

Institutional Investors and Corporate Social Responsibility: The Role of Islamic Financial Institutions

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Institutional investors have emerged as an integral force in the equity market and they are pushing companies to take long-term decisions that account for the welfare of communities- corporate social responsibility in the broader sense- where they operate. One potential motivation is that institutional investors are interested in the long-term cash flows of their investments which are increasingly linked to good CSR performance. Yet, another reason is growing regulatory pressure on investment companies in some countries e.g. UK to take care of the social responsibility record of the companies they invest in. But when it comes to Islamic Financial Institutions (IFIs), social responsibility and ethical investment are embedded in the very soul of this growing financial sector. In this paper we argue that IFIs can play an important role in moulding the behaviour of corporate entities toward greater attention to CSR and ethical decisions by incorporating ethical principles in their portfolio companies.

Keywords: Corporate Social Responsibility; Institutional Investors; Islamic Financial Institutions

1. Introduction

The role of institutional investors in corporate affairs and strategic decisions of their portfolio companies has attracted more attention, in recent years, not only from researchers but also from government and regulatory bodies. Research shows that institutional investors have been successful in improving the financial performance of companies but they also play a critical role in the encouragement and promotion of Corporate Social Responsibility (CSR) (Solomon, Solomon, & Norton, 2002; Sparkes & Cowton, 2004). Being legal entities, corporations are expected to behave in a socially responsible way which not only benefits the society but also leads the company towards stability and success in the long run by securing customer loyalty (Reichheld, 2001). Institutional investors are “the majority owners of most quoted businesses” (Sparkes & Cowton, 2004) and therefore, they are expected to align the interests of shareholders with those of other stakeholders i.e. employees, customers, suppliers, environment and the whole society because “they have the power to request, and if necessary instruct, corporate executives to include social and environmental guidelines in their business objectives” (Sparkes & Cowton, 2004, p. 49)

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Institutional investors can catalyze greater engagement in CSR on the part of corporations through two different routes, either i) through more intimate involvement in their decision making processes or ii) through investing only in those companies that take social responsibility into account in their operations. The second way, although it seems to be passive, has become a crystallized philosophy of some big investment companies in recent years and has been termed as Socially Responsible Investment (SRI) by some authors (Sparkes & Cowton, 2004) or also social screening, as in the application of social criteria to investment decisions. Some previous literature has also referred to this growing trend as Ethical Investment and defined it as “the exercise of ethical and social criteria in the selection and management of investment portfolio, generally consisting of company shares (stocks)” (Cowton, 1994).

If institutional investors consider ethical investment criteria in their investment decisions, they are capable of punishing (by selling or not purchasing the shares and thus reducing the market value) companies that do not meet these criteria. The development of socially responsible indexes e.g. FTSE4GOOD, SWISS SAM, and the Dow Johns’ Islamic Index has directed increased attention to the importance of social responsibility in investment decisions. The UK market has taken the lead in socially responsible investment and some authors believe that this is because of government requirement¹ on pension schemes to state their policy on SRI in their annual reports (Solomon et al., 2002). This is the reason that SRI firms negotiate with companies “to inform them of CSR concerns held by institutional investors” (Sparkes & Cowton, 2004). The ethical investment funds exclude companies involved in tobacco, liquor, gambling, weapons, nuclear power and armaments among others (Wilson, 1997).

Islamic finance has grown tremendously over the past few decades (Lee & Ullah, 2008) with estimated assets of US\$ 800 billion (Khan & Bhatti, 2008) but at the same time, there is a dearth of literature on the application and viability of Islamic ethical values in the business world (Beekun & Badawi, 2005). We argue that the Islamic ethical principles provide a broader framework for Corporate Social Responsibility motivating IFIs to actively pursue the CSR agenda in their portfolio companies. Rationally speaking, IFIs have a greater affinity to CSR because they are guided by strong religious/ethical principles and they are bound to keep up with these values while CSR and SRI are considered to be voluntary for conventional financial institutions. This article examines the ethical principles laid down by Islamic Shari’a and identifies their implications for the social responsibility orientation of IFIs and their portfolio firms. The next section briefly reviews the relevant literature on the role of institutional investors in CSR. Section 3 sheds light on the Islamic perspective of CSR and section 4 outlines our argument in relation to the role of IFIs in promoting CSR in their portfolio companies. Section 5 presents relevant conclusions and implications.

