Abstract

Over the past few decades, the provision and use of Islamic financial products and services has grown dramatically around the world. However, while there is now a wider understanding of the objectives for these products and services from the perspective of Shariah (Islamic law), less is known about the inherent social objectives of Islamic finance, many of which it shares with the social responsibility movement more broadly. This chapter provides a comprehensive review of the literature on social responsibility in Islamic finance and Islamic financial institutions. It outlines the religious background that supports the concept of social justice in Islamic finance, discusses the risks faced by Islamic finance-based institutions and investors, and how these risks encourage them to incorporate social responsibility in their behaviour. Finally, the chapter discusses the increasing pressures for these institutions to engage in socially responsible activities and the extent that these are incorporated into mainstream social responsibility frameworks.

Keywords: Islamic finance, social responsibility, social responsibility frameworks, Islamic financial institutions

1 Introduction

Over the past few decades, the provision and use of Islamic financial products and services has grown dramatically around the world. However, while there is now a wider understanding of many of the objectives for these products and services from the perspective of Shariah (Islamic law), less is known about the inherent social objectives of Islamic finance, many of which it shares with the social responsibility movement more broadly.

The principles of Islamic finance, as defined by Shariah, prescribe that among other things, finance must serve society. These revolve around the axioms of Islamic ethical philosophy, which comprises the concepts of unity (tawhid), justice or equilibrium (al-'adl), freewill or freedom (ikhtiyar), responsibility (fard) and benevolence (ihsan). Further, because Shariah prohibits usury (the receiving and paying of interest), Islamic finance is equity-based and therefore shares a common thread with community and ethical banking and with socially responsible investing. Islamic finance therefore requires a balance between financial and social objectives that necessitates a disciplined approach toward long-term sustainability.

In this chapter, we begin by considering the social dimension of Islamic finance, as it presently exists in the various products and services. We outline the religious background for these beliefs and the expectation of how the characteristics of each product and service benefit society. Apart from the societal benefits of debt-alternative finance, we particularly focus on social responsibility as demonstrated in Islamic managed funds.

We then discuss the various risks faced by Islamic financial institutions, firms, and individual and institutional investors and how these incorporate issues of social responsibility in their behaviour. Finally, we discuss the increasing societal pressure for
banks, nonfinancial firms, and investors to act responsibly toward the community and how the environment has translated into businesses engaging in socially responsible activities. Lastly, we examine how well Islamic financial and nonfinancial institutions are incorporated into existing national and international socially responsible frameworks.

2 The social dimension of Islamic finance

Islamic finance is part of a broader Islamic economic system regulated by Shariah, with the main sources being the Holy Quran and Sunnah. Shariah guides all Muslim activities, which reflect Islamic moral and ethical values. The overall objective of Shariah is to promote the wellbeing of humankind, which lies in safeguarding its faith (din), life (nafs), intellect (‘aql), progeny (nasl) and wealth (mal). This responsibility falls on the shoulders of the Islamic economic system, specifically, Islamic financial institutions.

The social dimension of Islamic finance exists in various products and services offered by Islamic financial institutions. Primarily, finance must serve society. The social dimension of Islamic finance is embedded in the Islamic ethical philosophy and the foundation of the Islamic economic system, which comprises the concepts of unity (tawhid), justice or equilibrium (al-‘adl), freewill or freedom (ikhtiyar), responsibility (fard) and benevolence (ihsan) (Beekun and Badawi, 2005; Naqvi, 1981). This foundation provides guidance to all aspects of human life, including economic activities and financial practices, for individuals, organisations, governments, and society as a whole.

The concept of unity (tawhid) refers to the recognition of the oneness of Allah (the God) and the role of man as a vicegerent on earth, also referred to as the vertical dimension of Islam wherein it deals with the relationship between human beings and Allah (Naqvi, 1981). Allah is the creator and the owner of the universe and human beings as trustees are entrusted to use and manage the resources wisely in accordance with Allah’s will as prescribed in Shariah. In the sight of Allah, all individuals are equal, save their piety and righteousness (Dusuki, 2008).

