

Environmental Disclosure of Islamic Financial Institutions (IFIs): Preliminary Evidence from Malaysia

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Abstract

Preservation of the natural environment is one aspect of social responsibility that is expected to be undertaken by Islamic Financial Institutions (IFIs) consistent with the Islamic perspective of corporate social responsibility (CSR) where human beings are regarded as *'khalifah'* (vicegerent on earth) and are required to take care of the natural environment entrusted to them. Using a sample of thirty-seven (37) IFIs, this paper presents preliminary findings on the environmental disclosure of IFIs in Malaysia for the year 2010. The results gleaned from this study revealed that environmental disclosure amongst IFIs in an emerging economy such as Malaysia is still low. The findings from an investigation into the key areas of environmental disclosure revealed that the focus of the IFIs in the context of environment revolves on activities toward the *conservation of the environment, environmental education* and on *environmental audit and independent verification of environmental information*. The implication of the findings from this study suggests that IFIs as capital providers and facilitators of industrial activities need to embark on a more holistic and systematic way of integrating environmental policies, procedures and processes into their overall business activities so as to improve their environmental performance and the disclosure of environmental information.

Keywords: Environmental disclosure, corporate social responsibility, Islamic financial institution

1. Introduction

1.1 Islamic Financial Institutions (IFIs) and Environmental Preservation

The growing awareness and demands among investors to invest in *Shariah* (Islamic law) compliant products on a global scale has created a flourishing Islamic capital market globally. Malaysia's participation towards the development of an Islamic capital market began in the 90s with the introduction of Islamic banks. By the end of July 2011, Malaysia's Islamic banking asset stood at RM389.3 billion or 21% of the total banking sector in the country with *takaful* (Islamic insurance) asset contributing to 8.7% of the total asset of the insurance industry. In addition, about 62.7% of the global outstanding Islamic *sukuk* (loan) issuance also originated from Malaysia (source Bloomberg, 2011). By virtue of being *Shariah* compliant, these Islamic Financial institutions (IFIs) are expected to be socially responsible in order to fulfill the collective religious obligation and to be exemplary figures to society (Farook, 2007).

Corporate Social Responsibility (CSR) from a conventional perspective has been defined from various perspectives. Bursa Malaysia for example defined CSR as *"an open and transparent business practices that are based on ethical values and respects for the community, employees, the environment, shareholders and other stakeholders"*. From the Islamic perspective, CSR revolves on the concept of ultimate accountability to God where human beings are regarded as *'khalifah'* (vicegerent on earth) and are expected to relate with other humans in order to take care of the natural environment entrusted to them (see for example Farook, 2007; Hassan and Harahap, 2010; Maali, Casson and Napier, 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010; Farook, Hassan and Lanis, 2011; Abbasi, Kausar, Ashiq, Inam, Nasar and Amjad, 2012). There have been numerous studies to measure the extent of CSR disclosure among IFIs in Malaysia (see for example Maali et al, 2006; Hassan and Harahap, 2010; Aribi and Gao, 2010; Farook et al., 2011) however, not many studies have focused on the environmental aspect of CSR disclosure among IFIs. Due to the paucity of empirical research in this area, this study specifically focuses on the environmental disclosure of IFIs in their efforts to preserve the natural environment. The aim of this study is to examine the environmental disclosure of IFIs in Malaysia for the year 2010 in order to gain insights on their involvement in the preservation of the natural environment.

The remainder of this paper is organised as follows. The next section provides the literature review while section (2) elaborates on the research methodology employed for this study. Section (3) presents the results and

discussions on environmental disclosure of IFIs in Malaysia. The final section (4) highlights the concluding comments.

1.2 Literature Review

In Malaysia, the establishment of Islamic finance traces its root back to the 1960s where initiatives and efforts were directed towards the establishment of Islamic banks in Malaysia. The IFIs in Malaysia is regulated by Bank Negara Malaysia (the Central Bank of Malaysia). Bank Negara Malaysia has also set-up a National *Shariah* Advisory Council on Islamic Banking and *Takaful* to support the Islamic finance infrastructure and to harmonise the IFIs in Malaysia. This council is the highest authority on Islamic Banking and *Takaful* in Malaysia and it assists in providing consistency and uniformity on *Shariah* rules issued by individual Islamic banks. In line with the government's aspiration to position Malaysia as an Islamic financial hub, Malaysia has also opened its door to allow foreign Islamic banks to establish their businesses in Malaysia. Currently, Malaysia's banking sector offers a variety of Islamic financial products and services.

