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# Socially responsible investment: insights from Shari'a departments in Islamic financial institutions

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*Islamic financial institutions (IFIs) are emerging as prominent players in the financial world and are increasingly known for their conservative socially responsible investment (SRI). Being the Shari'a regulators and monitors of IFIs, the Shari'a departments are expected to implement the Islamic perspective of SRI – drawn from Shari'a principles – in their respective institutions. The purpose of this paper is to develop an SRI framework applicable to IFIs and other Shari'a compliant entities and assess its applicability within Shari'a departments of two Islamic banks. This paper involves cross-case analysis based on interviews with Shari'a department officials in two settings differentiated by their respective independence. The proposed framework consists of required, expected and desired SRI aspects as applicable to IFIs. The findings reveal that the required aspects are uniformly observed by the two cases. There are, however, variations when it comes to observing the expected and desired ethical SRI aspects that may be driven by the independence of the Shari'a boards. This inconsistency and non-adherence of expected and desired aspects may lead to reputational risks in the long run.*

## Introduction

Humans, whether religious or otherwise, are able to make ethical judgments when faced with social situations. However, literature suggests that religion can also play a central role in shaping human behavior and thus invariably affects decision-making processes when facing ethical dilemmas (Vitell *et al.* 1993). Islam, being the second largely prevalent religion in the world, has a potentially salient influence on its followers' 'decision-making processes in business situations where such decisions may not be in conformity with economic interests [self-interests]' (Uddin 2003: 26). In some religions, an ethical investment (EI) is tied to religious values (Ghoul & Karam 2007). This is also true in Islam. The growing number of Islamic financial institutions (IFIs) as well as other Shari'a compliant companies requires people to invest their funds responsibly, in line with Islamic values. In other words, Islam advocates a multifaceted ethical decision-making framework anchored in fairness and justice, which are the founding principles of healthy societies (Uddin 2003: 26, Beekun & Badawi 2005).

IFIs are generally viewed as institutions that promote the common good and the general welfare of the community through their conservative religious approach. In contrast to conventional



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investment institutions, IFIs are perceived as being more balanced in the sense that they are more concerned with public, community benefit and social welfare and less obsessed with economic interests and pure profit maximization considerations. IFIs are indeed generally assumed to adopt an Islamic view of corporate social responsibility (CSR) guided by Shari'a, which tends to be more holistic and absolute in orientation (Dusuki & Abdullah 2007). In the context of Shari'a, the economic aspects of doing business cannot be separated from the moral and spiritual aspects, and IFIs are expected to comply with basic Shari'a values that revolve around compassion, justice and promoting the public good (Dusuki & Abdullah 2007). Strict compliance with Shari'a translates into concrete guidelines for IFIs in relation to balancing economic and social interests, pursuing humane benevolent actions and avoiding the blind, relentless pursuit of power and profit. This is generally referred to as the principles of fairness and justice – a standard, widely accepted guiding framework for Islamic finance and investment. However, the actual practice of IFIs may not always reflect this standard. Furthermore, there is a lack of consensus in the Islamic finance sector and elsewhere on what justice and fairness entail. This may give the benefit of the doubt to IFIs' management to use the gray areas for their profit-making considerations.

The Quran (the holy book of Islam) explicitly mentions that, 'Every soul will be (held) in pledge for its deeds' (74:38). It therefore encompasses Muslims' accountability for their individual actions and also for the actions/activities of Muslim-owned corporations because a 'corporation as a fictitious [legal] entity does not diminish the responsibility of its owners and managers for its actions' (Beekun & Badawi 2005: 135). The fairness and justice principle, which is also broadly adopted by the UK Financial Services Authority, has also been strongly endorsed in IFIs by the Islamic Financial Services Board (IFSB), a standard setting body (IFSB 2009b: Principle 1). This is the principle that advocates a 'no-harm' policy that makes socially responsible investment (SRI) an integral part of IFIs. IFIs are also encouraged to select a portfolio of companies that have a greater social impact. Thus, IFIs are expected to direct their investments into firms that do not cause any harm to society through their products and practices. Their portfolio should instead increase public welfare by undertaking high socio-economic impact projects, that is infrastructure building and avoiding investments in business sectors that could cause harm to society, for example tobacco.

IFIs can promote SRI in two ways: (i) by pushing companies to align their activities with the Islamic SRI concept based on fairness and justice or (ii) by divesting the ownership of such companies and selecting a portfolio that is more socially responsible. Indeed, the main distinctive feature of IFIs is that they should invest only in firms that meet the Shari'a expectations of the depositors and owners. The investment portfolio should therefore be scrutinized on the criteria of justice and social welfare. For example, supporting the tobacco industry is against the interests of society and should be avoided.

The objectives of social welfare can be classified in turn into three aspects: required, expected and desired. The required aspects, which include for example, avoiding any investment in interest-bearing vehicles, pornography, alcohol, gambling, are those that are considered very important and punishable, but not financially, in Shari'a if not observed. Furthermore, IFIs are only allowed to make profits if they have already met these required SRI aspects. In addition to the minimum required criteria, IFIs are also strongly expected to make investments in companies that have fair dealings with their stakeholders (Beekun & Badawi 2005, IFSB 2009b) including employees, customers, suppliers, government and community. One might find companies meeting these screening criteria in the developed world rather than the Middle East and thus an IFI can conveniently create its portfolio from FTSE-100 listed organizations. Expected aspects are highly recommended by Shari'a and can lead to a disgruntled reaction from the community and customers if not observed. Desired SRI aspects can be labeled as aspirations, that is going beyond the required and expected. An example would be the protection of the environment/nature that has been described as God's sign on earth (Quran, 35:27–28). IFIs are also desired to exclude arms (if the products are sold in the open market that could create harm) and expected to exclude tobacco companies from their portfolios. Meeting the desired SRI aspects can earn a good reputation for the company in this world and a reward for the owners and depositors in the hereafter.[1]