In addition to a responsibility toward Allah, human beings are also responsible to society (people) and the environment (planet), the so-called horizontal dimension of Islam (Naqvi, 1981). This is the concept of justice or equilibrium (al’adl), which emphasises that all individuals have a responsibility to contribute to social justice. This responsibility to society includes both a balance between those who have and those who have not, and individuals are entitled to equal treatment in their dealings, regardless of their status, race, religion or gender (Zinkin, 2007). The responsibility to the environment is to preserve the environment for future generations.

Despite the fact that Shariah regulates human beings, there is the freedom (ikhtiyar) to choose the way they desire to lead their own life, to decide the best behaviour they would like to follow, to use their own capabilities, and to utilise any economic resources in this world. That is, they have the ability to think and make judgements. For those who adhere with the prescribed rules and guidelines, they will behave ethically, acknowledging that they have a responsibility towards Allah, themselves, society and the environment.

Following the concept of freewill, the concept of responsibility (fard) aims to make human beings ultimately accountable for their actions. The implication is that the achievement of social justice is not for individuals alone, but mandatory for all human beings. Thus, all individuals need to be conscious of their actions, as they will be held responsible for the consequences of their actions on the Day of Judgment (Farook et al., 2011; Graafland et al., 2006).
Benevolence (ihsan) is an act that benefits persons other than those from whom the act proceeds without any obligation (Beekun and Badawi, 2005). In other words, the doer does the actions without any expectation of rewards and this action benefits others. Unlike justice, which is mandatory, benevolence lies beyond the mandatory (Qurtubi, 1966 as cited in Beekun and Badawi, 2005). In order to achieve socioeconomic justice, human beings are obliged to bring about justice, and at the same time, observe the principle of benevolence.

Further, Shariah prohibits riba (usury/interest), gharar (uncertainty), maysir (gambling), and other impermissible activities, such as those related to pork, tobacco, and pornography, and clearly stated in the Quran and Sunnah. The implication is that many interest-based products and services provided by conventional financial institutions are not permissible. Interest means making money from money. In Islam, money is not to serve as an asset or a commodity to generate profits, as it is purely a medium of exchange to create social value rather than wealth. Islam also encourages equity participation in business activities, implying the sharing of both business risks and profits.

Islamic finance also prohibits any element of gharar (uncertainty) in any business dealings. Examples of gharar are uncertainty in relation to the quantity, quality, deliverability, and existence of assets. In order to avoid risk, Islam requires transparency, such as full information disclosure in the contract, to remove any asymmetric information and rejects excessive risk taking or suggestion of speculation. Concomitantly, any financial transactions should link to some physical economic transaction.

Other social dimensions of Islamic finance include the obligations of Muslims and Islamic institutions to pay zakat. The recipients of zakat contributions, as specified in verse 9:60 of the Quran, include the poor, the deprived, those unable to pay their debts, destitute travellers, and those on the path of Allah. This injunction obliges Muslims to provide social safety to the needy. In addition, Islam also encourages Muslims to participate in voluntary donations or sadaqah to help these vulnerable groups.

2.1 Societal benefits of debt-alternative finance

The main implication of the prohibition of interest under Shariah is debt alternative finance in the form of risk and profit sharing. In practice, risk is the volatility (or standard deviation) of the net cash flows of a firm. In Arabic, a similar word to risk is mutakharah, which means, “…the situation that involves the probability of deviation from the path that leads to the expected or usual result” (Elgari, 2003). The definition implies that risk is uncertainty about the future and therefore is a possibility a business will bear losses as well as profits. One of the differences between Islamic and conventional finance is this concept of risk. While the former advocates risk sharing, the latter promotes risk shifting or transfer.

The foundation for profits in Islamic finance is al-ghumn bil-ghurm which means “…one is entitled to a gain (profit) if one agrees to bear the responsibility for the loss (risk)” (Rosly and Zaini, 2008). Thus, compensation without bearing any kind of risk is impermissible. On this basis, Islamic law prohibits riba, but still encourages trade, as it is the predetermined repayment in addition to the principal, which increases contractually over the length of time outstanding to the creditor.