2. Institutional Investors and Corporate Social Responsibility

Shareholders as a whole and in particular institutional investors and block holders have the ability to influence companies' decision-making processes. We have witnessed in recent years an increase in shareholder participation in corporate affairs, termed by researchers as "Shareholders' Activism" (Admati, Pfleiderer, & Zechner, 1994; Gillan & Starks, 2000; Smith, 1996). Institutional investors have emerged as more powerful influential players in corporate affairs because of their increasing shareholding in large companies (Clark & Hebb, 2004; Clark & Wójcik, 2005), especially in the Anglo-American market where UK institutional investors held 80 percent of the equity market on December 31, 2003 (Binay, 2005; Mallin, Mullineux, & Wihlborg, 2005), and the share of US institutional investors in the equity market has grown from 34 percent in 1980 to about 60 percent in 2003 (Binay, 2005). Studies conducted in other markets also reveal a high owner stake by the institutional investors in the equity markets. For example it was found that banks and affiliated institutional investors are prominent shareholders in Israeli companies (Blass, Yafeh, & Yosha, 1998). Another study conducted by Xu and Wang (1997) found the government and affiliated institutions are the most dominant investor groups in the Chinese stock market. Banking institutions are the dominant institutional investors in the German and Japanese economies as well. Some (Aoki, Patrick, & Sheard, 1993; Porter, 1992) have advocated the superiority of the Japanese bank-centred governance of companies arguing that banks "focus on long-term investment decisions" (Porter, 1992). Hoshi *et al.* (1991) add that banks also give a back-up support to financially troubled companies by providing them liquidity. A positive relationship between bank-ownership and firm value in German companies (Gorton & Schmid, 2000) also supports the findings of Porter (1992) and Aoki *et al.* (1993). Xu and Wang (1997) also found that bank-ownership has a stronger positive relationship with firm profitability in China and Sarkar and Sarkar (2000) reached the same conclusion for Indian companies. Based on this previous literature, some authors recommend strengthening the role of banks and other financial institutions in disciplining corporate executives (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). This literature suggests that institutional investors hold a significant portion of equity markets throughout the world and that they have a positive impact on their portfolio companies.

Although some Institutional investors e.g. mutual funds look for short-term returns, most of them seek stable returns on their investments in the long run in order to deliver their promises (Aguilera, Williams, Conley, & Rupp, 2006; Denis & Mcconnell, 2003). Therefore, they are interested in long-term profitability of the companies in their portfolios and hence have the incentive to get engaged in corporate strategic management rather than switching (Black & Coffee, 1994; Clark & Hebb, 2004). Given the increasingly documented positive correlations between long run health of companies and their social behaviour, institutional investors have an incentive- because they look for long term cash flows- to take the social responsibility of companies into account. Because of their expertise and strategic economic role, institutional investors are also encouraged by regulators to take active part in the governance and social behaviour of their investees.

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The UK's Combine Code (Code, 2003) for example lays down principles for institutional investors to take part in the governance of the portfolio companies by stipulating that "Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives" (Code, 2003, E.1). At the same time, the code also emphasizes on the "considered use of the votes" (Code, 2003, E.3) of institutional investors. Most of the UK's institutional investors are insurance companies and pension funds (interested in long-term cash flows); therefore, they are playing a more active role in corporate governance- and thereby social responsibility- which is not the case in the US where most of the institutional investors are mutual funds (Aguilera et al., 2006). The Combine Code also requires investment companies to declare the social responsibility components of their investment decisions; therefore, the investment companies are screening their portfolios for socially responsible companies. This is going to have a very positive impact on social activities of companies because if they don't do so, they can lose institutional investors' commitment and thereby their market value.