Consistent with the Islamic principles where Islamic organisations are expected to carry out their business activities and to participate in societal development, this study aims to explore the environmental practices of IFIs in Malaysia. Empirical evidence concerning environmental practices of IFIs is still lacking. In fact, the overall CSR disclosure of organizations in developing Asian countries such as Malaysia are said to have lagged behind in terms of accountability and transparency reporting, particularly relating to the quality of CSR information disclosed (Loftus & Purcell, 2008). Therefore, in an effort to promote CSR disclosure among companies in Malaysia, in September 2006, Bursa Malaysia launched a CSR framework covering four key dimensions of CSR relating to workplace, community, marketplace and the environment. The Bursa Malaysia framework is however applicable only to public-listed companies in Malaysia including financial institutions that is public-listed. There is an increasing pressure globally for financial institutions to embark on green banking activities including in the offering of their products and services. This is despite the fact that the operation of the banking sector does not directly construct a negative impact on the environment. However, it is argued that the effects of their services such as their lending decisions may implicitly affect the environment and the local communities (Thompson & Cowton, 2004).

In fact, Strandberg (2005), describe the finance industry as:

"... the key to sustainability, as they raise, allocate and price capital and provide risk coverage, influencing access to financing and risk protection, and determining which government, business or individual activities get financed or protected against risks." (Strandberg, 2005, p. 5)

The philosophy of Islamic CSR is different from conventional CSR where CSR in Islam focused not only on the economic perspective but also incorporates the spiritual values as derived from the *Holy Quran* and the *Sunnah*. Siwar and Hossain (2009) stated that Islam is not just a religion but as a complete way of life. The Quran and Sunnah govern the way on how Muslims should live their lives and performed their activities. The three major fundamental principles where mankind plays a vicegerent role on earth, their divine accountability to God and the obligation to enjoin good deeds and forbid evils forms the premise of Islamic CSR (Farook, 2007). In this context, Muwazir et al., (2006) emphasized that as a vicegerent, leaders in Islamic business organizations are required to practice CSR essentially from the principle of *Tauhid*. In addition, Kamla, Gallhofer and Haslam (2006) stated that as a vicegerent, mankind needs to take care of the earth and the environment. Preservation of the natural environment is one aspect of social responsibility that is contained in the verses of the Quran.

Aribi and Gao (2010) conducted a comparative study between CSR disclosure of IFIs and conventional financial institutions in Malaysia. The results of their study revealed that the level of CSR disclosure among IFIs was greater than for the conventional financial institutions. Yahya et al. (2005) on the other hand, examined the level of CSR disclosure of *Shariah* approved companies in Malaysia and found that the companies disclosed about 40 percent of their social activities in their annual reports. These prior empirical research regarding CSR for IFIs were predominantly based on CSR disclosure. This study however, takes a different approach by providing a preliminary investigation on the environmental practices of IFIs.

2. Method

2.1 Sample

Islamic banking business is defined as a banking business whose aims and operations do not involve any element which is not approved by the religion of Islam (Section 2, Islamic Banking Act, 1983). This study has identified

fifty-one (51) IFIs in Malaysia. Fourteen (14) of the IFIs were excluded from the sample due to various reasons such as unavailability of annual reports or incomplete CSR information in the annual reports resulting in a sample of thirty seven (37) IFIs. A content analysis of the annual and sustainability reports for the year 2010 were undertaken to examine the environmental disclosure of IFIs in Malaysia. This sample was then sub-divided into four (4) categories in accordance to the Act regulating the IFIs, namely; IFIs regulated by the Islamic Banking Act 1983 (IBA), takaful (Islamic insurance) and retakaful (Islamic reinsurance) operator registered under *Takaful* Act 1984 (TA), financial institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA) that participate in Islamic Banking Scheme and lastly development financial institutions prescribed under the Development Financial Institutions Act 2002 (DFIA) that participate in the Islamic Banking Scheme. Table 1 presents the sample for the study sub-divided according to the Regulatory Acts.

Table 1. Sample of Islamic Financial Institutions

| Regulatory Acts | Number of IFIs |
|--|----------------|
| Islamic Banking Act (IBA) | 17 |
| Takaful Act (TA) | 7 |
| Banking and Financial Institutions Act (BAFIA) | 7 |
| Development Financial Institutions Act (DFIA) | 6 |
| Total | 37 |

2.2 Key Areas for the Environmental Dimension

The environmental disclosure investigated was sub-divided into seven (7) key areas. The nature of disclosure for each key area can either be in the form of word(s), sentence(s), picture(s) or graphic(s). This study did not quantify the number of times of occurrences for each disclosed items in any single annual or sustainability report of the companies. The following environmental disclosure index indicates the score for the disclosure of environmental information for a company j , where N is the maximum number of relevant items a company may disclose and d_i is equal to 1 if the item is disclosed and 0 if otherwise, based on the seven (7) key areas namely; *Conservation of Environment*; *Protection of Endangered Wildlife*, *Mitigation of Environmental Pollution*, *Environmental Education*, *Environmental Products/Process*, *Environmental Audit/Independent Verification Statement* and *Environmental Management System (EMS)/Policy*. The minimum possible score is zero while the maximum possible score is 7. Table 2 presents the key areas identified under the environmental dimension.