Thus, as capital providers Islamic financial institutions become partners and investors in the businesses owned by entrepreneurs. As business partners, Islamic financial institutions share any profits or losses. This arrangement benefits the entrepreneur as it provides the flexibility needed to repay capital from the project cash flows. This also benefits the project as it reduces project risk and enhances the prospects of a successful outcome. Besides, it also
promotes cooperation between Islamic financial institutions and entrepreneurs, contributes to economic and societal wellbeing, and avoids the exploitation of any party to the transaction.

This contrasts with conventional banking, which employs a creditor–debtor relationship. In this relationship, there is a guarantee for financial institutions as creditors of income from any capital lent to others without risk. That is, entrepreneurs, as debtors, still have to pay interest even if the project is unsuccessful and loses money. Thus, by providing money today for more money in the future, the financial institutions effectively transfer risk to the entrepreneurs.

In addition, it is a widespread feature that a conventional financial institution will require collateral for a loan or credit contract. The basic argument is that the purpose of this is “to create a strong relationship to the lender” and that it benefits the borrower in the case of financial distress (Elsas and Krahnen, 2002). However, if fully secured, the loan contract is free from default risk. In this case, “…the interest income which is acquired by the lender is without potential losses since there is no uncertainty about loan recovery when the borrower fails to pay up” (Rosly and Zaini, 2008). The lender then creates wealth by assuming no risk but instead transferring all risk to the borrower, a feature totally prohibited in Islam. In Islamic finance, the only type of borrowing permitted is interest-free borrowing, known as Qard Hassan, a form of benevolent loan given to those in financial hardship in an attempt to alleviate severe poverty.

2.2 Socially responsible Islamic managed funds

The ethical and social responsibility demonstrated by Islamic managed funds (IMFs) make them potentially attractive to not only Muslim investors, but also other socially and ethically conscious investors desiring a socially just financial and capital market. The objective of Islamic managed funds is to generate a Shariah compliant portfolio with social, ethical, and environmental impact alongside some financial return.

Shariah governs every aspect of IMF investment management, including fund selection (portfolio formation, asset allocation, portfolio screening), operation of the business (investment and trading practices) and income distribution, and those concerning income purification (zakah and cleansing any impure elements through charitable giving) (Elfakhani and Hassan, 2005). The unique features of IMFs lie in three main elements. These are the presence of Shariah advisory boards (SAB), the process of security selection through Shariah screening to form a Shariah-compliant portfolio, and the income purification activities.

The SAB oversees the structure of financial products and services as well as their operation to ensure compliance with Shariah. The board is responsible for closely monitoring every aspect of business activity, such as stock selection, trading, record keeping, and reporting. At the end of the financial year, the board produces a Shariah compliance report as part of the IMF’s annual report verifying that the invested funds comply with Shariah. This is one of the important elements in a Shariah governance framework, representing an additional layer of corporate governance.

Screening is the process of portfolio construction that excludes companies from the potential pool of investments for Shariah mutual funds. Typically, an IMF will apply negative screening in portfolio formation whereby it excludes the stocks of companies involved in interest, uncertainty and other prohibited activities (including short selling, derivatives and speculation) as also prescribed by Shariah. The expectation is that Shariah screening will generate long-term positive externalities for society as it acts as a risk management tool for negative externalities.
Income purification is an ex post tool used to fulfil the social obligations of mutual fund companies and investors following investment, being the process of “…deducting from the returns on one’s investment those earnings, the source of which is not acceptable from a Shariah point of view” (Elgari, 2002, p. 156). In other words, it refers to the process of taking out that portion of income derived or generated from any prohibited activities. The need to purify income arises from the nature of economic transactions in the modern world whereby the strict avoidance of prohibited activities is almost impossible. For example, if the portfolio inadvertently earns interest-contaminated income, fund managers will need to undertake income purification by donating that portion of income to charity. Islamic managed funds are also obliged to clean income through paying zakat. This also acts as a mechanism for wealth distribution and thus social welfare.