IFIs are required to have a Shari'a compliance mechanism that ensures their maximum compliance with the required, expected and desired SRI aspects (IFSB 2009a). This mechanism is normally in the form of a Shari'a department, which performs a somewhat similar function as the ethics advisory committee in mutual funds, comprising a Shari'a board and in-house full-time Shari'a personnel. The Shari'a department is required to be independent from the influence of management (Safieddine 2009, Wilson 2009), and its job is to align IFIs' operations with Shari'a principles even if that results in reduced revenues and profits for the entity. The mechanism for Shari'a compliance is in the form of Shari'a compliance and audit units within IFIs in addition to Shari'a advisors and boards. The main responsibility of the Shari'a department is therefore to make sure that the required SRI boundaries are not crossed by IFIs, and the expected and desired boundaries are progressively observed. Hence, it is important to investigate the role of Shari'a departments in the active pursuit of the required, expected and desired SRI aspects. It should be noted that most IFIs will be inclined to form Shari'a boards that are also sympathetic to their own business interests.

The role of the Shari'a department in the context of IFIs has not received prior systematic attention. This is important as they shoulder an important responsibility in this respect and are generally regarded by stakeholders as the custodians of a pure ethical Muslim orientation (despite the controversial transparency attributed to Shari'a boards). The purpose of this paper therefore is to devise an SRI framework for IFIs and to evaluate it from both a Shari'a department's perspective and IFIs' actual compliance. This paper is therefore exploratory in nature and examines the role of Shari'a departments through an in-depth comparative case study in order to gain a better understanding of the responsibilities and actual practices of the department in relation to ethical and responsible investment behavior.

The next section explores SRI's relevance to financial companies in general followed by an examination of the relevance of SRI in the context of IFIs specifically. In addition, an exploration of the required, expected and desired SRI aspects in light of Shari'a commandments (*Ahkam*) is provided. The remaining sections then explain the methodology adopted followed by findings, discussion and conclusion.

## Relevance of SRI to financial companies

The terms SRI and EI are used interchangeably in the literature and are defined as 'the exercise of ethical and social criteria in the selection and management of investment portfolios' (Cowton 1994: 215). The concept of SRI is normally used in the context of financial companies (Abramson & Chung 2000, Beabout & Schmiesing 2003, Schueth 2003) because such companies have access to large sums of funds ready for investment. Thus, financial companies are in a position to exert pressure on other companies to make socially responsible decisions (Code 2003). Financial intermediaries, whose jobs include directing the funds of credit surplus units of the community to the credit deficient units (Obaidullah 2005), are expected to utilize the funds of the credit surplus units in such a way as to protect the collective interests of the community. These objectives can be achieved in two ways: (i) through more intimate involvement in the decision-making processes of the companies and (ii) through social screening, that is the application of screening criteria to investment decisions in order to exclude harmful businesses. The latter, although apparently passive, has become mainstream in some large financial companies in recent years.

The development of socially responsible indices (e.g. FTSE4GOOD, SWISS SAM) and the Dow Jones Islamic Market Index have directed attention to the importance of social responsibility in investment decisions. The regulatory pressure in some countries is one of the reasons, among others, that financial firms negotiate with companies in order to convey their social responsibility concerns to the portfolio companies (Sparkes & Cowton 2004). The surging interest in SRI has also been augmented by the increasingly documented positive correlations between the long-run health of companies and their social behavior (Burke & Logsdon 1996). Thus, financial institutions, usually seeking long-term and stable revenues, have an incentive to take the social responsibility record of companies into account by getting engaged in the strategic management of their portfolio companies (Black & Coffee 1994, Clark & Hebb 2004). They therefore benefit from the expected healthy financial performance and growth of socially responsible companies and are in a better position to deliver on their long-term promises (Denis & McConnell 2003, Aguilera *et al*. 2006).

## Relevance of SRI to IFIs

IFIs are financial companies whose operations are guided by the Islamic jurisprudence called Shari'a. Though religious belief is considered a private matter in many countries (Rice 1999), there is still a proliferation of literature that tries to associate different aspects of business to faith (Cavanagh & Bandsuch 2002, Giacalone & Jurkiewicz 2003, Angelidis & Ibrahim 2004). Some studies have been conducted on this association in both Christianity (Jones 1995, Lee *et al*. 2003) and Judaism (Pava 1997, 1998), and there are practical instances of real-world applications of this link between religion and business, for example the Roman Catholics' Ave Maria Rising Dividend and Aquinas Investment Company (Boasson *et al*. 2006). The recent ascendancy of the Islamic financial services industry is another example that has also been coupled with a rising awareness of Islamic business ethics in scholarly research (Beekun 1997, Wilson 1997, 2006, Rice 1999, Graafland *et al*. 2006).

Financial companies that are guided by religious values such as IFIs are more stringent in their investment decisions (Wilson 1997, Boasson *et al*. 2006). This is because religion fosters functions of self-regulation and control (McCullough and Willoughby, 2009) which apply equally at the individual and corporate level. For example, most faith-based funds exclude companies that are involved in tobacco, pornography and other business sectors that are considered conflicting with the faith (Boasson *et al*. 2006). In contrast to the Western views of social responsibility that are often based on legitimacy (Suchman 1995), social contracting (Moir 2001) and instrumentalism (Lantos 2001), the concept of social responsibility is infused with a more holistic agenda in the context of IFIs (Dusuki 2005, 2008). According to Dusuki & Abdullah (2007), IFIs should always aspire to achieve the objectives of Shari'a, that is the public good, an attribute of many mutual funds. They further argue that financial institutions based on Shari'a principles are not allowed to achieve their economic objectives by inflicting harm on society. Therefore, IFIs apply the exclusion criteria in investments and reject certain investment sectors whose businesses have adverse effects on society. The exclusion criteria are derived from the basic commandments (*Ahkam*) of Shari'a. Therefore, it is worthwhile to discuss these *Ahkam* before developing an SRI framework for IFIs.

