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Islamic Bank and Corporate Social Responsibility (CSR)

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Abstract

Islamic banking has been in the market for almost fifty years, since its inception during the 1960s. Since that time, Islamic banking has rapidly developed and is no longer a strange concept. The products and services provided have been well accepted, not only among Muslim countries but also non-Muslim countries. However, there is a lack of discussion on how Islamic back perform in term of corporate social responsibility compare than conventional bank. The paper aims to analyze the relationship of Islamic bank and CSR performance. It is a conceptual attempt to discuss on how Islamic principles of Islamic bank can influence the implementation of CSR. The religious characteristics that acted as a foundation for the establishment of Islamic banking are expecting to have an influence on corporate social responsibility. For that, the paper examines and analyse the relevant literature and develop the relationship between Islamic bank concept and CSR. The paper found that, the concept of Islamic bank that comply with religious provision should exhibit more proactive CSR activity and policies. Islamic bank performance should superior compare than conventional bank counterpart.

Keywords: Islamic Bank, Corporate Social Responsibility, Islamic Corporate Social Responsibility

1. Introduction

Most of the literature on Islamic banks asserts that, basically, they perform functions similar to those of conventional banks. However, their approach is different (Ahmad, 2000; Chapra, 2000; Warde, 2000; Henry and Wilson, 2004; Iqbal and Molyneux, 2005; Dusuki and Abdullah, 2007b; and Iqbal and Mirakhor, 2007). Kahf (1999, p. 445) commented as follows:

> *"Although some writers would describe Islamic banks as more than mere financial institutions, the fact remains that an Islamic bank is actually much like a conventional bank, in that it is a full-service financial intermediary. By definition an Islamic bank abides by the Islamic law, called the Shari'ah. A bank's commitment to the Islamic law is expressed only in the definition of its modes of financing and its contractual relations with suppliers of funds."*

Lewis and Algaoud (2001, p. 2) defined an Islamic bank as:

> *"A financial institution that provides a service to its customers free from interest, and the giving and taking of interest is prohibited in all transactions."*

Dar and Presley (2000, p. 7) stated:

> *"Like conventional banks, an Islamic bank is an intermediary and trustee of other people's money with the difference that it shares profit and loss with its depositors. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with some ownership rights in it. However, in practice most Islamic banks have an organisational set-up similar to their conventional counterparts."*

Nathan and Ribiere (2007) pointed out that the banking operations of Islamic banks are based on Islamic principles. Thus, Islamic banks can be differentiated from conventional banks in three major aspects: (1) foundation; (2) management; and (3) products. Lewis and Algaoud (2001) and Nathan and Rebiere (2007) highlighted five major elements that give Islamic banking and finance its distinctive religious identity: (1) *Riba* is prohibited in all transactions; (2) business and investment are undertaken on the basis of *halal* (legally permitted activities); (3) transactions should be free from *gharar* (speculation or uncertainty) and *maysir* (gambling); (4) *zakat* is to be paid by the bank to benefit society; and (5) to ensure that all activities are in line with Islamic principles, a special *Shari'ah* board supervises and advises the bank on the propriety of transactions.

Based on the above argument, this paper will explore the issues of Islamic bank and corporate social responsibility. Is expecting, that Islamic bank should show more proactive CSR activities compare than conventional counter part. For that reason, this paper will be presented in the following ways. First, we will discuss on the concept of CSR. Than we will explore the concept CSR base on Islamic perspective. The concept of Islamic CSR discussed in this paper is based on five Islamic principles: (1) *Tawhid*; (2) *Shari'ah*; (3) *justice*; (4) *benevolence*; and (5) *Maslahah.* These principles should be reflected in Islamic organisations' CSR activities and should, theoretically, distinguish Islamic banks' CSR practices from those of conventional banks. The next section will further discuss on the characteristic of Islamic bank and finally the paper will discuss on the relationship between Islamic bank and CSR.

2. The Concept of Corporate Social Responsibility

The corporate social responsibility (CSR) concept has had a long and varied history. Although references to a concern for social responsibility appeared during the 1930s and 1940s, the modern era of social responsibility began in the 1950s (Carroll, 1999).

Bowen (1953, cited in Carroll, 1999) referred to CSR as the obligations of businessmen to pursue those decisions, those policies, those lines of action which are desirable in terms of societal objectives and values. In the 1960s, in an overview of CSR, Frederick (1960) defined CSR as an action taken by businessmen to oversee the operations of an economic system so that it fulfils the expectations of the public. In other words, production and distribution must be conducted in such a way that will enhance total socio-economic welfare. Frederick (1960) drew attention to five major thoughts about business responsibility at that time, each attempting to tackle the problems of power in a complex society and highlighting the importance of businesses' responsibility to society.

Davis (1960) divided CSR into socio-economic obligation and socio-human obligation. As regards socio-economic obligation, the businessmen's role is to manage economic units in the society, with a broad obligation to the community with regard to economic development and public welfare. As regards socio-human obligation, businessmen are obliged to nurture and develop human values, such as morale, cooperation, and motivation. These two obligations should underlie businessmen's decisions and actions should be taken for reasons at least partially beyond the firm's direct economic or technical interests.

In the 1970s and 1980s, the debate on obligation extended to groups other than shareholders. Jones (1980) extended CSR to include the notion that corporations have an obligation to constituent groups in society other than shareholders and beyond those prescribed by law or union contract. Such obligation is voluntary and, second, the obligation is a broad one, extending beyond the traditional duty to shareholders to other societal groups, such as customers, employees, suppliers, and neighbouring communities. According to Carroll (1999), in the 1980s and 1990s research into CSR increased. Three conceptual categories were employed to discuss business performance: business ethic, CSR, and corporate social responsiveness. These categories influenced perceptions of the role of business (Epstein, 1987).