3 Risks facing Islamic financial and nonfinancial institutions and investors

Islamic financial institutions, firms, individuals, and institutional investors face various risks in conducting their daily business affairs. In order to protect themselves from these risks, they are instructed by Shariah to behave ethically and to be concerned about the impact of their investments, financing, and operations on society, the community, and the environment. Importantly, not only businesses have to be responsible for their own unethical actions, the financial institutions that provide financing or investment to these businesses are also required to be responsible for those actions.

The recent global financial crisis, corporate scandals, and accounting failures have awoken all parties to the importance of incorporating socially responsible frameworks in business policy and strategic decision making as an important risk management strategy. The benefits of incorporating social responsibility may also enhance the value of the business, avoid negative perceptions about the company, reduce incidents of reputational damage, and lower the risk of economic and financial crisis. Better human resources, customer loyalty, reduced reputational and legal risk, improved corporate reputation, and enhanced public image may result (Davis, 1973). Coles et al. (2001) also found that companies with better corporate governance enjoy higher valuations.

One of the risks that businesses and financial institutions face are reputational risks that result from brand damage from bad press and consumer boycotts, as well as dealing with the threat of legal action. A corporate reputation that took decades to establish could be lost overnight or even in a few hours if there are incidents involving corruption or environmental scandals. Thus, socially responsibility enables the avoidance of reputational risk.

A company that ignore the importance of being socially responsible may also face commercial risk involving the loss of customers to competing firms. In a situation where people are concerned about society and the environment, firms are better off acting socially responsibly. Social risks have also become a major concern for corporations. In order to mitigate social risks, many financial and nonfinancial institutions are attempting to construct a positive Islamic image (that is, being socially responsible), as a negative corporate image can have serious economic implications for the organization (Buhr and Freedman, 2001, p. 294).

Islamic financial institutions face two types of risk. These are risks concerning their financing activities similar to conventional finance, and risks related to their Shariah compliant operations. The former generic risks comprise credit risk, liquidity risk, market risk, operational risk, reputational risk, and macroeconomic risk. The latter specific risks are unique to Islamic financial institutions because of their risk sharing principles. These risks are
rate of return risk, Shariah noncompliance risk, displaced commercial risk, and equity investment risk. This suggests that Islamic financial institutions face additional challenges in fulfilling the requirement for balance between the maximisation of shareholder wealth and concern for socially responsible behaviour.

Unlike conventional finance systems where financial institutions largely transfer fund provider risk to entrepreneurs, Islamic financial institutions share these risks. Because of this, Islamic financial institutions require a modified risk management framework. For instance, the risk of moral hazard and information asymmetry are more critical in Islamic finance than in conventional finance. The problem of moral hazard arises when Islamic financial institutions are “…unable to monitor the actual efforts performed by the customers or debtors” (Dar and Presley, 2000) while information of asymmetry is critical when customers manipulate operating cost to minimise any profits shared with Islamic financial institutions (Hassan and Kayed, 2009).

In order to mitigate these risks, Islamic financial institutions are required to increase their participation in the entrepreneur’s business and implement proper monitoring. Proper monitoring helps to reduce information asymmetry, improve the social and financial performance of the business, and ensures that the business operations accord with Shariah, legal, environment and social values.

*Shariah* noncompliance risk is the most significant risk for Islamic financial institutions. These risks arise when Islamic banks fail to comply with *Shariah* principles. Noncompliance with *Shariah* has a negative impact on the image of Islamic financial institutions and increases reputational and legal risks. Examples of *Shariah* noncompliance risks include when Sheikh Taqi Usmani declared in 2007 that the majority of *Sukuk* (Islamic bonds) were not *Shariah* compliant, and when the International Council of Fiqh Academy declared in 2009 that some *tawarruq* contracts contained interest elements (Dinar Standard and Dar Al-Istithmar, 2010).

Displaced commercial risks arise when Islamic banks face commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by *mudharabah* deposits. The Islamic bank may have to forgo part or its entire share of profit in order to retain the fund providers and dissuade them from withdrawing their funds. For example, Islamic bank depositors may transfer their funds to conventional banks when the rate of return provided by the Islamic banks is significantly lower. Unlike conventional banks, which operate on a predetermined return sharing agreement with deposit holders that guarantees them principal and a fixed rate of return, Islamic banks operate a profit sharing agreement with their depositors. The profit sharing agreement exposes the deposit holders to the loss of principal, which Islamic banks are not legally obligated to indemnify. Because of this profit sharing nature, the expectation is that Islamic banks will follow a higher standard of morality and ethics, and hence forgo profit opportunities that involve any compromise on these core values.