### The commandments (*Ahkam*) of Shari'a

The exclusion of different sectors and businesses from IFIs' investment portfolio is based on a set of Islamic legal and moral rulings known as *Ahkam* in Arabic (*Ahkam* is the plural of *Hukm*, which means command). *Ahkam* are therefore Islamic commandments derived from four main sources, namely (i) The Quran, (ii) the prophetic traditions, (iii) *Ijma*, the consensus of Islamic scholars and (iv) *Qiyas*, that is solving emerging issues by finding their analogies in the first three sources (Al-Allaf 2003). Based on their relative importance and priority, *Ahkam* are further divided into five categories. Some of the *Ahkam* constitute orders to either perform or not perform certain actions/behaviors while others are strongly recommended courses of action. Another category of *Ahkam* gives a degree of freedom of choice to the Muslims (Abduh 1958). Literature has divided *Ahkam* into five categories, based on such considerations or prioritization. A brief discussion of this categorization follows:

1. **Obligatory (*Fardh* and *Wajeb*):** This is a command to do certain things derived from *Ahkam*'s first two sources, that is Quran and Sunna (Al-Allaf 2003) and must be supported by definitive proofs. Performance of an Obligatory *Hukm* is rewarded and non-performance is punished. However, most of the obligatory *Ahkam* are regarding rituals, such as praying, fasting, etc. and are not applicable to IFIs (Visser 2009). *Zakat* is also obligatory but only to IFIs' Muslim owners and account-holders and not to the entities themselves.
2. **Recommended (*Mandoob*):** This is the second category of *Ahkam* in terms of prioritization. The

performance of recommended actions/behaviors is rewarded; however, their non-performance is not punished (Abduh 1958). For example, payment of above-market wages and provision of good working conditions and workload are both recommended and rewarded, as the Quran mentions 'And whatever you spend of your wealth, (its reward) will be paid back to you in full and you shall not be treated unjustly' (2:272). However, paying wages that are not necessarily above-market wages is not punished.

3. **Permitted (*Mubah*):** These *Ahkam* are related to lawful actions/behaviors where Muslims are given the freedom to do them with no restrictions. For example, using the natural resources for human benefit is permitted. However, improper use (or abuse) of permitted actions/behaviors that ultimately cause harm or disorder in life can make them *Makrooh* (disliked) or *Haram* (prohibited).
4. **Disliked (*Makrooh*):** *Ahkam* in this category are related to actions/behaviors that are strongly detested and discouraged. Refraining from disliked actions/behaviors is rewarded but engagement is not necessarily punished. For example, smoking is a disliked act; however, it is not punished. Recurrent involvement in disliked activities can make them *Haram*.
5. **Prohibited (*Haram*):** Actions and behaviors in this category are strictly prohibited. Engagement in these actions/behaviors is punished, and avoidance is rewarded. For example, drugs, gambling, interest, adultery are clearly prohibited. Quran talks about some of the prohibited actions/behaviors in these words: 'O you who believe! Intoxicants and gambling [dedication of] stones and [divination by] arrows are the abomination of Satan's handwork. So avoid that in order that you may be successful' (Quran, 5:90).

It is important to note that this categorization is useful for analytical purposes, yet the identified categories are not perfectly mutually exclusive as in some circumstances, a recommended action/behavior can become obligatory and a permitted one can become disliked or prohibited. Similarly, a disliked action/behavior can become prohibited. For example, as suggested earlier in the text, while the use of natural resources is permitted to support human endeavors, their recurrent abuse and lack of consideration of the welfare of the planet for future generations can make them disliked or even prohibited over time.

## Relevance of *Ahkam* to SRI

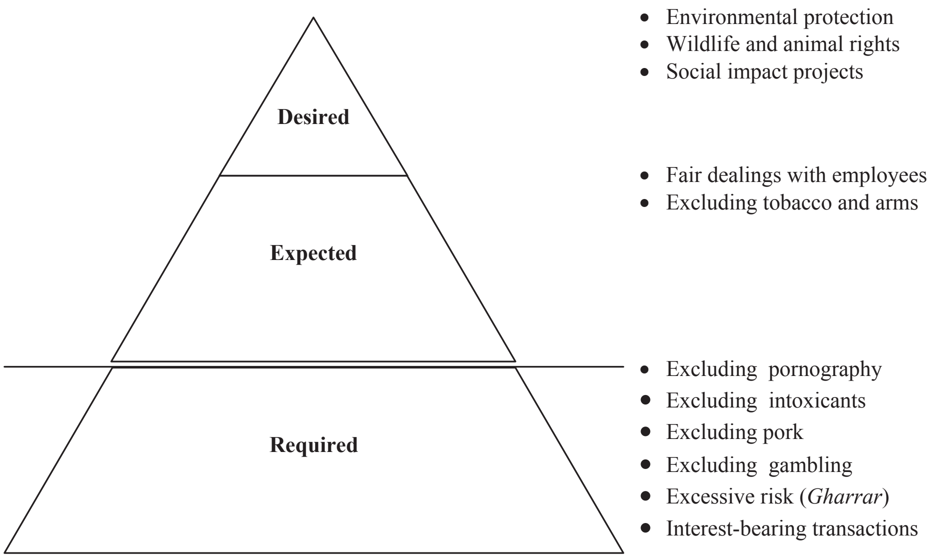
IFIs are a collective of Muslims and hence what applies to individuals also applies to the collective. Noting that some of the obligatory *Ahkam* encompass worship and ritual practices that are mostly applicable to individuals, the majority of these *Ahkam* and the overall spirit embodied in them are, however, certainly applicable in the context of IFIs. Therefore, these *Ahkam*[2] are grouped together in Table 1 to form the basis of the three SRI aspects discussed at the outset of this paper, namely the required, expected and desired. As illustrated in Table 1, the obligatory and prohibited *Ahkam* provide the foundation or justification for the required SRI aspects; the recommended and disliked *Ahkam* translate into expected SRI considerations and the permitted *Ahkam* form the basis of the desired SRI aspects.