Frederick (1986) divided CSR into four developments known as CSR_1, CSR_2, CSR_3, and CSR_4. CSR_1, called the first wave of CSR, began in the early 1950s and carried forward into the mid 1970s. It focused on corporate social responsibility. During that period (1950-1970) people felt that something was wrong with the norms governing business conduct. Moreover, although scholars recognised the importance of CSR and accountability, their work was unspecific regarding the values of CSR. Husted and Allen (2000) stated that during this period, scholars spoke only of what obligations corporations should fulfil in order to improve the social environment, rather than how they should respond and react in order to improve it.

Corporate social responsiveness emerged in 1970 as a reaction to the lack of clarity on CSR_1 in order to provide managers with tools for managing CSR_1. It is an ethical-philosophical concept of CSR, since corporate social responsiveness is viewed as being concerned:

> *"with the ability of the firm to respond to social pressure in an apparently antagonistic environment with the firm on one side and the 'stakeholders' on the other" (Frederick*, 1998, p. 154).

Scholarly interest then moved to the way corporations can enhance skills and effectiveness when dealing with social pressures (Frederick, 1986). CSR_2 was a move from an ethical and philosophical concept to an action-oriented managerial concept of social responsiveness. Frederick (1986, p. 135) subsequently referred to CSR_3 as social corporate attitude:

> *"CSR_3 embodies the notion of moral correctness in actions taken and policies formulated. Its general value referent is that body of sometimes dimly and poorly expressed but deeply held moral convictions that comprise the culture of ethics."*

A CSR_3 corporation whose normative elements are based on ethics and values will:

a) acknowledge that ethics belong at the core and not just the periphery of management decision and policies;
b) employ and train managers who accept and practise the central role of ethics;
c) possess sophisticated tools for detecting, possibly anticipating, and coping realistically with ethical problems affecting the company and its employees; and
d) attempt to align its current and planned future policies with the core values found within the culture of ethics.

Frederick (1998) finally proposed CSR_4 that considers the cosmos, science and religion in social responsibility issues. CSR_4 was developed as a result of the inadequacies of the then prevailing CSR definition. Frederick (1998) stated that in CSR_4, the researcher should expand the study of CSR to emphasise how business practice should reflect the broadest realms of human knowledge and experience instead of limiting their analysis to the norms and values of any given society or historical period. Frederick (1998) also mentioned that it is important for the researcher to study CSR based on the religious viewpoint. Religious belief is of importance in CSR research since it can influence organisational decision-making and workplace behaviour. Thus, this present study aims to undertake a comprehensive overview of CSR activities, especially in natural environmental management, based on the religious perspective represented by banks' managers' religious affiliations and employer bank types.

Carroll (1991) argued that one of the factors that contributed to the ambiguity that frequently shrouded discussions about social responsibility was the lack of consensus on what the concept meant. The concept of CSR expounded by Carroll (1979; 1991 and 1994) introduced four layers of CSR or four kinds of social responsibility: economic, legal, ethical and philanthropic. According to Carroll (1991), the four components of CSR begin with the basic notion that economic performance undergirds all else. At the same time, business is expected to obey the law because the law is society's main reference of acceptable and unacceptable behaviour. It is also obliged to do what is right, just, fair, and to avoid or to minimise harm to stakeholders. Business is also expected to be a good corporate citizen. This can be achieved through philanthropic responsibility, where business is expected to contribute financial and human resources to the community and to improve the quality of life. The four levels of corporate social responsibility outlined by Carroll (1979; 1991; and 1994) are shown in Table 1 below.

Table 1: The CSR Pyramid

Economic Responsibility	• It is a profit motive of the business. • Business is considered the basic economic unit with the principal role to produce goods and services that consumers need and want and to make an acceptable profit in the process.
Legal Responsibility	• As a partial fulfilment of the 'social contract' between the business organisation and society, businesses are expected to pursue their economic missions within the framework of the law.
Ethical Responsibility	• To avoid those activities and practices that is prohibited by societal members, even though they are not codified into law. • Encompasses additional behaviours and activities that are not necessarily codified into law but nevertheless are expected of business by society's members.
Philanthropic Responsibility	• Encompasses business actions that are in response to society's expectation that businesses be good corporate citizens. • This responsibility is purely voluntary and the decision to be philanthropically responsible is guided only by the desire of business to engage in social roles not mandated, not required by law, and not even expected in an ethical sense. • Includes activities such as contributions to the arts, education or the community.

3. Corporate Social Responsibility in Islam

Islam provides a complete code of behaviour for life since it embraces every aspect of life. CSR is therefore not isolated in the Islamic view and is one of the main concepts in Islamic teaching. Dusuki and Abdullah (2007b) stated that the concept of CSR is deeply inscribed in the *Shari'ah.* Therefore, any corporation such as an Islamic bank that claims to follow *Shari'ah* based principles should naturally practise CSR, as it enshrines Islam's true spirit.
Williams and Zinkin's (2010) study on the compatibility between the tenets of Islam and the United Nations' Global Compact found that the teachings of Islam not only appear to be in close conformity with the Ten Principles of the United Nations' Global Compact, but in many respects, go further than the minimum standards adopted by this framework. In their study, Williams and Zinkin (2010) found that Islamic teachings exceed the requirements of the Global Compact in a number of important ways:

1. They appear to be wider in scope, for example, in the development of human capital and transparency requirements in business transactions.
2. They have a clear codification defining what is permissible or *halal* and what is forbidden or *haram*.
3. Islam has an explicit enforcement mechanism in the *Shari'ah* as well as in the community and there is the final accountability of the individual for unethical behaviour on the Day of Judgement.