In relation to Islamic managed funds, investors face diversification risk where the portfolio of managed funds contains more idiosyncratic risks than conventional funds due to *Shariah* screening. However, ethical screening can also be part of a fund management company’s risk management strategy. For example, avoiding unethical stocks may minimise the risk of future litigation from unethical activities such as pollution. Islamic managed funds may also indirectly benefit from avoiding high-risk speculative activities, short selling, and investment in derivatives.
Individual and institutional investors are also becoming more concerned about business activities, and the operations of firms are as much a concern as the financial performance their portfolios provide. They are especially concerned about how their investment affects the community and environment. In addition, ethical or Muslim investors seek their funds to be utilised in ethical or halal activities, respectively, in that they may potentially suffer from the risk of losing their investment if the company is involved in litigation. Therefore, investors are better off not supporting unethical behaviour, avoiding speculation, and focusing on the social impact of their investment.

Thus, investors choose Shariah or ethical investment as the screenings serve as risk management tools that limit the exposure the investor could face to activities that are suspicious and contain elements of uncertainty (gharar and maysir). While not all investment activities that link to real economic activities are included in the investment portfolio, Shariah screenings are still able to play a central role in regulating the market (Hassan and Kayed, 2009).

4 Societal pressure for businesses to act responsibly

Nowadays, there is increasing social pressure that obliges financial and nonfinancial institutions to act socially responsible or to be more responsible for their behaviour. These social pressures come from internal (employees, managers, Shariah board, shareholders) and external stakeholders (customer, consumer, regulators, NGOs, investors). As examples, these pressures could be in the form of regulation and government enforcement, consumer boycotts, media and internet campaigns, brand damage, harm to a firm’s reputation or brand equity from NGOs and social activists (Baron et al., 2009, p. 2).

Firms are attentive to these kinds of pressure as these could directly affect the firms’ market value and profits, by driving some investors away from the firm and by damaging brand equity or reputation, respectively (Baron et al., 2009, p. 2). Studies have shown that societal pressures are able to influence the behaviour of firms to act responsibly towards community. The greater the social pressure they receive, the higher would be their social performance results (Baron et al., 2009; Orlitzky et al., 2003; Refiner, 2001).

Recent financial crisis and corporate scandals (such as Enron) have made society more aware of the impact financial institutions and the corporate sector can have through their financing and investment policies. These have raised important concerns about the roles and responsibilities of financial institutions and companies, and they have begun to feel pressure from the public, government, and NGOs demanding them to act socially and environmentally responsibly. For employees, it has now become common for younger generations to look for employers that integrate social and ethical values into their business policy and operations. Socially conscious consumers, entrepreneurs, and leaders are now expecting businesses to play their role in generating social goods.

In addition, both individual and institutional investors are becoming more aware of the benefits of Shariah compliant and socially responsible investment. They are expecting that the companies in which they invest perform well both in terms of both financial and social performance and act responsibly beyond mere legal and Shariah compliance. Ethical investors are keen to know the full activities of these companies, including the impact on the environment, local communities, and the workforce. NGOs and investors are also putting pressure on customers and institutional investors, such as fund management companies, to invest in ethical companies. For example, consumer based corporate sectors such as Nike,
Walmart, and BP have recently needed to adhere to the needs of society for social responsibility.

5 Islamic socially responsible frameworks

Despite a strong social dimension in Shariah principles, there has been significant criticism of the practices of Islamic finance and nonfinancial institutions, mainly involving the divergence from theory, the overdependence on prohibition, and the lack of social disclosure.