Figure 1 in turn arranges these SRI aspects into a pyramid. The base of the pyramid represents the required aspects. Recommended aspects carry middle-level importance and desired occupy the top of the pyramid showing their relative importance. Invariably, these SRI aspects or considerations influence IFIs' investment strategies. According to Figure 1, IFIs must avoid interest-bearing transactions, excessively risky transactions (*Gharrar*) and investments in business sectors, for example alcohol and pornography, which come under the required category. If any investment is accidently made in such sectors, the associated profit is forfeited and

**Table 1: Categorization of *Ahkam* into SRI aspects**

| Shari'a *Ahkam* | SRI aspects |
|---|---|
| Obligatory | Required |
| Prohibited | |
| Recommended | Expected |
| Disliked | |
| Permitted | Desired |

**Figure 1: Required, expected and desired SRI aspects for IFIs**




given to charity (Beekun 1997, Beekun & Badawi 2005, Dusuki 2005, Hassan & Latiff 2009).

In addition to meeting the minimum required SRI aspects, IFIs also have *expected* responsibilities to engage in fair and equitable dealings with all stakeholders as per Shari'a stipulations and to avoid activities that are disliked in Shari'a. Thus, an IFI will strive to avoid businesses involved in tobacco and any kind of exploitation such as child labor, unfavorable treatment of employees, involvement in any illegal activities, etc. Such financial companies are also expected to direct their investments into areas that can have positive externalities – for example, social infrastructure building – for the society (Aggarwal & Yousef 2000). Even though non-observance of the expected SRI aspects does not make an IFI's profit forfeitable, it can be damaging to its reputation.

A third layer of screening for IFIs during their investment decisions is what we call the *desired* aspects, which may be considered optional socially responsible behavior on the part of IFIs. This includes protecting the natural environment or animal welfare by avoiding companies involved in sectors that pose a threat to the environment. Environmental protection might be a non-religious approach but something desired by society and expected/required by governments and non-governmental organizations. Non-observance of the desired SRI aspects would neither make an IFI's profit forfeited nor will it create serious stigma or risk to its reputation, but conversely its observance can enhance the IFI's public image to a great extent.

The required, expected and desired aspects of SRI presented in Figure 1 correspond closely to the concept of *Maslahah* (or public good) which lies at the heart of all Shari'a principles. *Maslaha* means public welfare, public good or public benefit. It is recognized in Islam as an important principle guiding the conduct of all Muslims, and is commonly divided into three categories: *Daruriyat* (or essentials), *Hajiyat* (or complementary) and *Tahsiniyat* (or embellishments) (Dusuki & Abdullah 2007). The *Daruriyat* are the essentials upon which human life depends, including faith, life, intellect, posterity and wealth. They are a must and cannot be avoided or ignored much like the required SRI aspects. The *Hajiyat* are complementary interests that supplement the essentials, and if neglected, can lead to hardship or distress. In other words, much like the expected aspects of SRI, they provide validation and reinforcement to the required essential orientation and healthy human conduct. *Tahsiniyat* are those interests that if realized lead to perfection in the conduct of people (Dusuki & Abdullah 2007) and therefore map directly to the desired aspects of SRI fleshed out earlier in the text. This classification is rooted in the Shari'a and ensures both the subsistence of human life and the balancing of self-interest and public good.

It is precisely in this context that the role of the Shari'a department has recently evolved as crucial in the context of IFIs by way of ensuring and overseeing their compliance with the required, expected and desired ethical norms dictated by Shari'a (Archer *et al*. 1998). Having a Shari'a department, or at least a Shari'a consultant, is a requirement on institutions offering Islamic financial services (IFSB 2009a), even though the exact structure and composition of this department and other Shari'a governance mechanisms vary across institutions and countries (Wilson 2009). While some institutions, for example Dubai Islamic bank, have strong and formal Shari'a governance mechanisms in place, others might only rely on a single person or an external consultant whose independence can be questioned. However, the usual structure of a Shari'a department consists of a Shari'a board and in-house full-time Shari'a personnel. The job of such a department is not only to prescribe Shari'a-compliant policies and procedures for their institutions but also to make sure IFIs comply with such policies and procedures during the course of their operations. Thus the Shari'a department is normally comprised of (i) a Shari'a board that prescribes, though not publicly, Shari'a compliance policies, (ii) a Shari'a compliance unit that makes sure these policies are observed during the operations, and (iii) a Shari'a audit/review unit that conducts a thorough Shari'a audit at the end of each financial year (IFSB 2009a). IFIs also usually have a full-time Shari'a advisor who gives Shari'a pronouncements on issues that occur on a daily basis. Most sections of the Shari'a department, other than the Shari'a compliance unit, are not housed in the traditional organizational hierarchy of IFIs. Thus, the overall Shari'a department is considered an independent body (IFSB 2009a) that imposes an additional layer of governance.

Keeping in view the Shari'a *Ahkam* regarding the required, expected and desired SRI aspects as well as the corresponding role of the Shari'a department, it becomes very relevant to explore how the personnel in the Shari'a department view the different SRI aspects and how this in turn shapes their CSR views and orientations.

