>956 Board Positions in 22 Countries</td>
<td>1050 Board Positions in 24 Countries</td>
</tr>
<tr>
<td>Sheikh Nizam Mohammed Saleh Yaquby</td>
<td>46</td>
<td>77</td>
<td>78</td>
</tr>
<tr>
<td>Sheikh Abdul Sattar Abdul Karim Abu Ghuddah</td>
<td>45</td>
<td>72</td>
<td>77</td>
</tr>
<tr>
<td>Sheikh Mohammed Eid Elgari</td>
<td>31</td>
<td>64</td>
<td>65</td>
</tr>
<tr>
<td>Sheikh Abdulaziz Khalifa Al Qassar</td>
<td>22</td>
<td>37</td>
<td>38</td>
</tr>
<tr>
<td>Sheikh Mohammad Daud Bakar</td>
<td>22</td>
<td>35</td>
<td>38</td>
</tr>
<tr>
<td>Sheikh Abdulla Bin Sulaiman Al Manea</td>
<td>20</td>
<td>37</td>
<td>38</td>
</tr>
<tr>
<td>Sheikh Hussein Hamid Hassan</td>
<td>19</td>
<td>29</td>
<td>32</td>
</tr>
<tr>
<td>Sheikh Ali Mohyuldin Al Qarradaghi</td>
<td>17</td>
<td>23</td>
<td>31</td>
</tr>
<tr>
<td>Sheikh Essa Zaki Essa</td>
<td>17</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Sheikh Ajeel Jasim Al Nashmi</td>
<td>15</td>
<td>24</td>
<td>22</td>
</tr>
<tr>
<td>Average Board and Chairman Position Per Scholar</td>
<td>25.3</td>
<td>42.3</td>
<td>44.4</td>
</tr>
</tbody>
</table>


Amongst the top 10 Shari’ah scholars, Sheikh Nizam Muhammad Saleh Yaqubi is ranked first with 78 board positions followed by Sheikh Abdul Sattar Abu Ghuddah, 77, Sheikh Muhammad Ali Elgari, 65, Sheikh Abdulaziz Khalifa Al Qassar, Sheikh Abdullah Sulaiman Al Manea and Sheikh Mohammad Daud Bakar, 38 respectively, Sheikh Hussein Hamid Hassan, 32, Sheikh Ali Mohyuldin Al Qarradaghi, 31, Sheikh Essa Zaki Essa, 25 and Sheikh Ajeel Jasim Al Nashmi, 22. As regard to the chairman position, Sheikh Abdul Sattar Abu Ghuddah and Sheikh Hussein Hamid Hassan hold 21 Chairman Positions respectively, Sheikh Abdullah Sulaiman Al Manea, 20, Sheikh Nizam Muhammad Saleh Yaqubi, 10, Sheikh Abdulaziz Khalifa Al Qassar, 9, Sheikh Muhammad Ali Elgari, 8 and Sheikh Ali Mohyuldin Al Qarradaghi, 7. The average of board position for top 10 Shari’ah scholars in 2008 is 25.3 while in 2009, it increased to 42.4 followed in 2010 whereby the figure amounted to 44.4.

As would be apparent from the above figures, most of the Shari’ah board positions are monopolized by the same Shari’ah scholars. It is understood that we can not solely blame the Shari’ah scholars for such practices as IFIs need for qualified, experienced and well known individual for Shari’ah advisory services. In view of such negative findings, the existing practice needs a corporate governance reform to ensure the effectiveness of Shari’ah board in playing its functional roles as well as to promote CSR initiatives in IFIs. For instance, the
Shari’ah Governance Framework issued by the Central Bank of Malaysia (BNM) put condition of at least five members for each Shari’ah board in IFIs and Shari’ah scholars are not allowed to sit in more than one board at a particular time. This regulatory initiative will promote a good practice of corporate governance in IFIs and at the same time enables Shari’ah board to mobilize its function to foster CSR practices in Islamic finance industry.

5.5 Transparency and Corporate Social Reporting

The hallmark of corporate governance is transparency. The element of transparency is important for IFIs and it is one of the pillars of good practice of corporate governance. With regard to CSR, good corporate governance requires IFIs to disclose their CSR activities either in the annual report or any other avenues. The disclosure on CSR initiative will inculcate confidence of the stakeholders upon the contribution made by IFIs towards community at large. The trend of CSR disclosure through standard reporting is becoming popular. It is reported that 90 of the top 100 European companies and 59 of the US top 100 have published their CSR reports in 2005-2006 (Context, 2006: 10).