3. The Islamic Perspective on Social Responsibility

Religious belief is considered as a private matter in many countries (Rice, 1999) and is separated from modern business practices but, still, there is a proliferation of literature that tries to associate different aspects of business to faith (Angelidis & Ibrahim, 2004; Cavanagh & Bandsuch, 2002; Giacalone & Jurkiewicz, 2003). The recent ascendancy of the Islamic financial services industry- the application of Shari'a principles to financial practices- is an evident example of the practicality of this link. Some studies have been conducted on this association in Christianity (Jones, 1995; Lee, McCann, & Ching, 2003) and Judaism (Pava, 1997, 1998) although there is no practical application of the principles of these two religions to modern business transactions except a few faith-based funds e.g. Roman Catholics' Ave Maria Rising Dividend. We have detected nevertheless a limited but rising awareness regarding Islamic business ethics in recent scholarly research (Beekun, 1997; Graafland, Mazereeuw, & Yahia, 2006; Rice, 1999; Wilson, 1997, 2006).

Islam is a religion that guides every aspect of life including spirituality, business and social justice by encompassing an entire socio-economic system (Rice, 1999). Being based on clear ethical principles (Table 1), it restricts a number of business transactions e.g. interest, pornography, gambling, speculation, and alcohol where the justification for such restraints are anchored in considerations of social justice, equitable distribution of wealth and overcoming social evils (Usmani, 2002). While the capitalist system is based on personal interests and stresses that every possible action should be taken for achieving the monetary interests of the owners of a particular business entity (Fama, 1980; Fama & Jensen, 1983), there is a great emphasis on trusteeship (*Amanah*) in Islamic teachings and the business is considered as a sacred trust with the managers. Therefore, managers are expected to act in the owners' best interests and not indulge in any activity that can harm the owners. But this does not mean that owners and managers are allowed to use every means in pursuit of profit maximization. Even though the right to personal property and profit-making is not negated in Islam, it does not allow these objectives to be achieved at

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the expense of other stakeholders (Beekun & Badawi, 2005) and unnecessary claims on resources are to be minimized (Chapra, 1992).

Table 1
Islamic Ethical Principles

Unity	Justice	Trusteeship
-Belief in One God	-Eradication of inequity, injustice, exploitation and oppression (Rice, 1999)	-People believed as trustees of God on earth (Rice, 1999)
-The whole life is based on this unity	-No bearer of burdens can bear the burdens of another;...man can have nothing but what he strives for..." (Qura'n, 53: 38-9)	-Resources are for the benefits of all and should be acquired and consumed in the righteous way and the well-being of all should be taken into account in the disposition of resources (Al-Faruqi, 1976; Rice, 1999)
-Unity of ideas and actions (Asad, 1993)	-No cheating, uphold promises and fulfill contracts (Rice, 1999)	-All economic activities are regarded as worship conducted in the right way (Chapra, 1992)
-Relationship of brotherhood and equality (Abu-Sulayman, 1976)	-Constant circulation of wealth (Chapra, 1992)	
-All people are equal partners (Rice, 1999)	-Basic needs of the poor to be taken care of (Rice, 1999)	

Based on (Abu-Sulayman, 1976; Al-Faruqi, 1976; Asad, 1993; Chapra, 1992; Rice, 1999); Qura'n and Sunnah

Freeman (1984) formulated the stakeholder theory suggesting that owners are not the only claimants of a business entity rather there are some other stakeholders like employees, suppliers, customers, environment etc whose interests are to be protected. Freeman's theory is quite in line with the Islamic justice system but the difference is that Islam gives each stakeholder its due right in the organization and all stakeholders are not treated equally but rather in relation to their relative stake. It is very evident from various sources that Islam supports every activity aimed at the welfare of the whole society e.g. Al-Gazali is reported to have said, "The very objective of the Shariah is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable" (SBP, 2007, p. 4).

From an Islamic perspective, stakeholders can be divided into three categories (Beekun & Badawi, 2005) based on the priority of their rights in the business; i) those who are directly and substantially affected by the success or failure of the business e.g. owners and employees ii) those who are sufficiently affected by the success and failure of the business and its activities e.g. suppliers, customers and government and iii) those who are subject to the externalities of the business e.g. environment and community. This classification is based on the Islamic system of justice where all parties are entitled to

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benefits according to their stake. The idea that all the stakeholders should have equal rights in the organization does not seem to be a just idea because owners have their money on stake in the organization and are most severely affected in case of failure; therefore they are entitled to more benefits than the other stakeholders.