## Methodology

This research adopts a case study methodology (Yin 1994, 2008) that has now become an established approach for conducting research in the field of management (Harrison & Leitch 2000). Though some aspects of case study research have similarities with hypothesis testing, other aspects like 'within-case analysis and replication logic are unique to the inductive case-oriented process' (Eisenhardt 1989: 532). Therefore, case study research has greater validity, rather than generalizability, due to the extensive case-specific analysis. Given the lack of literature in this area, case study methodology seems most appropriate for this research as it can uncover the intricacies of this complex social situation (Denscombe 2003). This paper adopts a multiple-case design that 'may be preferred over single-case designs' (Yin 2003: 135) because of the additional robustness multiple-case designs add to the results of the study. The multiple cases either reinforce the results through 'literal replications' or 'contrasting' findings (Yin 2003: 5) allowing for comparisons and triangulation. Often, the purpose of cross-case analysis is to find a chain of evidence to make the study more robust (Miles & Huberman 1994, Yin 2003).

Two cases were selected for the purpose of this study, both in different geographical locations and regulatory regimes and exhibiting differences in their governance structures. Both cases are Islamic commercial banks; one is based in the UAE and the other one in Pakistan. For the purpose of this research, the UAE-based case will be referred to as 'Case A' and the Pakistan-based case will be referred to as 'Case B'. Case A is the first commercial Islamic bank established in the UAE with the motivation to provide Shari'a-compliant services to the local community and is generally known for its strict adherence to Islamic principles in its operations. On the other hand, Case B was initially incorporated as a state-owned conventional bank that was later partially converted into an Islamic bank. Though the two cases claim to be operating according to Shari'a principles, there are significant structural differences between them. For example, Case A is a full-fledged Islamic bank and its Shari'a department reports to the general body rather than the management or board of directors (BOD) while the other is a

**Table 2: Respondents' profiles across the two cases**

| No. | Country | Designation | Level of education | Type of education | Arabic literacy | Type of case |
|---|---|---|---|---|---|---|
| 1 | UAE | Shari'a Consultant | Master | Conventional/Islamic | Very Good | Fully Islamic |
| 2 | UAE | Shari'a Consultant | Master | Conventional/Islamic | Very Good | Fully Islamic |
| 3 | UAE | Shari'a Consultant | Master | Conventional/Islamic | Very Good | Fully Islamic |
| 4 | UAE | Shari'a Consultant | Master | Islamic | Very Good | Fully Islamic |
| 5 | Pakistan | Deputy Shari'a Advisor | Master | Conventional/Islamic | Good | Islamic Window[3] |
| 6 | Pakistan | Shari'a Research Officer | PhD | Islamic | Very Good | Islamic Window |
| 7 | Pakistan | Shari'a Advisor | Master | Conventional/Islamic | Good | Islamic Window |
| 8 | Pakistan | Head of Islamic Banking department | Master | Conventional | Very Weak | Islamic Window |

partially converted Islamic bank working under the same BOD that manages the Islamic and conventional aspects of the organization. This could be translated into a lack of independence between management and Shari'a board. Furthermore, the Shari'a Board of Case A is elected in the general body meeting while the BOD nominates the Shari'a Board of Case B, which is later verified in the general body meeting. Thus the whole Shari'a department of Case A is relatively more independent than Case B.

The data were collected from the Shari'a departments of the two cases through semi-structured interviews. The research instrument was developed by collecting preliminary data via telephone interviews with three respondents. The responses from the telephone discussions were used to develop the semi-structured questionnaire. Access to Case A was gained by arranging an appointment with a Shari'a scholar working with the organization who then helped arrange interviews with other respondents within the case. In Case B, access was gained through a contact who was working in the Shari'a department. A total of eight interviews were conducted; four in Case A and four in Case B as detailed in Table 2.

All the interviews were conducted face-to-face in the offices of the respondents. The respondents of Case A were interviewed in English in which case neither the interviewer nor the interviewees were native speakers of English. This kind of situation raises issues as the respondents may not be able to express their true feelings due to a potential restriction in vocabulary. However, the interviews were conducted in a very supportive environment, which reduced the language problem to some extent. These interviews were then directly transcribed into English by the interviewer. In contrast, interviews with Case B were conducted in the mother tongue of both the interviewer and the interviewees. Though this reduced the language issue during the interviews, this situation posed a challenge during transcription. Since the transcription was conducted in English from the audio recording of the interview, it was at times hard to find relevant words and sentences for the exact terms used by the respondents. This was alleviated through consulting a dictionary and exerting systematic efforts at accurate translation.

The semi-structured interview questions are shown in Table 3, with further case-specific questions being asked throughout each interview. The findings discussed further in the text represent the current scenarios and patterns of answers as presented by the officials of the Shari'a departments of the two cases.

## Findings and analysis

The findings and analysis of the paper have been arranged around the required, expected and desired SRI aspects of IFIs and are summarized in Table 4. The following three subsections contain the analysis and findings surrounding the three main SRI aspects.

### Required SRI aspects

There are certain business sectors, for example alcohol, interest-bearing, pornography and gambling,

Table 3: Semi-structured interview protocol

| Subgroup | Questions asked |
|---|---|
| Required SRI aspects | What types of business sectors are you required to exclude from or include in your portfolio?<br>What is the rationale behind such exclusions?<br>What is the level of compliance of your bank with this aspect? |
| Expected SRI aspects | What types of business sectors are you expected to exclude from or include in your portfolio?<br>What is the rationale behind such exclusions?<br>What is the level of compliance of your bank with this aspect? |
| Desired SRI aspects | What types of business sectors are you desired to exclude from or include in your portfolio?<br>What is the rationale behind such exclusions?<br>What is the level of compliance of your bank with this aspect? |