Thus, an investigation of Islamic financial institutions (Islamic banks) was relevant in this study since they should establish or implement CSR practices and natural environmental management policies which are at least comparable with or at best exceed those followed by conventional non-Islamic banks. In addition, this study sought to identify whether religion influenced Islamic bank managers' perceptions of attitudes to natural environmental management since the study aimed to identify differences between conventional banks' and Islamic banks' approach to environmental issues. In order to gain a better understanding of Islamic CSR, the next section focuses on Islamic principles that should be reflected in Islamic organisations' CSR practices.

3.1 The Concept of Unity (*Tawhid)* and the Principle of Vicegerency

In Islam, the concept of CSR is consistent with the concept of Unity *(Tawhid*). According to this concept, God is the Creator, Owner and Source of all things and has entrusted mankind to use and manage all things wisely. In return for the use of the physical universe, mankind agrees to be accountable for how they use and manage the universe (Farook and Lanis, 2007). Thus, the purpose of man is to live his life in submission and obedience to Allah (Graafland et al., 2006).

The principle of vicegerency denotes that mankind is the representative of God on Earth and, as such, Allah (God) has entrusted mankind with stewardship of His possessions.

> *"Al Quran 2:30: "And remember when your Lord said to the angels: "Verily, I am going to place (mankind) generations after generations on earth…."*
>
> *Al Quran 35:39: "He it is who has made successive generations after generations on the earth…."*

The concept of vicegerency in Islam requires mankind to take care of God's creation (Farook, 2007; Siwar and Hossain, 2009). God will question everything that has been done in this world during the Day of Judgement. Therefore, all actions must be based on God's rules and regulations. According to the vicegerency concept in Islam, the human being has responsibility towards other human beings, society, and the natural environment. Zinkin (2007) indicated that Islam has prescriptions that are consistent with a modern view of what needs to be done to enhance the social, human, and natural environment. Zinkin also found that Islamic principles are in harmony with the principles of the UN Global Compact.

The concept of vicegerency is related to the concept of *Tawhid* and trusteeship in Islam. The concept of *Tawhid* states that all possessions, wealth, expertise, abilities, positions and power belong to Allah. The human being is only a trustee of them. For example, ownership of land in Islam is connected and conditioned by the ability of the owner to sustain and nourish the land. The accumulation of wealth is not the key objective of landowners in Islam, but their ability to sustain and bring benefit to self and others from the land (Kamla et. al., 2006). This concept is different from the conventional concept of profit as, in Islam, the management of all resources must be in accordance with religious requirements.

Based on the concept of vicegerency and trusteeship, every human act in this world will be questioned on the Day of Judgement. Farook (2007) called this concept 'divine accountability' and it is the basis for all actions of Muslims and, in turn, representative organisations of Muslims. The concept of divine accountability is clearly stated in the holy Quran in such verses as:

> *"When you are greeted with a greeting, greet in return with what is better than it or (at least) return it equally. Certainly Allah is Ever a Careful Account Taker of all things" (Quran 4:86).*

In Islam, worship to Allah is not restricted to the five pillars of Islam. It involves all activities and daily routines in life. Any activity not only brings reward in this world but also in the Hereafter. For example, the objective of business is not restricted to materialistic gain only but also to bring about human well being and achieve a good life overall (Williams and Zinkin, 2005). Thus, profit is not a main driver of business.

Williams and Zinkin (2005) stated that, in Islam, there is no separation between the individual's public and private life. Thus, every decision and act in life and business must be based on Islamic teachings. This principle not only applies among Muslims but also in their relationship with non-Muslims, society, and the environment.

Based on the vicegerency concept, there are no inhibitions attached to economic enterprise, and people are encouraged to avail themselves of all opportunities available (Rice, 1999). There is no conflict between the moral and socio-economic requirements. People can enjoy profit and wealth, but there must be an allocation for paying *zakat*[1]. Moreover, even though, the right to personal property and profit-making is not negated in Islam, it does not allow this right to be achieved at the expense of other stakeholders (Beekun & Badawi,

[1] *Zakat* is one of the five pillars of Islam. The payment of *zakat* is a religious obligation and must be fulfilled by Muslim who own wealth above the threshold (i.e 2.5%) (Jehle, 1994; Kamali, 2003; Ali and Myles, 2010). *Zakat* can be divided into two types *zakat-al-fitr* and *zakat-al-mal*. *Zakat-al-fitr* must be paid for charity at the end of Ramadan (fasting month in Islamic Calendar), while *zakat-al-mal* is the *zakat* on wealth (Ali and Myles, 2010 pp.838).

2005; Ullah & Jamali, 2010). Resources are for the benefit of all and not just a few, and everyone must acquire resources rightfully (Rice, 1999).

Based on the concept of *Tawhid,* Islamic organisations should produce a more proactive CSR and natural environmental management than conventional banks. However, actual implementation and policy might differ from the expectation. This study therefore explores how Islamic banks actually manage natural environmental risk in their project financing. The study also examines the differences between Islamic banks' and conventional banks' natural environmental risk management practice.