Generally, there are four types of CSR Reports in practice namely Social Responsibility Report (SRR), Sustainability Report (SR), Ethical Consumerism Report (ECR) and Environmental Policy Report (EPR). SRR and SR are the most famous forms of CSR reports. Hackston and Milne, (1996: 78) defines CSR report as the provision of financial and non-financial information relating to the firm’s interaction with physical and social environment as recorded in the annual report or corporate social report and these includes information on environmental issues initiatives, energy, fair business practices, human resources and community involvement.

Considering the importance of unified or standard CSR report to systematically foster CSR initiatives, the United Nation Environment Programme has developed Global Reporting Initiative (GRI), a standard guideline for global corporate social reporting. This is followed by the Accountability AA1000 Assurance Standard developed by London-Based organization, the Institute of Social and Ethical and Accountability (ISEA). In view of some distinct characteristics with typical corporate entities which make the existing international guidelines insufficient for IFIs, the AAOIFI has also made an initiative to issue the Governance Standard for CSR. This AAOIFI Governance Standard provides guidelines and guiding principles for IFIs by combining the voluntary and obligatory frameworks of CSR.

CSR report is a key tool for communicating with stakeholders in providing information pertaining to corporate social activities such as involvement in community development and education and efforts on employees’ protection.
Unlike in conventional, there is no specific and intensive study on the trend of CSR reports in IFIs except several researches on the general disclosure of social activities. For instance, Farook and Lanis, (2007), conducted a study on the social disclosure level of 47 IFIs from 14 countries from two dimensional perspective of social responsibility and sense of community. As expected, the study reveals that majority of IFIs have significantly low level of social disclosure indicating the weak practice of CSR disclosure. This is affirmed in Dar and Ahmad Azami, (2010: 49) as illustrated in table 7.

Table 7: Information on CSR on IFIs in the GCC

<table>
<thead>
<tr>
<th>IFIs</th>
<th>Social Responsibility</th>
<th>Sense of Community</th>
<th>Total Max (10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noor Islamic Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Dubai Islamic Bank</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Dubai Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Bank Al Bilad</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Al Rajhi Bank</td>
<td>3</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Bahrain Islamic Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Shamil Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Qatar International Islamic Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Qatar Islamic Bank</td>
<td>0</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Dar and Ahmad Azami, (2010: 49)

Table 7 affirms the assumption that IFIs have very low disclosure practice on CSR. 80% of IFIs only score 3 points out of 10 indicating the seriousness of level of CSR disclosure. In fact, 80% of IFIs had not disclosed their social responsibility information while only 20% IFIs scored 1 and 3 point respectively. In term of sense of community, all of IFIs score 3 point indicating weak CSR disclosure practice. Only 10% IFIs score 6 point witnessing that some positive development on CSR disclosure. The above figures show that CSR disclosure is not prevalent practice to IFIs in GCC countries.

Perhaps, this phenomenal is contributed by either lack of awareness or less support from the regulatory authorities. Another assumption is that there is no pressure group as in the case of other jurisdictions such as in the US and the UK to influence the CSR initiative in GCC countries. The negative findings on CSR practice in the GCC countries are regrettable. With a high level of economic development and income especially from oil ad gas industry, IFIs in GCC countries should grab this golden opportunity to move beyond considering economic objectives as the sole motive to the importance of improving non-economic consideration via CSR initiatives.
Another interesting study is conducted by Aribi, (2009) who examined the disclosure pattern of 21 IFIs in GCC Countries. Similar with the previous study, Aribi, (2009) affirmed that the disclosure practice in IFIs was significantly low. This study provides detail analysis about the contents of CSR disclosure and these include commitment to CSR, employees, philanthropy, community, product and services, customers, environment and values and ethics. The findings in this study are summarized in table 8.