Emphasis on justice and balance (referred to as *adl* and *qist* in Qur'an) in every aspect of life are explicitly mentioned in the Qur'an e.g. the Qur'an says "... Be fair for God loves those who are fair (and just)". The Qur'anic verse "Be just! For justice is the nearest to piety" (Qur'an, 5: 80) can be interpreted in this context. On another occasion the Qur'an says "Dealt not unjustly and ye shall not be dealt with unjustly" (Qur'an, 2: 279). The above verses also imply that all other stakeholders get what is just for them e.g. customers are entitled to fair prices, quality goods, information disclosure and employees are entitled to salaries, health benefits, education, share in the profits. Similarly, environment is a natural resource that belongs to all inhabitants and therefore, companies are not allowed to exploit it for their private monetary benefits because doing so is an injustice to other claimants including animals.

Based on everything we have presented, it can be argued that there are three main principles- summarized in Table 1 above- in Islamic ethics; unity, justice and trusteeship. Table 2 summarizes in turn the relationships of different stakeholders to the firm in light of these three Islamic ethical principles. It is very evident that these principles and the way they are taken up and applied vis a vis different stakeholders presents in itself an application of CSR. We argue here that Islamic ethical values are concerned with the welfare of the whole community while providing protection to the self-interest of the shareholders, which is consistent with the basic principles of CSR.

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Table 2
Obligations and rights of different stakeholders from an Islamic perspective

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

4. The Role of Islamic Financial Institutions in CSR

As discussed above, some researchers argue that CSR diverts the focus of a business entity from its sole purpose i.e. value maximization for shareholders and therefore it should be set aside. They further argue that the market forces should decide the optimal

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allocation of the scarce economic resources. But advocates of CSR emphasize that ethical and social behaviour of business entities will lead to the overall well-being of the society of which the businesses themselves are members. Religion itself is a regulator of ethical values in any society. Thus the “ethical principles of Islam do influence the decision making process in a business situation where such decisions may not be in conformity with decisions made in the economic interests of the firm” (Uddin, 2003 p. 26) and thus Islam advocates the “overall human well-being through socio-economic justice” (Uddin, 2003 p. 26) by using a “moral filter” to eliminate “unnecessary claims on resources” (Chapra, 1992 p. 200). Islam stresses on justice, balance, fairness and benevolence and every individual will be held responsible if he/she violates the prescribed principles in regard to these criteria. The Qur’an explicitly says that “Every soul will be (held) in pledge for its deeds” (Qur’an 74: 38). This verse is not only applicable to a person’s private life but also to the activities of the companies that he/she has invested in. Beekun and Badawi (2005 p. 135) argue that the “corporation as a fictitious entity does not diminish the responsibility of its owners and managers for its actions.” Thus if a person has invested in a company’s stock which goes beyond the stated principles of Islamic justice, balance, fairness and benevolence, the shareholder will be held responsible for the activities of the company. The profit from a company that is involved in prohibited (Haram) transactions is not allowed to be taken by a Muslim investor. In such circumstances, where the company is involved in Haram activities, the ethical shareholder has two options; i) force the company to align its activities with the broad stakeholder criteria or ii) sell the shares of this particular company and invest in those companies that are more socially responsible and are meeting the other Islamic securitization criteria.

Islamic individual investors generally want their corporations to be Shari’a-compliant and socially responsible but they still need the financial services and want their savings to be invested in Halal businesses. Therefore, Muslim investors invest their savings in Islamic financial institutions with the expectations that the IFIs will take care of Shari’a principles and will adhere to the Islamic system of justice and balance. The IFIs, in turn, invest the depositors’ money in a number of investment products including corporate shares. Thus they are liable to invest only in those corporations that meet the Shari’a-expectations of the depositors; the target corporations should be scrutinized on the criteria of Islamic justice e.g. they should not deal in interest, pornography, alcohol, pork, human rights violations and any other unjust activity. Nike has reportedly used child labour in its factories in Indonesia and Pakistan (Beekun & Badawi, 2005) which is obviously a violation of human rights because childhood is the age of education which is essential (Fardh) for all Muslims (men and women). Therefore, IFIs are not entitled to invest in such companies that violate human rights. Also, investment is not allowed in those companies that damage the natural environment and do not provide any compensation for it. Natural environment has been described as God’s sign on earth by saying, “Don’t you see that God sends down rain from the sky? With it, we then bring out produce of various colors. And in the mountains are tracts white and red, of various shades of colour and black intense in hue. And so amongst men and crawling creatures and cattle are they of various colors [...]” (Qur’an, 35: 27–28). Therefore it is the responsibility of every Muslim to preserve it as it is. Some may argue that environment and its associated