3.2 The *Shari'ah*

In Islam, the *Shari'ah* or 'Islamic Law' is the foundational basis for understanding CSR in Islam. The concept of the *Shari'ah* in Islam consists of ethics and values covering all aspects of life (e.g. personal, social, political, economic, and intellectual). Dusuki and Abdullah (2007a) stated that the concept of the *Shari'ah* reflects the holistic view of Islam, which is a complete and integrated code of life encompassing all aspects of life, be it individual or social, both in this world and the Hereafter. Zinkin (2007) indicated that the *Shari'ah* is not just a legal, but also a moral framework. It differs from secular laws, where laws and ethics may differ. The purpose of the *Shari'ah* is to make people and society do good as well as to provide a legal framework. Thus, its objective is moral and ethical.

The *Shari'ah* is best understood through its objective (*Maqasid-Al-Shari'ah*). According to Al-Ghazali cited by Dusuki and Abdullah (2007a, p. 31),

> *"The objective of the Shari'ah is to promote the well being of all mankind, which lies in safeguarding their religion (din), their human-self (nafs), their intellect (aql), their family (nasl) and their wealth (mal)"*

For example, in relation to wealth and property management, Islamic banks act as an alternative to conventional banks which charge interest that has a negative impact on the distribution of income and fairness in economic transactions. The activities of Islamic banks must be consistent with the objective of the *Shari'ah.*

The *Shari'ah's* content consists of three main elements: (1) the *Aqidah* that discuss belief and faith; (2) the *Akhlaq* that discuss morality and ethics; and (3) the *Fiqh* or legal rulings governing the acts of human beings. Fundamental aspects, such as the *Aqidah* and *Akhlaq,* are not subject to change, however, the *Fiqh* or legal rulings may change and vary according to time (Dusuki and Abdullah, 2007a; Siwar and Hossain, 2009).

Farook (2007) states that human beings are responsible for their actions to Allah, therefore, they must act responsibly and endeavour to do good and avoid doing evil. Such responsibility encompasses all aspects of a Muslim's life and constitutes the basis of individual or business social responsibility.

As a general guideline, Islamic jurisprudence (*Fiqh*) provides five categories of degree of lawfulness (*halal*) and unlawfulness (*haram*) in daily activities that can also be used as useful guides in daily business transactions. They are described below:

1. *Fardh* (required)
   This represents the class of actions that are mandatory on every person claiming to be a Muslim. For example, the responsibility of business to pay *zakat* and to use Islamic banks' products in daily business transactions.
2. *Mustahabb* (recommended)
   These actions are not obligatory but highly recommended for Muslims, for example, donations, charitable acts, and endowments.
3. *Muhab* (indifferent)
   These actions are neither mandatory nor forbidden, for example, to gain profit in business activities.
4. *Makhruh* (reprehensible)
   These actions are not absolutely forbidden but are detested. *Makhruh* is less than *haram* (prohibited), and the punishment for *makruh* is less than that for acts that are *haram*, except when done in excess.
5. *Haram* (prohibited)

Haram are actions that are unlawful and prohibited and committing them is a major sin, such as engaging in business activities that involve interest.

The *Shari'ah* has evolved within the guidelines set by its objective (*Maqasid-Al-Shari'ah*) which is to promote the well-being of all mankind. First, the interest of the community takes precedence over the interest of the individual. Second, relieving hardships takes precedence over promoting benefits and, third, a bigger loss cannot be prescribed to alleviate a smaller loss and a bigger benefit takes precedence over a smaller one. Conversely, a smaller harm can be prescribed to avoid a bigger harm and a smaller benefit can be dispensed with in preference to a bigger one (Khalid, 2002).

Dusuki and Abdullah (2007a) also indicated that the concept of the *Shari'ah* has three implications for the concept of CSR. First, in Islam, CSR is a moral and religious initiative based on the belief that a corporation should be good despite the financial consequences. Based on this concept, businesses are not driven by profit maximisation alone, but by the pursuit of ultimate happiness in this life and in the Hereafter. Second, Islamic guidance enshrined by its principle of justice brings about a balance between the individual's rights and their duties and responsibilities towards others and between self-interest and altruism. Lastly, the concept of reward is broadened by incorporating within its reward in this world and the Hereafter. This provides a strong and self-propelling motivation for good, just behaviour, without denying one's natural instinct for personal gain.

The aforementioned principles and guidelines necessitate Islamic banks operating differently from conventional banks. The *Shari'ah* acts as an internal control over Islamic banks alongside secular legislation. Such internal control should make Islamic banks more sensitive towards CSR and environmental risk management than conventional banks.

3.3 Justice in Islam

Islam is a religion that emphasises justice. Graafland et al. (2006) relate the principles of justice in Islam to several types of business activity. First, justice includes the fulfilment of promises, pacts and contracts. Therefore, Muslims should be honest, sincere and truthful in their business dealings, and ensure exactness in terms of promised products and specifications. Second, justice encourages equal treatment in labour management. Hiring people and wage payment should be based on merit and competencies. Finally, justice in Islam also includes the equitable distribution of wealth. In the *Quran* there are several verses that discuss justice:

> *"We sent aforetime Our messenger with clear signs and sent down then The Book and the Balance (of right and wrong), that mankind may establish justice" (Quran 57:25).*
>
> *"Allah commands justice, the doing of good (equity), and charity to kith and kin, and He forbids all shameful deeds and injustice and rebellion: He instructs you, that you may receive admonition" (Quran 16:90).*

Besides the above, Islam promotes justice and the equal treatment of all living beings. Based on the principles of justice, Muslims need to be fair, not only amongst themselves but also in their dealings with others and even with their enemies (Zinkin, 2007).