Table 8: Disclosure Practice on CSR in IFIs

<table>
<thead>
<tr>
<th>Disclosure</th>
<th>Percentage (21 IFIs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment to CSR</td>
<td>Statement on CSR</td>
</tr>
<tr>
<td>Employees</td>
<td>Equal Opportunities</td>
</tr>
<tr>
<td></td>
<td>Training and Development</td>
</tr>
<tr>
<td></td>
<td>Employee’s Benefit</td>
</tr>
<tr>
<td></td>
<td>Work Environment</td>
</tr>
<tr>
<td>Community</td>
<td>Qardh al Hasan</td>
</tr>
<tr>
<td></td>
<td>Social Activities</td>
</tr>
<tr>
<td></td>
<td>Health Support</td>
</tr>
<tr>
<td></td>
<td>Contribution to National Economy</td>
</tr>
<tr>
<td></td>
<td>Community Investment</td>
</tr>
<tr>
<td>Philanthropy</td>
<td>Charity and Donation</td>
</tr>
<tr>
<td></td>
<td>Zakah</td>
</tr>
<tr>
<td>Product and Services</td>
<td>Quality of the Product</td>
</tr>
<tr>
<td></td>
<td>Product Innovation</td>
</tr>
<tr>
<td>Customers</td>
<td>Customer Service</td>
</tr>
<tr>
<td></td>
<td>Meet Customer Needs</td>
</tr>
<tr>
<td></td>
<td>Customer Satisfaction</td>
</tr>
<tr>
<td>Environment</td>
<td>Environmental Issues</td>
</tr>
<tr>
<td>Values and Ethics</td>
<td>Islamic Ethics</td>
</tr>
<tr>
<td></td>
<td>Ethical Conduct</td>
</tr>
<tr>
<td></td>
<td>Adherence to Islamic Principles</td>
</tr>
</tbody>
</table>


The findings in the above study reveal some interesting information. As to the disclosure on commitment to CSR, the study reveals that 57% of IFIs mentioned in the annual report about their position in this aspect. In term of employees’ issues, majority of IFIs disclosed training and development and employee’s benefit while only minority of IFIs disclosed equal opportunities and work environment. In addition, surprisingly, none of IFIs disclosed information on any initiatives pertaining to environmental issues. While Islam strongly emphasizes on environmental responsibilities, IFIs on the other hand is seen weak in this aspect.

Another aspect pertaining to community, the disclosure practice is very low for qardh al hasan, social activities, health support, and contribution to national economy and community investment. With respect to philanthropy, significant
percentage of IFIs disclosed information on *zakah* while only 42.9% disclosed on charity and donation. The information on *zakah* and charity is essential for IFIs particularly to the external stakeholders as IFIs are expected to contribute to society and community. Lack of disclosure on this aspect may create wrong perception on the roles of IFIs.

The findings in Aribi, (2009) suffer several limitations. The research sample is small consisted of only 21 IFIs which do not represent the practice of Islamic finance industry in GCC countries as a whole. Moreover, the data is derived from the Annual Report in 2004 which is quite outdated. In view of these limitations, this paper further provides analysis on the disclosure practice of IFIs in Malaysia and GCC Countries based on the data derived from the annual report of 2009. Table 9 illustrates the difference of disclosure practices of CSR in 20 IFIs in Malaysia, Qatar, Kuwait, UAE, Bahrain and Saudi Arabia. This table classifies the disclosure practices into five aspects namely CSR Report in Annual Report, Policy or statement on CSR, Initiatives on community awareness and education, participation for community development and description of contributions to charitable activities.

*Table 9: Disclosure Practices of CSR in IFIs*

<table>
<thead>
<tr>
<th>IFIs</th>
<th>CSR Report in Annual Report</th>
<th>Policy/ statement on CSR</th>
<th>Community awareness or education</th>
<th>Community development</th>
<th>Description on charitable initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Islam (M) Berhad</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Bank Muamalat Malaysia Berhad</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Al Salam Bank – Bahrain</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Ahli United Bank-Bahrain</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ithmaaar Bank-Bahrain</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Kuwait International Bank-Kuwait</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank of Kuwait and the Middle East-Kuwait</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boubyan Bank-Kuwait</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Dar-Kuwait</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Al Rayan Bank</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>
Out of 20 IFIs, only 8 IFIs published their CSR Report in the annual report. 15 IFIs have a clear statement and policy on CSR which is stated clearly on their websites about CSR commitment and initiatives. 7 IFIs disclosed their CSR initiatives on community awareness and education. 13 IFIs disclosed their participation on community development. 15 IFIs disclosed in details the description of contribution to charitable activities. These figures obviously indicate the low level of disclosure practice of CSR in IFIs particularly on the aspect of social reporting. More than 50% of IFIs have failed to produce CSR report in the annual report indicating very weak practice.

