



## Impact of Corporate Social Responsibility on Financial Performance of Islamic Banks: A Case from Pakistan

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**Abstract:** The present study seeks to investigate the impact of corporate social responsibility on the financial performance of the Islamic banks located in Pakistan. For this purpose, the study uses CSR as the independent variable and financial performance as the dependent variable. The data was gathered from the financial statements of the Islamic banks over a period from 2012 to 2019. The proxies for FP as the proxies of the dependent variable were ROA, ROE and NPM. This study employs the Probit regression model and found a positive impact of CSR on the FP of the Islamic banks. The study concludes that CSR activities lead to an increase in the financial performance of the Islamic banks in Pakistan.

**Keywords:** CSR, Financial Performance, Islamic Banks, Pakistan, Probit Regression

### I. INTRODUCTION:

The concept of Corporate Social Responsibility was evolved in the 1960s<sup>1</sup>. It has become an important area where organizations are working exponentially<sup>2</sup>. The organizations are becoming a part of the betterment of the environment because the organizations are considered a primary source of doing the environment polluted. That's why the organizations actively and keenly participate in the well-being of the society and environment<sup>3</sup>. The firms perform CSR practices to attract and create long-lasting relations with their customers<sup>4</sup>. Likewise the organizations, the banks are also practicing CSR. The discussion about CSR in banks was initiated from the developed countries. Over time, it was adopted by the banks of developing countries<sup>5</sup>. The growing interest of the banks related to CSR practices demonstrates that it affects the financial performance of the banks<sup>6</sup>. The FP exhibits the financial health of the banks. The banks are performing CSR activities for the social well-being of society.

<sup>1</sup>Sami Bacha and Aymen Ajina, "CSR performance and annual report readability: Evidence from France", *Corporate Governance*, 20, No. 2, (2020): 201-215.

<sup>2</sup>Abul Hassan and Syafri Harahap, "Exploring Corporate Social Responsibility Disclosure: The Case of Islamic Banks", *International Journal and Middle Eastern Finance and Management*, 3, No. 3, (2010): 203-227

<sup>3</sup>Frederick, W., Post, J. and Davis, K.E. (1992), *Business and Society. Corporate Strategy, Public Policy, Ethics*, 7th ed., McGraw-Hill, London

<sup>4</sup>Abigail McWilliams and Donald Siegel, "Corporate social responsibility: a theory of the firm perspective", *Academy of Management Review*, Vol. 26 No. 1, (2001): 117-127

<sup>5</sup>Norlan Orazalin, "Corporate Governance and Corporate Social Responsibility (CSR) Disclosure in Emerging Economy: Evidence from Commercial Banks of Kazakhstan", *Corporate Governance*, 19, No. 3, (2019): 490-507.

<sup>6</sup>Albert Caruana, Joseph Vella, Jirka Konietzny and Saviour Chircop, "Corporate greed: its effect on customer satisfaction, corporate social responsibility and corporate reputation among bank customers", *Journal of Financial Services Marketing*, Vol. 23 Nos 3-4, (2018): 226-233

Since the 1970s, Islamic Banking has grown all over the globe and it has expanded in more than 70 countries<sup>7</sup>. A gigantic change has been observed in the banking industry due to Islamic banks. The total assets of the Islamic banks are becoming more than 1.8t dollars<sup>8</sup>. Interest-free banking provides the opportunity for the customers to practice their religious faith. Islamic banks follow the Islamic principles which do not allow interest. The Islamic banks also play a vital role in the welfare and well-being of society. From the welfare perspective, the Islamic banks are considered more liable as compared with conventional banks particularly in Pakistan where more than 97 percent of Muslims reside. Recently, a sharp increase in Islamic banking has been observed in Pakistan. Islamic banks need to actively participate in CSR activities to boost up their FP.

In Pakistan, two different kinds of banks are operating and practicing CSR activities. Commercial banks are already involved in such services and some studies have been done about CSR and FP. However, only a few studies have been made that discuss CSR and FP in IBs. So, this paper intends to inspect the effect of CSR on the FP of the IBs operating in the Pakistan. It contributes to the existing literature regarding CS by mentioning the CSR practices performed by the IBs in Pakistan. In this regard, the study employs the OLS regression model to check the relation between CSR and FP. It also contributes to the IB-related literature where the CSR practices are needed to flourish.