The concept of vicegerency also implies that human beings are equal, except on the basis of piety and good character (Dusuki, 2008). As vicegerents in this world, the concept of justice is important as humans are not only responsible to God but also to society and the natural environment. Thus, they must not only consider every act and decision for their own self-interest but also for society and the natural environment. Kamla et al. (2006) indicated that human beings' responsibility towards nature is not only related to benefits for themselves, it is a comprehensive responsibility which includes society and future generations, and extends to the valuation of nature itself, irrespective of man's or other creatures' use of it. Based on this concept, Islamic organisations are expected to be more proactive in natural environmental management than conventional organisations. Do they consider Islamic principles in their CSR practices? This study endeavoured to answer this question as previous research by Zinkin (2007) found that

Muslims' score on CSR practices was lower than that of other religious groups.

For Dusuki (2008), human interactions should be based on trust, equity and justice. The right attitude of human beings is not to serve only one's own or the national 'self-interest', but to cooperate with others to fulfil basic needs, to develop the entire human potential, and to enrich human life as a whole.

In economic activities, in order to achieve social justice in society, Islam provides a foundation for establishing socio-economic justice and therefore social responsibility. For example, Islam imposes obligatory payment of income and wealth (*zakat*), philanthropic trusts (*waqf)*, alms and charity (*sadaqah*), and interest free loans (*Qard al Hassan*). To ensure socio-economic justice, *zakat* is compulsory in Islam and is one of its five pillars. Non-fulfilment of this requirement is a sin and results in punishment in the Hereafter. Economic competition is encouraged as long as it is healthy, raises efficiency, and helps promote human well being.

According to Abeng (1997), there are six matters of justice that need to be fulfilled by Islamic business organisations in daily business activities:

1. Fulfilment of promises (pacts and contracts, verbal and written).
2. Exactness in weights and measures (specifications) in all business related items, including work, wages and payment, and labour movement.
3. Truthfulness, sincerity and honesty.
4. Efficiency, for example, jobs should be carried out without any lapse or omission, with best planning, and to the best of one's ability and competency.
5. Selection of merit.
6. Investigation and verification. These are essential because they constitute a prelude to right and ethical conduct.

Based on the concept of justice, Beekun and Badawi (2005) divided stakeholders in Islam into three main categories based on their priority in a business. First are those who are directly and substantially affected by the success and failure of the business. Owners and employees come under this category. The second category refers to those who are affected by the success and failure of the business and its activities, such as suppliers, customers and government. In the third category are those who are subject to the externalities of the business. The environment and community are grouped under the third category.

3.4 Benevolence *(Ihsan)* Concept

The concept of benevolence in Islam complements the concept of justice in Islam. Beekun and Badawi (2005) defined benevolence in Islam as to an act which benefits persons other than those from whom the act proceeds without any obligation. The *Quran* clearly states the requirement of justice and benevolence:

> *"Verily Allah Enjoins justice and worshipping none but Allah alone and Al-Ihsan and giving help to kith and kin (i.e. all that Allah has ordered you to give them such as wealth, visiting, looking after) and forbids Al-Fahsa (i.e all evil deeds such as illegal sexual acts, disobedience to parents, to kill a life without right) and Al-Munkar (all that is prohibited by Islamic law) and Al-Baghy (All kinds of oppression). He admonishes you, that you may take heed" (16:90).*

Al Qurtubi (1966, cited by Beekun and Badawi, 2005) classified justice as mandatory and benevolence as being beyond the mandatory. To adhere to the concept of justice, a person's inner intentions and feelings should be consistent with his/her declared words and actions. The concept of benevolence beyond the concept of justice requires the person's inner intentions and feeling to be better than his or her outward actions.

4. Islamic Banking Business Characteristics

Riba or interest is the common factor that differentiates Islamic banking from conventional banks. One of the reasons for the establishment of Islamic banks was to avoid interest in banking transactions (Samad and Hassan, 1999). Much of the literature states that one of the major reasons for the establishment of Islamic banking was to provide an interest free banking system (Khan, 1987; Ariff, 1988; Gerrard and Cunningham, 1997; Samad and Hassan, 1999; Dar and Presley, 2000; Lewis and Algaoud, 2001; Rosly and Bakar, 2003; Dusuki and Abdullah, 2007b; Nathan and Ribiere, 2007).

Interest in Islam is defined as predetermined return on capital (Nienhaus, 1986). For Lewis and Algaoud (2001), interest refers to the addition to the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. Rosly and Bakar (2003) indicated that interest may occur as a contractual increase arising from a loan, whether in money or barter. With *riba*/interest, there is no risk of loss (Gerrard and Cunningham, 1997). Ahmad and Hassan (2007) defined *riba* based on the *Shari'ah* and *Fiqh* perspectives. *Riba* in the *Shari'ah* technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. In the *Fiqh*, *riba* means an increase in one or two homogenous equivalents being exchanged without this increase being accompanied by a return.

Ariff (1988) and Ahmad and Hassan (2007) pointed out that prohibition of interest is mentioned in four different revelations in the *Quran*. First, the *Quran* states that interest will deprive the one taking it from the wealth of God's blessings. Second, imposing interest is wrongful and inappropriate. Third, Muslims are enjoined to avoid interest for the sake of their own welfare and, last, a clear distinction is established between interest and trade. The prohibition of interest is also cited in the *Hadith* (the sayings of the Prophet).