$$\sum_{i=1}^{m_j} \frac{d_j}{N}$$

Table 2. Environmental Dimension based on Key Areas

| ENVIRONMENTAL DIMENSION | |
|-------------------------|---|
| Key Areas | Conservation of Environment |
| | Protection of Endangered Wildlife |
| | Mitigation of Environmental Pollution |
| | Environmental Education |
| | Environmental Products/Process |
| | Environmental Audit/ Independent Verification Statement |
| | Environmental Management System(EMS)/Policy |

3. Results and Discussion

Table 3 presents the minimum, maximum and the mean scores for the environmental information disclosed by the IFIs for the year 2010. The results show a mean score 0.46 suggesting that the disclosure of environmental

information is still generally low as the mean score is less than 50% of the total possible maximum score.

Table 3. Mean Score for Environmental Disclosure

| | N | Minimum | Maximum | Mean | Std Deviation |
|--------------------------|----|---------|---------|------|---------------|
| Environmental Disclosure | 37 | 0 | 1 | 0.46 | 0.505 |

The environmental score of the IFIs were then sub-divided according to the different categories of IFIs in accordance to the Regulatory Acts. Figure 1 presents the mean score for the environmental disclosure sub-divided by categories.

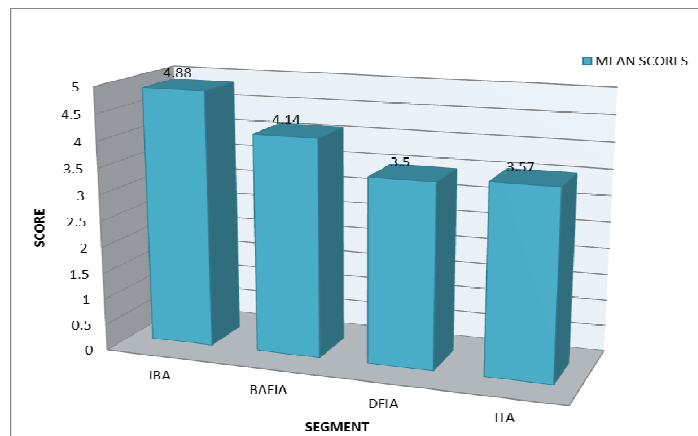


Figure 1: Mean Score of Environment Disclosure Sub-divided by Categories

The results from Figure 1 show that IFIs regulated by the Islamic Banking Act, 1983 (IBA) have the highest mean score (4.88), followed by IFIs regulated by the Banking and Financial Institution Act, 1989 (mean score of 4.14) and IFIs regulated by the Takaful Act, 1984 (TA) (mean score of 3.57). The lowest environmental disclosure was related to IFIs regulated by the Development and Financial Institution Act, 2002 (DFIA) (mean score of 3.5). The results revealed that IFIs regulated by IBA were in the fore-front in terms of environmental disclosure. This is a positive development and reflects the consciousness of IFIs in this category in terms of their responsibility towards the environment. This finding is consistent with the concept of CSR from an Islamic perspective where managers, being vicegerent of God on earth are expected to take care of the natural environment entrusted to them. The low scores for the environmental disclosure for IFIs regulated by DFIA could be due to the fact that these IFIs were focusing more on their core business as they were established to develop and promote key strategic sectors of the economy resulting in them playing a less active role in environmental activities. Figure 2 presents the mean score for the environmental disclosure segregated by key areas.