The structure of this research is as: the literature is presented in part two, the third section exhibits the data and methodology of the study, the empirical findings of the study have been analyzed in the fourth part and the fifth part shows the conclusion part.

## II. LITERATURE REVIEW:

The term CSR is used in various ways among academicians and businesses<sup>9</sup>. Corporate Social Responsibility constitutes a gigantic financial reporting in developed economies and currently developing countries also tend to check it. CSR and firm performance have been studied in several studies. The existing literature mostly has focused on the developed countries<sup>10</sup>. Olaf Weber is in view that performance and CSR are positive relationships<sup>11</sup>. Md Zahidul Islam, Sarwar Ahmed and Ikramul Hasan are in the view that banks having a high CSR show a high return on the asset as compared with the low CSR<sup>12</sup>. Thomas Jones and Andrew Wicks discussed the FP of the IBs regarding CSR and concluded the positive impact of CSR<sup>13</sup>. Mallin, Farag and Ow-Yong used 90 Islamic banks to check the CSR and FP of the banks and they were in view that causality runs from financial performance to CSR<sup>14</sup>.

Elena, Mehmet, Rob and Sabri made a study on CSR and FP in the Gulf countries and the outcome exhibits a vital relationship between CSR and FP<sup>15</sup>. Mohammed Benlemlih and Isabelle Girerd-Potin focused on CSR and

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<sup>7</sup>Md Mustafizur Rahaman and Sharmin Akhter. "Bank-Specific Factors Influencing Profitability of Islamic Banks in Bangladesh", *Journal of Business and Technology* 10, No.1 (2015): 21-36

<sup>8</sup>Ernst and Young (2016) World Islamic banking competitiveness Report 2016

<sup>9</sup>Alexander Dahlsrud, "How corporate social responsibility is defined: an analysis of 37 definitions", *Corporate Social Responsibility and Environmental Management*, Vol. 15 No. 1, (2008): 1-13

<sup>10</sup>Bohyun Yoon, Jeong Hwan Lee and Ryan Byun, "Does ESG performance enhance firm value? Evidence from Korea", *Sustainability*, Vol. 10 No. 10, (2018): 3635

<sup>11</sup>Olaf Weber, O. (2017), "Corporate sustainability and financial performance of Chinese banks", *Sustainability Accounting, Management and Policy Journal*, Vol. 8 No. 3, pp. 358-385.

<sup>12</sup>Md Zahidul Islam, Sarwar Ahmed and Ikramul Hasan, "Corporate social responsibility and financial performance linkage. Evidence from the banking sector of Bangladesh", *Journal of Organizational Management*, 1, No.1, (2012): 14-21

<sup>13</sup>Thomas Jones and Andrew Wicks, "Convergent stakeholder theory", *Academy of Management Review*, Vol. 24 No. 2, (1999): 206-21.

<sup>14</sup>Christine Mallin, Hisham Farag and Kean Ow-Yong, "Corporate Social Responsibility and Financial Performance in Islamic Banks", *Journal of Economic Behavior and Organization*, 103, (2014): 21-38

<sup>15</sup>Elena Platonova, Mehmet Asutay, Rob Dixon and Sabri Mohammad, "The Impact of Corporate Social Responsibility Disclosure on Financial Performance: Evidence from the GCC Islamic Banking Sector", *Journal of Business Ethics*, 151, (2016): 451-471.

FP by collecting the data of firms from 25 countries over a period from 2001 to 2011 and they concluded that shareholder-oriented firms are less affected as compared with stakeholder-oriented firms<sup>16</sup>.