Interest is prohibited in Islam due to its negative effect on society and the economic system. Interest is viewed as an act of exploitation and injustice and as such is inconsistent with Islamic notions of fairness and property rights (Lewis and Algaoud, 2001). Siddiqi (1983) discussed the serious consequences of bank financing based on interest. A business may incur losses arising from difficulties in repaying both the principal and the stipulated interest, and have to make up the deficiency from its assets. This is why the concept of interest is related to injustice. Siddiqi (1983, p. 25) stated:

> *"If the results of the enterprise are uncertain due to the nature of the world, the supplier of capital should be guaranteed a fixed positive return rather than the burden of uncertainty, in the form of loss, falling entirely on the entrepreneur."*

The same situation is faced by the lender (depositor) in a conventional bank, especially when the return on their deposit, which has been channelled by the bank to entrepreneurs, is not commensurate with the actual performance of the investment (Lewis and Algaoud, 2001; Dusuki and Abdullah, 2007b). Thus, the prohibition of interest is Islam's response to arresting social imbalances arising from inequitable distribution of income created by the credit system.

Given the above, Islamic banks deliver a set of distinctive products in the financial market (Gerrard and Cunningham, 1997; Samad and Hassan, 1999). As an alternative, profit and loss sharing (PLS) contracts has been introduced to substitute for interest in banking activities. Profit and loss sharing (PLS) contracts is predominantly based on the *mudarabah* (profit-sharing) and *musharakah* (joint venture) concepts of the Islamic contract (Chong and Liu, 2010). There is a partnership between the Islamic bank and its depositors on the one side and between the bank and its investment clients on the other. An Islamic bank does not charge interest but participates in the yield resulting from the use of funds, and the depositors share in the profits of the bank according to a predetermined ratio (Lewis and Algaoud, 2001). Hasan and Dridi (2010) summarised the relationship between Islamic banks and their customers compared with conventional banks and their customers as follows:

Table 2 Risk Sharing and Risk Transfer

Islamic Banks	**Conventional Banks**
Sources of Funds	**Sources of Funds**
Investors (Profit sharing investment account) holders share the risk and return with Islamic banks. The return of the investment is not guaranteed and depends on the bank's performance.	Depositors transfer the risk to the bank, which guarantees a pre-specified return.
Uses of funds	**Uses of funds**
Banks share the risk in PLS contracts.	Borrowers are required to pay interest independent of the return on their project. Banks transfer the risk through securitisation or credit default swaps. Financing is debt-based.

Sources: Hasan and Dridi (2010)

Ariff (1988) contended that profit sharing can help allocate resources efficiently as the profit sharing ratio is influenced by market forces so that capital will flow into those sectors which offer the highest profit-sharing ratio to investors. At the same time, PLS contracts lead to a more efficient allocation of capital as the return on capital and its allocation depend on the productivity and viability of the project (Chong and Liu, 2010). Accordingly, Islamic bank activities through PLS contracts can contribute to achieving a just, fair and balanced society as envisioned by Islamic economics (Dusuki and Abdullah, 2007b).

In addition to the above cited advantages, Chong and Liu (2010) offered the following:

1. Through the PLS paradigm, the assets and liabilities of Islamic banks are integrated in the sense that borrowers share profits and losses with the banks, which, in turn, share profits and losses with the depositors.
2. The risk sharing feature of the PLS paradigm, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher-return profiles and thus to promote economic growth.
3. The PLS paradigm creates greater market discipline. Islamic banks are required to put more effort into distinguishing good customers as they have more to lose than conventional banks. Depositors are required to choose their banks more carefully and to monitor the banks more actively to ensure that their funds are being invested prudently.

Islamic banks must also be free from *gharar* and *maysir*. *Gharar* refers to speculation and uncertainty. To avoid *gharar* transactions, every contract in Islamic banking must be well defined and without ambiguity (Chong and Liu, 2010). For example, the sale of fish from the ocean that has not yet been caught is prohibited. One of the reasons for the prohibition of *gharar* is to protect the weak from being exploited. Due to the *gharar* term in contracts, one party cannot exploit another party and one party cannot acquire profit if the other party does not.

According to Imam and Kpodar (2010), *maysir* refers to uncertainties which are not part of everyday life, such as gambling or going to the casino. Entrepreneurship can also be interpreted as a form of gambling, however, unavoidable risk is permitted. *Maysir* (gambling) and *gharar* are inter-related. Where there are elements of *gharar*, elements of *maysir* are usually present (Institute of Islamic Banks and Insurance, 2011). For example, *maysir* exists in a contract between the policy holder and insurance company when the policy holder contributes a small amount of premium in the hope of gaining a larger sum. The policy holder loses the money paid for the premium when the event that has been insured for does not occur. The company will be in deficit if the claim is higher than the amount contributed by the policy holder.

Islamic banking also differs from conventional banking as it must ensure the entire operations of the business comply and are in accordance with the *Shari'ah* regulations (Khan, 1987; Ariff, 1989; Lewis and Algaoud, 2001; Rosly and Bakar, 2003; Ahmad and Hassan, 2007; Nathan and Ribiere, 2007; Dusuki, 2008; Hassan and Latiff, 2009; Chong and Liu, 2010; Hasan and Dridi, 2010; Ullah and Jamali, 2010). Therefore, Islamic banks only allow the financing of *halal* (legal) activities. For example, they are not supposed to lend to companies or individuals involved in activities deemed to have negative impacts on society, such as projects that have a negative impact on the natural environment and are illegal under Islamic law. This would include, for instance, financing construction of a plant to makes alcoholic beverages or a business that is involved in gambling activities (Dusuki and Abdullah, 2007a; Nathan and Rebiere, 2007; Imam and Kpodar, 2010).