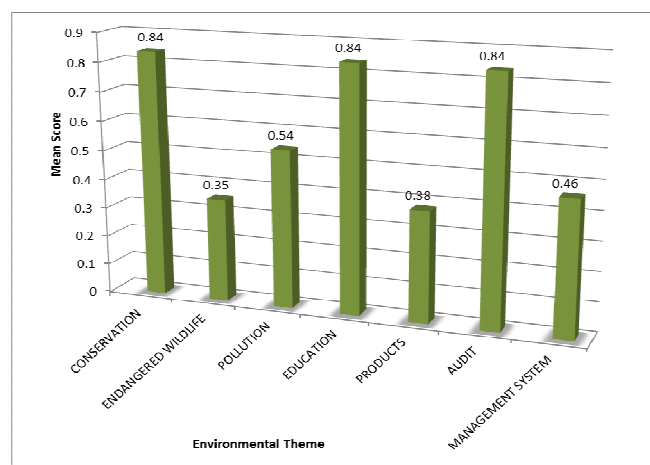


Figure 2: Mean Score of Environmental Disclosure by Key Areas

The results from Figure 2 revealed that *Conservation of the Environment*, *Environmental Education* and *Environmental Audit/Independent Verification Statement* all attained similar scores (mean scores of 0.84) and were ranked as the top three key areas receiving the most attention by the IFIs. The lowest mean score was registered by the key area relating to the *Protection of Endangered Wildlife* (mean score 0.35). The results suggest that most of the IFIs were involved in activities towards the conservation of the environment and are taking measures to educate the public on the importance of preserving the environment. The IFIs also seemed to be concerned about aspects of environmental audit and the independent verification of environmental information. The low scores for the key area *Protection of Endangered Wildlife* suggests that IFIs were putting less emphasis on efforts towards the protection of endangered wildlife which in the Malaysian environment would relate to the protection of animals such as tigers, orang utans or turtles. Table 4 presents the mean scores for each key area and the ranking of the key area.

Table 4. Mean Score and Ranking of Environment Disclosure by Key Areas

| Key Areas of Environmental Disclosure | Ranking based on mean score | | |
|---|-----------------------------|---------------|---------|
| | Mean | Std Deviation | Ranking |
| Conservation of Environment | 0.84 | 0.374 | 1 |
| Protection of Endangered Wildlife | 0.35 | 0.484 | 5 |
| Mitigating Environmental Pollution | 0.54 | 0.505 | 2 |
| Environmental Education | 0.84 | 0.374 | 1 |
| Environmental Products/Process | 0.38 | 0.492 | 4 |
| Environmental Audit/ Independent Verification Statement | 0.84 | 0.374 | 1 |
| Environmental Management System (EMS)/Policy | 0.46 | 0.505 | 3 |

The key areas relating to *Environmental Management System/Policy* (mean score 0.46) and *Environmental Products/Process* (mean score 0.38) also seemed to be receiving less attention from the IFIs in their environmental activities. This suggests that the IFIs were not managing their environmental programs in a holistic and comprehensive manner. This could be due to the nature of their business where IFIs may take the stand that the banking sector activities do not directly construct a negative impact on the environment, hence it was not necessary to have a comprehensive EMS or policy on environment. The low score for the key area on *Environmental Products/Process* also indicates that the IFIs were not incorporating environmental aspects in their product and product development processes.

4. Conclusion

This study examined the environmental disclosure of Islamic financial institutions in Malaysia for the year 2010 and presented preliminary evidence on the state of environmental disclosure of thirty seven (37) IFIs in Malaysia gathered from a content analysis of their annual and sustainability reports. IFIs formed the primary focus of this study as these financial institutions were established on the desire to run an economic system based on the values and principles of *Shariah* and are therefore expected to have a heightened sense of social responsibility. This study focused on the environmental disclosure of CSR since as vicegerent on earth, managers of IFIs are expected to take care of the natural environment entrusted to them.

The evidence from the analysis of environmental disclosure reflects that the environmental disclosure amongst IFIs is still generally low as the mean score for the disclosure is less than 50%. However, among the IFIs, the IFIs that are being regulated by the Islamic Banking Act 1983 have the highest environmental disclosure and are in the leading position. This is a positive development and is consistent with the Islamic principles because the IFIs that are regulated by the Islamic Banking Act 1983 comprised of Islamic banks, (both local and foreign) that had set up their operations in Malaysia.

The findings derived from the investigation into the key areas of environmental disclosure revealed that

Conservation of the Environment, Environmental Education and Environment Audit/Independent Verification Statement were the top three key areas receiving the most attention by the IFIs. This indicates that the focus of IFIs in the context of environment revolves on activities relating towards the conservation of the environment and environmental education. The concern on environmental audit and independent verification of environmental information suggests that IFIs have incentives to provide credible information to stakeholders. The low scores for the key areas *Environmental Management System/Policy* and *Environmental Products/Process* revealed that IFIs were not managing their environmental programs in a holistic and comprehensive manner and were not incorporating environmental aspects in their product and product development processes. In addition, the results revealed that the IFIs were also not participating in the protection of endangered wildlife as this key area had the lowest mean score.

Overall, this paper contributes to a better understanding of the environmental disclosure among Islamic financial institutions in the setting of an emerging economy such as Malaysia where organisations are still grappling with the concept of CSR. The implication of the findings from this study suggests that IFIs as capital providers and facilitators of industrial activities need to embark on a more holistic and systematic way of managing their environmental affairs in accordance with Islamic principles so as to integrate environmental procedures and processes into their overall business activities in order to improve their environmental performance and the disclosure of environmental information.

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