which are considered harmful to society from an Islamic perspective and therefore forbidden. We found a profound consensus among the respondents from the two cases on avoiding these sectors in their investment decisions. For example, one respondent from Case A said 'we are responsible to invest the money in the right places'. The authors inferred that statement literally meant avoiding the wrong investments, that is the prohibited sectors. The Islamic banks also conduct regular checks on the companies in which they invest even after the initial investment is made in order to make sure the company has not entered prohibited sectors during the course of the investment. One respondent from Case B replied that 'if the nature of the transaction requires it, we ask the company to conduct regular Shari'a audits'. If it is found in the audit that the company has entered the prohibited sectors during the execution of the contract, the bank's profit from such a contract is forfeited to charity. One interviewee mentioned, 'at the end of the day when it is pointed out in the Shari'a audit, the profit will go to charity'. A respondent from Case A went one step further when talking about avoiding harmful and unethical investments, saying that 'Anything which is prohibited in Fiqh Muamalat [Islamic mercantile law] is not allowed in Islamic banks. For example, Islamic banks will not enter into transactions dealing with alcohol, etc. because these things are not good for the society . . . one may think that these are just Islamic values that are followed by the bank but in reality, these values translate and guide our contributions to the society'. This statement, in essence, encompasses the wider Islamic concept of social responsibility (Dusuki 2008). Fiqh Muamalat lays down a much wider scope for business transactions; it includes protection of human rights, environment and the owner's interests, which are also protected by conventional laws. These elements are supposed to represent the essence of Islamic banking and finance.

## Expected SRI aspects

In line with mainstream economics, fairness and justice with fellow humans have been strongly emphasized in Islamic literature. Shari'a insists on fair dealings with employees and the well-being of the community so that the objective of 'overall human well-being through socio-economic justice' (Uddin 2003: 26) is achieved. However, the emphasis on fairness and justice increases significantly in the case of one's own employees, customers and suppliers. Our respondents seemed to consider employees as key stakeholders of their respective institutions, as one respondent from Case A said 'the administration of the bank always conveys the message to the employees that they are the stakeholders and that they are the bank'. Another respondent from Bank A said that 'you have other stakeholders, you start primarily with employees in the benefits and in the way you treat them'. However, the respondents agreed that they do not consider Shari'a implications in relation to employees as that aspect is dealt with by the management and the Shari'a department's authority does not encompass that. Some responses were, 'I think part of this is done through the system itself', 'I think each institution has its own culture and its own policy', 'there are company policies', 'the

Table 4: Theoretical vs. actual SRI considerations within Case A and Case B

| SRI aspects | Categories | The ideal scenario | Respondents' perspective | Actual scenario in Case A | Actual scenario in Case B |
|---|---|---|---|---|---|
| ***Required*** *(harmful business sectors)* | ***Interest-based entities*** | Not allowed | Not allowed | Do not invest | Do not invest |
| | ***Pork business*** | Not allowed | Not allowed | Do not invest | Do not invest |
| | ***Pornography*** | Not allowed | Not allowed | Do not invest | Do not invest |
| | ***Gambling*** | Not allowed | Not allowed | Do not invest | Do not invest |
| ***Expected*** *(human and social concerns)* | ***Own employees*** | There must be no exploitation in any way | Key stakeholders are protected | Proactive and reactive approaches | Only reactive approach |
| | ***Employees of the investee companies*** | To be treated equally, fairly and equitably | Should be considered | Yes/no | No |
| | ***Tobacco*** | Not allowed | Not allowed | Do not invest | Do not invest |
| | ***Arms*** | Not allowed | Not allowed | Do not invest | Do not invest |
| ***Desired*** *(environment and nature)* | ***Environment*** | Unnecessary claims must be minimized | IFIs should protect the environment | Exceptional cases considered | No |
| | ***Animals and wildlife*** | Should be protected | Animals should be protected | Yes/no | No |
| | ***Social impact projects*** | Should be undertaken even at the expense of some return | Should be preferred | Preferred sometimes at the cost of profits | Preferred but not at the cost of profits |

Shari'a boards or Shari'a advisors are not involved in these things. These are management related problems' and 'these issues are not under our control, these are under the control of management'. When we asked if Shari'a boards should take employee-related issues into consideration, the respondents seemed to be sidelining these issues but at the same time taking some kind of responsibility as a Case A respondent said, 'I think they [Shari'a departments] can advise but cannot get involved and they should not get involved'. Another respondent from Case B said, 'I think salary determination is not the job of a Shari'a board. This is because of different reasons. Anyhow, we can dictate a minimum wage rate for different jobs'. This discussion signals concern of the two cases for their own employees but still the employee-related issues are dealt with by the management whose primary objective is to maximize profits, which is obviously at odds with the objectives of Islamic finance. Therefore, one can have doubts regarding the implementation of Shari'a-advocated behavior in this respect.

However, when we investigated fairness with employees in SRI considerations, we found little evidence that the two cases consider fair treatment of employees by the companies in which they invest. One respondent in Case B said that 'we can tell him [the company] not to exploit someone etc in order to safeguard our reputation. The bank can go to that extent. The rest is his own business . . . he will hire employees, deal with his suppliers. He is responsible for his own deeds . . . if we come to know that he is doing something wrong to the society; that is harmful for us because we have shared profits. If he pays less to his employees, we are not concerned with that. But if he does not care about Halal/Haram and we come to know, we will stop him from doing that'. This statement has two potential implications: (i) it indicates the bank's detachment from the ways the companies selected for investment deal with their employees even though the respondent admits to shared profits with these companies and (ii) it presents a very narrow scope of the concept of Halal/Haram (*allowed and prohibited things*). The respondent implies that even if he knows that the target company is involved in human/social exploitation, it will not make his share of profit Haram (*prohibited*). His definition of Halal/Haram seems to revolve around the issues of interest and prohibited industries. Other exploitative activities seem to be unimportant. This behavior of the two cases is in contradiction to what they should be doing, that is a Shari'a audit of the companies they invest in.