Islamic banks are also obliged to pay *zakat*. Lewis and Algaoud (2001) described the *zakat* payment as a religious levy and as almsgiving by an Islamic institution that is beneficial to society. The *zakat* payment is a mechanism to achieve justice, equality, and a minimum standard of living in society (Imam and Kpodar, 2010). Additionally, the zakat payment enhances productivity in economic activities. For example, Rosly (1989) stated that the *zakat* payment acts as a penalty on banks for not mobilising investable funds for productive use. If there is less money in circulation this will lead to lower production, high unemployment, and reduced incomes.

Islamic banks can also be differentiated from conventional banks based on their management structure. From the management perspective, Islamic banks are under a different corporate governance structure since they are obliged to appoint a board comprising Islamic scholars called the *Shari'ah* Supervisory Board (SSB) (Nathan and Ribiere, 2007). The objectives of the SSB are to ensure Islamic banks operate in conformity with the *Shari'ah* and to minimise risk (Rammal, 2006). If the terms agreed in a contract do not effectively comply with Islamic jurisprudence they are not valid under Islamic law. SSB members' existence ensures the audit systems in Islamic banks encourage them to strictly follow and abide by Islamic principles. Any divergence from Islamic principles can expose Islamic banks to non- *Shari'ah* compliance and heavy penalties. Accordingly, with regard to CSR management issues, especially natural environmental risk management, Islamic banks are expected to show more comprehensive and active management.

In general, the characteristics and differences between Islamic banks and conventional banks are as Table 2. This table is based on work carried out by Ahmad and Hassan (2007) and Dusuki (2008) who examined in detail the characteristics of and differences between Islamic banks and conventional banks.

Table 3: The Characteristics of and Differences between Islamic banks and Conventional Banks

	Islamic Banks	Conventional Banks
1.	Are based on the principles of the Islamic *Shari'ah.* Functions and operations are guided by sources of the *Shari'ah,* namely the Quran and the Sunnah (traditions of the Prophet Muhammad p.b.u.h)	Based on man-made principles. Functions and operations are guided by secular principles and not based on any religious doctrines and values
2.	Investment based on risk sharing between the provider of capital (investor) and the user of funds (entrepreneur)	The investor is assured of a predetermined rate of interest
3.	Profit maximisation is allowable but subject to *Shari'ah* restrictions	Profit maximisation without any restriction
4.	*Zakat* obligation	No *zakat* obligation
5.	Participation in partnership business is the fundamental function of the banks	Lending money and getting it back with interest is the fundamental function of the banks
6.	The banks have no provision to charge any extra money from defaulters	Banks can charge additional money (compound rate of interest) in the case of default
7.	The PLS paradigm of the banks' operation makes the banks pay greater attention to developing project appraisal and evaluations	Since income from advances is fixed, banks attach little importance to developing expertise in project appraisal and evaluations
8.	Islamic banks give greater emphasis to the viability of projects	Banks place greater emphasis on the credit-worthiness of clients
9.	The bank and client relationship is considered to be between partners, investors and traders.	The bank and client relationship is considered to be between creditors and debtors.
10.	Islamic banks need to show social and economic responsibility by paying *zakat* (a compulsory religious levy) out of their income	There is no requirement to perform charitable acts.
11.	Islamic banks are prohibited from participating in economic activities which are unethical and prohibited by the *Shari'ah* such as financing businesses involving alcohol, prostitution, pork, environmental pollution, etc.	There is no such restriction

Source: Dusuki (2008) and Ahmad and Hassan (2007)

From the above, it can be concluded that Islamic banks differ from conventional banks in three main areas: (1) principles; (2) products; and (3) management. In terms of principles, the main difference concerns *riba*. *Riba* is prohibited in Islam and, because of this, Islamic banks have introduced profit and sharing (PLS) contracts whereby they do not charge interest but participate in the yields resulting from the use of funds and depositors share in the profits of the banks according to a pre-determined ratio. PLS contracts therefore create a different relationship between customers and Islamic banks. Customers play an active role as they are partners in the banking business. Moreover, as stakeholders, they are more sensitive to banks' activities, especially with regard to CSR. As a result, Islamic banks are expected to have stricter natural environmental risk evaluation procedures than conventional banks in CSR and to show more proactive CSR practices.

5.Islamic Banks and Corporate Social Responsibility (CSR)

The establishment of Islamic banks was due to criticism of conventional banks charging interest on their banking activities. The practice of interest has been reported to have a negative effect on the development of the socio-economic system (Siddiqi, 1983; Ariff, 1988; Lewis and Algaoud, 2001; Ahmad and Hassan, 2007). Chong and Liu (2010) state that the prohibition of interest or *riba* in Islam can be viewed as part of Islam's general vision of a moral economy.

Thus, Islamic banking was introduced as an alternative to conventional banking. Islamic banks have a strong responsibility to society, to establish a fair distribution of income, justice in the economy, and efficient capital mobilisation. These requirements clearly suggest that Islamic banks should display a strong fundamental sense of social responsibility towards society. The present study's examination of the corporate social responsibility of Islamic banks was therefore important in order to establish whether their CSR practice is in accord with the spirit of their establishment.