Unlike table 9, figure 2 demonstrates the trend of CSR disclosure practice from country specific behavioral perspective. Graph below clearly illustrates the extent of CSR disclosure of IFIs in Kuwait (5 IFIs), Bahrain (3 IFIs), Malaysia (3 IFIs), Qatar (3 IFIs), UAE (3 IFIs) and Saudi Arabia (3 IFIs). This illustration is beneficial for purpose of country specific analysis and to provide comparative perspective on the CSR disclosure practice in these six jurisdictions.

*Figure 2: CSR Disclosure Practice from Country Specific Behavioral Perspective*
Figure 2 reveals that all IFIs in Malaysia disclosed information on D3, D4 and D5, followed by Bahrain on D2 and Qatar on D5. Weak practice is shown by IFIs in Kuwait, Qatar, UAE and Saudi Arabia whereby only 1 IFI respectively issued or published CSR report. In fact, in UAE, none of IFIs disclosed information pertaining to community awareness and education and description on charitable initiatives.

In term of initiative on social reporting, IFIs in Malaysia and Bahrain indicate good practice of CSR reporting in which majority of them had published their annual CSR report while in Qatar, Kuwait, UAE and Saudi Arabia, only 1 IFI respectively issued the same. This finding demonstrates that social reporting is not a common practice in IFIs. The overall results also depict that Malaysia and Bahrain slightly have better CSR disclosure practice as compared to Kuwait, Qatar and Saudi Arabia. Although IFIs in UAE are amongst the pioneer in Islamic finance such as Dubai Islamic Bank, the result nevertheless indicates otherwise where the overall CSR disclosure practice is rated as very low.

While IFIs are expected to be transparent, the existing practices nevertheless show otherwise. Moreover, transparency and corporate disclosure particularly on CSR are not common in IFIs and in fact very weak. The lack of CSR disclosure in IFIs then must be overcome by facilitating its initiatives with sound regulatory frameworks and certain incentives. In Islam, disclosing social information for the reason of transparency and accountability is perceived as social obligation. In fact, the disclosure on CSR initiatives is regarded as religious obligation rather than moral obligation per se. In this regard, transparency via corporate social reporting is deemed important as part of good corporate governance practices.

6.0 Concluding Remarks

This paper aims at providing an overview of corporate governance on CSR in IFIs as part of their ethical responsibilities. The Islamic ethical dimension denotes a solid epistemological orientation for IFIs as motivation to fulfill these ethical responsibilities via CSR initiatives. To sum up, corporate governance is an important mechanism and one of the factors that determine and influence the IFIs’ initiatives on CSR. Strong corporate governance with pro-active roles of stakeholders, appropriate organizational structure, ownership structure, sound monitoring and supervisory frameworks and proper corporate social reporting would be able to stimulate and induce the IFIs to play more roles in social and moral initiatives.

In view of lack of CSR disclosure practices in IFIs as demonstrated in section 5.5, this paper strongly advocates any efforts and endeavors to promote transparency and disclosure on social responsibilities. Numerous CSR efforts and initiatives of
IFIs are insufficient or even to certain extent meaningless in the context of commercial or business entity. These initiatives must be supported with significant disclosure through strengthening proper reporting structure and format and any other disclosure avenue. Transparency must be part and parcel of IFIs in which stakeholders and general public may access to the information on CSR disclosure. This factor will further generate confidence of the stakeholders on the roles play by IFIs in mobilizing their funds and investments.

Despite several limitations, this paper has yielded several contributions to the topic of corporate governance and social responsibilities within the IFIs’ framework. First, it explains the relationship between ethics and corporate governance dimension in IFIs on CSR. Second, it demonstrates the ethical dimension of corporate governance and critics over lack of social responsibility initiatives in IFIs. Third, it provides comparative overview of the CSR framework in IFIs and their conventional counterparts. Finally, it discusses the roles of corporate governance in IFIs towards better CSR practices. In whole, this paper suggests normative and strategic dimension of corporate governance from Islamic point of view and its functional roles on CSR as one of the aspirational objectives of Islamic finance.
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References


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