A similar response was repeated by another respondent from Case A saying that 'If that is an Istisna [a product of Islamic banking] agreement then the bank is not involved to such extent to regulate issues regarding wages, exploitation, environment, etc. We send inspection teams to check that the work is done according to the description. But we do not go into the domain of behavior vis à vis employees'. However, the difference between the two respondents is that the latter associates SRI monitoring with the nature of products and engagement with the company; meaning that certain products tend to be less demanding in SRI screening than others. Another respondent who is the Shari'a advisor at Case A strongly disassociated the bank from the malpractices of the company in which the bank may have certain ownership interests. He said, 'we are not responsible for any exploitation he is committing in his company. That is a separate business. That is not my responsibility and I can't take that headache to know how much he pays to his employees, what kind of labor [pointing to child labor] he uses, what is his character, used stolen material or used public property. This is neither our job nor can we do it. But if I come to know that he has used stolen material, then we don't deal with him. But we are not responsible to investigate it'. Though this respondent recognizes the fact that everyone is responsible for his or her own deeds, he fails to recognize that the bank has an ownership stake in the company and should be held responsible for the company's acts (Uddin 2003).

Some respondents identified a split between a personal response and a response as a member of the bank to such exploitative activities of the companies they invest in. This was noticed as one respondent from Case A said 'my decision as an individual, I would prefer not to have dealings with a company if I know it is involved in exploitation. Well for institutions, it is usually not the way that we describe them and deal with them. . ..' This statement is indicative of the fact that some Islamic banks may not be as ethical as the individuals themselves and that there is a hidden trade-off between business objectives and ethical objectives and considerations.

Another respondent from Case A went on to explain how things should be by saying that 'if we know that there are such exploitations, then Shari'a should deny such a case because of its negative effects'. When we asked the same respondent if the Shari'a department actually took steps in such scenarios, he replied that 'they are currently not doing it but they should'. Only one respondent from Case A confirmed that the socially responsible behavior of their investee companies is important for the bank and that the bank has actually taken steps to stop human exploitations within the investee company. They said, 'We have a subsidiary that provides employees to other companies. Once we observed exploitation in that company . . . we stopped it after a thorough investigation by a team involving Shari'a auditors. So whenever such exploitations occur, no matter at whatever level, and when they fall under the control or jurisdiction of the Shari'a board and management, we stop them'.

### Desired SRI aspects – preservation of nature

Nature has been described as God's sign on earth for human beings in the Quran (Quran, 35:27–28) and therefore its preservation for the benefits of all is Muslims' obligation. Unnecessary and unjust consumption of nature has also been discouraged[4] as it is the property of all which is akin to efficiency in decision making given limited resources. Our respondents also agreed with the just mentioned endorsements as one respondent in Case A said that 'God sent Adam and his wife to be the Khalifah (carer) of this earth and that they had to populate this Earth and at the same time take care of it, take care of whoever lived on that Earth; plants, animals, humans, the mountain . . . we have been given a hand to utilize them but there are rules of utilizing them'. This was further reinforced by another respondent from Case A who accepted the bank's responsibility for any damage to the nature/environment caused by its investments by saying that 'these are bank's assets and if there is any direct or indirect damage to nature, it means that the bank is doing this. And this is not allowed in Shari'a'. Another respondent in Case A went further to address the protection of not only the environment but also the rights of animals as a responsibility of Islamic banks. He said, 'Islamic banks will not invest in anything harmful, not only for humans but also for animals'. However, when asked about the banks' existing policies and their implementation regarding the preservation of nature, the response was far from the ideal situation prescribed by literature and even the one presented by the respondents themselves. They rather agreed that environmental concerns had to be dealt with by the regulatory authorities rather than the banks themselves. Some responses were 'this is achieved by the regulatory requirements of that specific country', 'there are government regulations that have to be met in all such investment decisions', 'there is absolutely no check on this but it is very important', 'there are two things; one is the law of the land and second is the policy of our Shari'a board in this regard', 'there are government regulations for such factories' and 'this is the responsibility of the government to make sure these rules and regulations are followed. We can't do it'. The just described scenario indicates a significant shift from the ideal SRI performance in terms of protecting the natural environment.

## Discussion

The analysis reveals certain important aspects of SRI concerns of IFIs especially as seen by the Shari'a departments of the two cases. It is evident from the analysis that Islamic banks have a built-in informal ethical framework that has to be followed in investment decisions. Thus they avoid certain businesses, for example, alcohol that may be seen as damaging to society. Such sectors are also avoided by the ethical investment companies in other countries (Perks *et al.* 1992), even though the EI companies may have their own selection criteria of what is ethical and what is not. Islamic banks have a prescribed list of industries that must be avoided in investment decisions. Our analysis shows that there is a good monitoring mechanism to screen out such companies from the list of their portfolios, for example, companies dealing in tobacco, alcohol, arms, drugs, pornography, gambling and companies under excessive interest-bearing debts. The mechanism for screening out such sectors is fairly established in the two cases, and if the IFIs have dealings with such companies by mistake, the relevant profits are donated to charity. However, there could be ambiguity regarding the stated policies and their implementation as is the case in EI funds (Cowton 1999). For example, what are the exclusion criteria for the tobacco sector? Do IFI's exclude retailers from their investment portfolio on the basis that they sell tobacco? Is there a certain threshold? These are the points that need further investigation. However, when it comes to human exploitation and environmental degradation, Shari'a departments seem to be diverging from the ideal Shari'a prescriptions in spite of the fact that they appreciate their importance. For example, when it comes to fair dealings with employees in the portfolio companies based on principles of fairness and justice, IFIs seem to refrain from directly addressing these matters although such issues might be considered very important from an Islamic perspective (Dusuki 2008). IFIs also do not seem to seriously consider the environment as a key stakeholder in their investment decisions. They would rather leave it to the regulatory bodies to worry about. The respondents seemed merely concerned about meeting basic regulatory requirements regarding environmental issues.