Islamic banks' commitment to CSR can be decoded through the philosophy underlying their establishment. According to Dusuki and Abdullah (2007b), Islamic banking rests on three main philosophies which distinguish it from its conventional counterpart. First, Islamic banking strives for a just, fair and balanced society, as envisioned by Islamic economics. Second, Islamic banking is constructed upon the principles of brotherhood and cooperation, and a system of equity sharing and stake taking. Last, as a system grounded in the ethical and moral framework of the Islamic law of the *Shari'ah*, Islamic banking is characterised by ethical norms and social commitments.

Ahmad and Hassan (2007) have indicated that one of the missions of Islamic banks is to work towards the establishment of an Islamic society and to create a deepening of the religious spirit among the people. Islamic banks' existence is based on the religious view and spirit. Thus, Islamic banks must ensure that their activities adhere strictly to the rules of the Islamic *Shari'ah*. They must ensure that all actions and business activities reflect Islamic principles.
For these reasons, Ahmad and Hassan (2007) have contended that Islamic banks' obligations towards society are greater than those of conventional banks for the following three main reasons:

1. An Islamic bank has a certain philosophical mission to achieve. According to Islamic principles, Allah is the creator and ultimate owner of all resources. Humans and institutions have a vicegerency role to play in society. Therefore, Islamic banks are not free to do as they wish, rather they have to integrate moral values with economic action.
2. An Islamic bank has to provide credit to those who have talent and expertise, thereby strengthening the economic foundations of society.
3. An Islamic bank should aim to create harmony in society based on the Islamic concept of sharing and caring in order to achieve economic, financial and political stability.

The activities and operations of Islamic banks are not only based on government rules and regulations but, at the same time, must comply with the *Shari'ah* law. Therefore, Islamic banks' permissible activities are limited compared to those of conventional banks which are not subject to such restrictions, instead being obliged to comply solely with legislation and not with additional religious obligations. Any activities that contradict Islamic values and principles must be avoided. Thus, Islamic banks should not invest in companies that violate human rights and damage the natural environment (Ullah and Jamali, 2010). Moreover, Islamic banks are not allowed to finance any enterprise involved in activities relating to pork, pornography, tobacco, gambling, and alcoholic liquor (Nathan and Ribiere, 2007). As a consequence, Islamic banks bring ethical values and corporate social responsibility to banking practices simply because they are required to abide by Islamic law and the *Shar'iah,* which are loaded with moral values (Kahf, 1999; Dusuki and Abdullah, 2007b).

While the above principles restrict Islamic banks' activity, they support Islamic banks' core values and activities that cultivate entrepreneurship, trade and commerce, and bring societal development or benefit (BNM, 2010). Khan (1987) indicated that these core values are one of the major principles underlying Islamic banking. Thus, the contribution of Islamic banks to CSR practice is important.

The *zakat* payment obligation also shows the commitment and contribution of Islamic banks to CSR. As has been discussed in previous sections in this chapter, the *zakat* payment is an important tool for redistribution of income. Moreover, it contributes to better and more efficient economic development of the country. Thus, Islamic banks that are driven by religious philosophy should, theoretically, evidence more ethically-founded CSR policies than conventional banks given the additional religious prerequisites to their activities.

As previously discussed, the concepts of profit and loss sharing (*mudarabah*) and joint venture (*musharakah*) ensure that Islamic banking transactions are interest free transactions and comply with the *Shari'ah's* requirements. However, Chong and Liu's (2010) study on Islamic banking in Malaysia suggested that Islamic banking, as it is practised today in Malaysia, tends to deviate substantially from the profit and loss (PLS) paradigm for the following reasons:

1. Only 0.5% of Islamic banking financing is based on PLS (*mudarabah* and *musharakah*). Islamic banking financing is still based largely on non-PLS modes of financing (*murabahah,* etc.). Even though non-PLS modes of financing are permissible under the *Shari'ah*, these types of financing ignore the spirit of the usury prohibition.
2. While 70% of deposits are based on the *mudarabah* concept, Chong and Liu (2010) found that Islamic deposits are not really interest-free, but are similar to conventional bank deposits. Islamic bank deposit PLS practices are closely pegged to the deposit rate setting practices of conventional banks.

6. Conclusion

Since the aforementioned Chong and Liu (2010) study suggests that current Islamic banking activities deviate from the Islamic spirit, and their implementation and practice are no different from those of conventional banking activities, a study of the current practice of Islamic banking was important to identify if differences exist between Islamic banks and conventional banks. In this way the correlation between theory (compliance with religious norms) and practice can be ascertained. It was also important to study if and how Islamic teachings and views have impacted upon Islamic banking activities.

Ullah and Jamali (2010) contended that Islamic ethical principles provide a broader framework for CSR and should motivate Islamic banks to actively pursue it. Islamic banks should also have a greater affinity to CSR because they are guided by strong religious/ethical principles and obligated to adhere to these principles.

Importantly, Islamic principles must be translated into action and actual practice in Islamic banks' activity. If not, such principles and guidance become theoretical only. A recent study by Chong and Liu (2010) found that Islamic banking practices in Malaysia do not much differ from those of conventional banks and therefore concluded that Islamic banks exist in theory only. In CSR especially in natural environmental management, Sairally (2007) reported that the issues appear to be of minor concern.

The rapid development of Islamic banks in the world also requires an instructive examination of their CSR practices. It has been argued by Dusuki and Abdullah (2007a, p.145) that Islamic banks should play a leading role in CSR implementation such as environmental risk management, human resource development, human rights and community development. Therefore, it is advisable for the future study to be conducted empirically to measure and compare the performance of CSR between conventional and Islamic bank institution.

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