First, one argument is that Islamic institutions continue to pursue profit maximisation and maximisation of shareholder value over their fundamental Shariah-based objectives. In evidence, despite Shariah promoting socioeconomic justice by offering profit and loss sharing financial contracts, the practice of Islamic banking institutions is more toward sales-based instead of equity-based contracts. Alarmingly, Chong and Liu (2009) found that the practice of Islamic banking differs little from conventional banking. For example, despite the fact that Shariah prohibits riba and promotes equity participation, they found that only 0.5 percent of financing involved equity participation. The divergence in the practice of Islamic financial and nonfinancial institutions from its initial philosophy to serve society has then become critical.

Elsewhere, Haron and Hisham (2005) conducted a study involving two Islamic banks in Malaysia and found that they lacked any aspect of socioeconomic development. Socioeconomic performance was measured in terms of the proportion of qard hassan (benevolent loans) dispensed, the distribution of financing by economic sector, zakah contribution, and overdrafts and activities to support the preservation of Islamic culture (Haron and Hisham, 2005). The expectation is that Islamic banks should, but frequently do not, promote charitable takaful savings plans, social impact-based investment programs, and Shariah compliant microfinance initiative (Dinar Standard and Dar Al-Istithmar, 2010).

Second, the practices of Islamic finance often excessively focus on avoidance or negative prescriptions, and this diverts them from the socioeconomic dimension (see Lewis, 2010; Sairally, 2007; Wilson, 1997). For Islamic banks, this is amply evidenced by the prohibitive nature of Shariah, and the minimal attention to positive practice (Barom, 2013; Derigs and Marzban, 2008; Marzuki, 2012; Nainggolan, 2011). There is also minimal social disclosure save zakah payments. Overall, Islamic financial institutions should offer more socioeconomic welfare products, including those relating to microfinance, social banking, ethical banking, community reinvestment, and qard hassan to help the poor. Islamic financial institutions may also be able to demonstrate their social responsibility by giving priority in their financing to health and social (affordable housing projects) projects, providing scholarships for the poor, and financially supporting community events.

Finally, few Islamic institutions disclose corporate social responsibility (CSR) initiatives in their annual reports. Maali et al. (2006) investigated the social reporting of 29 Islamic banks from 19 countries and found that social reporting by Islamic banks was significantly below expectations. Their results suggest that Islamic banks that are subject to pay zakah or Islamic religious tax provide more social disclosure than those that are not, further supported by a recent study by Hassan and Harahap (2010), which concluded that CSR strangely did appear a major concern for Islamic banks.

However, Maali et al. (2006) suggests that financial institutions in developing countries behave differently than financial institutions in developed countries in their commitment to social welfare. They found that issues such as the environment are of less concern in developing countries where most Islamic financial institutions reside. This
influences the results whereby Islamic financial institutions report less concern social issues. They also suggest that less disclosure on social issues by Islamic financial institutions may be because of Islamic teachings that preach that it is better not to publicise one’s own good conduct.

A study by Al-Sabir and Ahmad (2013) found that the Tadhamon International Bank in Yemen partly financed its social responsibility from tainted source of revenue/income. However, the bank still managed to fulfil its Shariah obligations by participating in socioeconomic activity such as providing scholarships to poor families and financing health and social projects. In addition, it also assisted government with natural disaster and other social problems (Al-Sabir and Ahmad, 2013). This well recognises the complexity of Islamic financial institution decision making and strategy.

According to a recent survey on social responsibility practices among 29 Islamic financial institutions worldwide, the practices of social responsibility in these institutions were not limited to Shariah and legal compliance but also expanded to other areas of responsibility such as community contribution and environmental concerns (Dinar Standard and Dar Al-Istithmar, 2010). The survey also found that there is a significant improvement in their CSR initiatives.

In relation to social responsible frameworks, Islamic financial institutions and the regulators have come out with own frameworks which follow the rules and regulation or values prescribed by Shariah. Even though many aspects of the frameworks used in Western countries such as the OECD principles and the UN Global Compact are not against Shariah values (Abu-Tapanjeh, 2009; Williams and Zinkin, 2010; Zinkin, 2007), some may not be suitable for the structure of Islamic financial institutions.

For example, Bursa Malaysia, the Malaysian stock exchange, introduced a corporate social responsibility framework applicable to listed companies in 2006. Malaysia has also come out with an Islamic Corporate Social Responsibility framework (i-CSR) ready for adoption by Malaysian Islamic banks and financial institutions after 2015 (Hamzah, 2014). This draws on Islamic ethical values and philosophy divided into two categories, obligatory and recommended dimensions.