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benefits are free and everyone is entitled to use them but there are certain limits on the use of such resources. “Any person may make use of any thing that is free provided that in doing so no injury is inflicted upon any other person” (Al Majalla, serial no. 2486, paragraph 1254). Obviously, damaging the environment creates hazards for all its inhabitants and therefore one is not allowed to exploit it for his/her personal profits. However, if a company operates in a locality and is using its natural environment (which is the property of all the inhabitants of that area), it should compensate the inhabitants in the form of providing educational, medical, employment and other such opportunities to the locality. In addition to that, the company is also liable to produce quality goods and services and provide them to the public at fair prices, deal with its suppliers justly, meet its obligations to creditors and not exploit its workforce. The role of IFIs, here, is that they should invest only in those companies that meet these scrutinization criteria. Thus they will be building a portfolio of companies that can be classified as “Sharia-compliant portfolios” and being Sharia-compliant ultimately means socially responsible in its broader sense.

Now the question is “Can IFIs make a difference in the global investment market?” Given the fact that i) “Muslim countries represent some of the more affluent customers in the world” (Beekun & Badawi, 2005 p. 131), ii) the assets managed by IFIs are about 1 trillion US\$ at present with a double digit growth in spite of the ongoing financial crises worldwide where a number of large financial institutions have gone bankrupt (Dr. Ahmad Mohammad Ali, IDB Chief, said in January, 2009 that “Islamist-oriented finance was shielded against the global financial crisis because it was not dealing with speculations”) and iii) one fifth of the world population is Muslim (Ghouri, Atcha, & Sheikh, 2006) with an increasing number and awareness of Islamic values and investment, it is obvious that IFIs will gain a considerable share in the world’s financial system in the near future and they are likely therefore to be able to make a difference particularly in relation to CSR.

5. Conclusion

Islam is more than a religion that guides every aspect of life and so the Islamic financial institutions are expected to consider the Islamic ethical values in their investment decisions. As Islam seeks to protect the rights of both primary and derivative stakeholders, IFIs have to seek investments in companies that respect the due rights of all the stakeholders and are not involved in any kind of exploitation. IFIS are bound to observe the principles of trust (amana), equity, balance and fairness (adl and qist), benevolence and excellence (Ihsaan) in their own operations but also scrutinize the operations of their portfolio companies on the basis of these criteria. It is argued in turn that these Islamic ethical principles have a great affinity to the concept of CSR. Although IFIs currently manage a very small proportion of the world’s wealth, this sector has experienced steady growth in the past few years and is thereby attracting more attention from the global financial community. Therefore the article argues that IFIs can make a difference long-term in catalyzing and mainstreaming the CSR agenda.

At a time when Islam and the Islamic religion have attracted bad publicity with the recent movie by the Deutch MP, Geert Wilders,- this article has attempted to provide a more balanced and accurate delineation of the main principles of the Islamic religion, and their

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implications for investment decisions and also CSR. We do hope and indeed invite and encourage more research along these lines, that can highlight the interfaces of Islam and business practices and transactions in their various forms. This kind of research will no doubt be more objective and help shed light on the true essence of the Islamic religion, and its far reaching implications, particularly when reconciled with various practical aspects of business. Both Islam and CSR have humanitarian underpinnings, and the linking of the two concepts will no doubt result in positive synergies, that we have attempted to sketch briefly in this paper. More research along these lines is welcome, and is likely to add value in a time and era when Islamic principles are being tarnished and distorted to the sadness of all informed and faithful Muslims worldwide.

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