It appears that the Shari'a departments are relatively powerless in enforcing their policies in certain areas even though they feel the importance of such issues. For example, when talking about screening for the desired aspects of environment-friendly investments, one respondent said 'they [banks] are not doing it currently but they should'. This statement is an indication of potential powerlessness of Shari'a personnel where they feel something should be done but are unable to exert pressure on the management to take practical steps on such issues. This situation of discontent was also clear in regard to the expected aspect of fair dealings with employees as one respondent said 'we have not yet gone into this process to select industries and see how they do things . . . there is no such system of screening'. We also found that some respondents were not even aware of some of the expected and desired SRI aspects. When talking about issues of fairness and environment, one respondent said 'we have not gone deeper into these issues but we will consider them after this discussion with you'.

The analysis indicates that the two cases exhibit different orientations in relation to aspects of SRI. On the required aspect, both cases have essentially the same orientation when it comes to avoiding certain business sectors because of their harmful nature. It is important to note that all these sectors are considered as *Haram* (prohibited) in Shari'a and if IFIs are found to be involved in such sectors, their profits from such investments will be given to charity. These sectors are also considered damaging by the customers and thus any involvement in such sectors can greatly damage the regulation and reputation of the Islamic banks. However, there are certain expected and desired aspects from a Shari'a point of view that need to be addressed in investment decisions. It seems that the two cases have different approaches toward the expected and desired aspects. It is clear that the two cases give relatively less attention to the desired aspects than the required aspects but interviewees in Case B were generally less concerned about the expected and desired aspects. As a result, human rights, the environment and investments in social welfare are sidelined or neglected. The responses obtained suggest greater concern with the expected and desired aspects of SRI in Case A, even though good intentions did not always translate into concrete action.

It is important to note in this respect that there are structural differences between the two cases. The Shari'a department of Case B is not as independent and powerful as that of Case A. The Shari'a board of Case B is appointed by the BOD and reports to them; this seems to give the Shari'a board less leeway, authority or autonomy or even the drive and intention to monitor adherence to the expected and desired aspects of Shari'a in SRI; in Case A, the Shari'a department is elected by the shareholders and reports to them. It seems to therefore be more empowered to pursue adherence to all aspects of Shari'a in investment decisions, to live up to the expectations of stakeholders of a fully fledged Islamic Bank although it still finds the enforcement of the expected and desired aspects protracted in practice given a host of practical implementation challenges. Therefore, it appears that the independence of the Shari'a departments affects their orientation toward SRI considerations. It would be interesting to further investigate the independence of the Shari'a Board and its approach to SRI and Shari'a compliance.

Being a demand-driven industry where demand is based on Shari'a-compliance, Islamic financial institutions should strictly adhere to the ideal social output that is required by Shari'a (Lee & Ullah 2011). However, there is limited public debate on the determination of Shari'a compliance within IFIs. Customers just trust the members of the Shari'a board serving the institutions. Customers, however, currently seem to be forgiving IFIs for minor deviations from Shari'a principles; recurring digression may cause cognitive dissonance among the customers and the general public, which will strongly damage the reputation of such institutions. While failure to observe the expected and desired aspects of SRI may be due to these issues not being considered seriously in the geographical locations of the two cases considered, the nuanced differences detected in the answers provided by respondents in both cases and also structural differences pertaining to their Shari'a departments suggest that the key consideration lies in the structure and overall orientation of the Shari'a board, who can play a more or less empowered role in realigning the performance of IFIs and bringing them in closer conformity to overall Shari'a rules and expectations.

## Conclusions

Islam guides every aspect of life and so IFIs are expected to consider the Islamic ethical and moral values in their investment decisions. As Islam is keen 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 not only bound to observe the principles of trust, equity, balance and fairness (IFSB 2009b) in their own operations but they are also required to scrutinize the operations of their portfolio companies based on these criteria.

It is evident that IFIs pay attention to the required SRI screening by strictly scrutinizing industries in their investment decisions in order to exclude businesses that are harmful to society. However, there appears to be a gap between their ideal SRI screening and current practice on the expected and desired SRI aspects, especially on the environmental and human resource aspects. It is also important to note that the foundation of Islamic banking is based on a demand for Shari'a-compliant products and services and one might expect strict Shari'a compliance within IFIs for their long-term sustainability.

It also appears that an IFI's approach to SRI issues is related to the independence of the Shari'a department and Shari'a board. The case whose Shari'a department is more independent (Case A) has exhibited more sensitivity to the expected and desired SRI output than the one whose Shari'a department is not totally independent from the influence of the management and BOD. We recommend that IFIs, being Shari'a-compliant financial institutions, should adhere to the Shari'a principles in their true spirit and thus the Shari'a department should be authorized to oversee each and every aspect of the business. In addition to complete authority, the Shari'a department should be provided with all the relevant information regarding each investment so that it can pay due consideration to all SRI aspects. Furthermore, the Shari'a department should not be seen as a hindrance by the management, rather it should be considered as the steward of the very identity of the institution.

It would be interesting to empirically analyze the relationship between the independence of the Shari'a department, especially the Shari'a board and financial performance of IFIs. It would also be interesting to investigate the perceived impact on the financial performance (Cowton 1994) of IFIs if they fail to comply with Shari'a principles. We recommend further research along these lines on a wider scale encompassing the Islamic banking industry. We also suggest quantitative studies to explore the relationship between the Shari'a board's independence and CSR in general and SRI in particular. The limitation of the study is that it is based only on two cases and eight respondents. It would be interesting to include another institution that is an Islamic subsidiary of a conventional bank.

## Notes

1. Muslims believe in the life-after-death concept called the 'hereafter'. According to this concept, all actions

done by human beings will be rewarded/punished in the hereafter. Thus good deeds will be rewarded and bad deeds punished. This concept is a driving force for Muslims' actions.
2. It is important to remember that *Ahkam* are only partially applicable to IFIs in regard to their engagements in SRI. For example, IFIs are exempt from the obligatory rituals.
3. The branch of a conventional bank that offers Islamic financial products is referred to as an Islamic window. Case B in our study is a conventional bank having a number of branches as Islamic windows.
4. Al Majalla, serial no. 2486, paragraph 1254.

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