In relation to international socially responsible frameworks, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has released its own standards for CSR. This is Governance Standards No. 7: Corporate Social Responsibility, Conduct, and Disclosure for Islamic Financial Institutions, which cover 13 areas of social responsibility. Among the recommended areas are responsibilities towards clients, employees, charity, responsible investments, and zakah or waqaf management. CSR as defined by AAOIFI, comprises “…all activities carried out by Islamic financial institutions to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries as individuals and institutions” (AAOIFI, 2010). This definition requires IFIs to practice CSR as part of their religious obligation and ethical commitments to Shariah and socioeconomic development.

The Islamic Financial Services Board (IFSB) in Malaysia also issued its guiding principles on social responsibility, the “Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services,” in 2009 (amended version). However, even though these Islamic finance institutions have developed guiding standards and

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1 The international organisation responsible for development and issuance of standards on accounting, auditing, ethics, governance and Shariah standards for Islamic finance industry
principles for social responsibility, including corporate governance principles, they are not fully accepted or applied and none is enforceable. They also do not have the authority to enforce implementation. For example, the AAOIFI standards have been adopted in only a few Islamic finance jurisdictions, including Bahrain, the Dubai International Financial Centre, Jordan, Qatar, Sudan, Syria, and the Islamic Development Bank group (Dinar Standard and Dar Al-Istithmar, 2010).

At the regional level, the launch of Hawkamah Index for the Middle East and North Africa (MENA) region offers investors investment products that address a broader range of social responsibilities within Muslim countries (Barom, 2013). Hawkamah is a joint collaboration between a Dubai-based institution and Standard & Poor’s, supported by the International Finance Corporation, which launched the first MENA-wide Environmental, Social and Corporate Governance Index, the S&P-Hawkamah Pan Arab ESG Index (HASPI). This ranks and tracks the performance, transparency, and disclosure of regional companies on ESG issues. The constituents of the index include the largest companies listed on the stock exchanges of the United Arab Emirates, Saudi Arabia, Qatar, Bahrain, Oman, Kuwait, Jordan, Egypt, Lebanon, Morocco, and Tunisia (Saidi, 2011).

Other positive development includes the launch of the Dow Jones Islamic Sustainability Index in 2006. This index ranks companies based on their practices in Islamic investment principles and sustainability criteria (Lewis, 2010) and acts as a mechanism or pressure tool to influence corporations to behave ethically and responsibly. Companies that are listed in the index provide an indication of their commitment to incorporate social responsibility in their investments (Barom, 2013) and they enjoy a good reputation, which is able to attract investors, individual, and institutional, concerned with religious and ethical obligations.

6 Conclusion

This chapter examined social responsibility in Islamic finance, with a particular focus being how Islamic financial products and services may not only meet their religious requirements, but may also benefit society more broadly. The chapter also discussed the risks faced by Islamic financial and nonfinancial institutions and individual and institutional investors, and how these incorporate issues of social responsibility through Islamic principles in their behaviour. Likewise, the chapter considered the increasing societal pressure for banks, nonfinancial firms, and investors to act responsibly towards their communities by engaging in socially responsible activities. Lastly, the chapter surveyed the interplay between general national and international socially responsible frameworks and specific Islamic social responsibility frameworks. The chapter concluded that even though the principles of Islamic finance theory advocate that finance must serve society, the practices of Islamic financial and nonfinancial institutions often depart from their fundamental basis.

We suggested that the Islamic finance industry should be more proactive in promoting its social objectives by actively communicating their social activities in their financial statements and other mediums such as the media and social media. Islamic finance players should also be more innovative in developing new products and services based on equity participation rather than relying excessively on debt-based finance, particularly as these can enhance the social responsibility credentials of Islamic finance. In terms of future studies, it would be interesting to compare the social responsibility performance of conventional and Islamic financial institutions. It would also be interesting to explore in detail the impact of Islamic and conventional social responsibility frameworks upon each other.
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