Similarly, Soojean Sarah Jang, HyessoKo, Yanghon Chung and ChungwonWoo explored the relation between CSR and FP in Korea by using the data from 2012 to 2015 and they implicit a positive association between CSR and FP<sup>17</sup>. Venere Di Bella and NedatAl-Fayoumi carried out a study in Jordan to check the perception of stakeholders about the CSR of IBs and they observed a positive behavior about the CSR<sup>18</sup>. On the contrary, Lee Preston and Douglas O'Bannon analyzed the CSR and FP by using 67 organizations of the US and found a negative connection between CSR and FP of the organizations<sup>19</sup>. The theory of stakeholder also states the importance of CSR regarding the firm performance<sup>20</sup>. On the ground of existing literature, this study develops the following hypothesis:

H0: CSR impacts on the FP of the Islamic banks positively.

HA: CSR impacts on the FP of the Islamic banks negatively.

### III. METHODOLOGY:

In this study, cross-sectional data of the major five Islamic banks of Pakistan were gathered over a period from 2016-2018 through the financial statements of the banks. In this research paper, probit regression was used where the dependent variable was Corporate Social Responsibility and the independent variable was financial performance. From the measurement perspective of financial performance, accounting and market-based proxies have been used<sup>21</sup>. The financial performance was measured through two proxies: ROA, ROE and NPM. ROA provides the operating efficiency and returns on equity as the shareholder return<sup>22</sup>. Many other studies used it as a proxy to check the relationship between CSR and FP<sup>23</sup>. It has been used to measure the relationship between CSR and FP<sup>24</sup>. Similarly, return on equity is also considered an important proxy for measuring the relationship between financial performance and CSR<sup>25</sup>. Net Profit Margin has been also used for this in several studies related to financial performance and CSR<sup>26</sup>. In this research paper, risk and size were used as a control variable. The risk was constructed as the total liabilities by total assets. In this way, the ordinary least square regression will be as following:

$$CSR = \alpha_0 + \beta_1 \text{Financial Performance} + \beta_2 \text{Size} + \beta_3 \text{Risk}$$

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<sup>16</sup>Mohammed Benlemlih, and Isabelle Girerd-Potin, "Corporate social responsibility and firm financial risk reduction: on the moderating role of the legal environment", *Journal of Business Finance & Accounting*, Vol. 44 No. 7, (2017):1137-1166

<sup>17</sup>Soojean Sarah Jang, Hyesso Ko, Yanghon Chung and Chungwon Woo, "CSR, social ties and firm performance", *Corporate Governance*, Vol. 19, No. 6, (2019):1310-1323

<sup>18</sup>Venere Di Bella and Nedat Al-Fayoumi, "Perception of stakeholders on corporate social responsibility of Islamic Banks in Jordan", *EuroMed Journal of Business*, Vol.11, No. 1, (2016):30-56

<sup>19</sup>Lee Preston and Douglas O'Bannon, "The corporate social financial performance relationship: A typology and analysis", *Business Society*, 36, (1997): 419-429

<sup>20</sup>Martin Samy, Godwin Odemilin and Roberta Bampton, "Corporate social responsibility: a strategy for sustainable business success. An analysis of 20 selected British companies", *Corporate Governance: The International Journal of Business in Society*, Vol. 10 No. 2, (2010): 203-217.

<sup>21</sup>Mohammed Chakib Kolsi and Osama Attayah, "Environmental policy disclosures and sustainable development: determinants, measure and impact on firm value for ADX listed companies", *Corporate Social Responsibility and Environmental Management*, Vol. 25 No. 5, (2018): 807-818

<sup>22</sup>Yi-Chun Chen, Mingyi Hung and Yongxiang Wang, "The effect of mandatory CSR disclosure on firm profitability and social externalities: evidence from China", *Journal of Accounting and Economics*, Vol. 65 No. 1, (2018): 169-190.

<sup>23</sup>Juanita Oeyono, Martin Samy and Roberta Bampton, "An examination of corporate social responsibility and financial performance: a study of the top 50 Indonesian listed corporations", *Journal of Global Responsibility*, Vol. 2 No. 1, (2011): 100-112

<sup>24</sup>Muhammad Shoukat Malik and Lubna Kanwal, "Impact of corporate social responsibility disclosure on financial performance: case study of listed pharmaceutical firms of Pakistan", *Journal of Business Ethics*, Vol. 150 No. 1, (2018): 69-78.

<sup>25</sup>Olayinka Marte Uadiale and Temitope Olamide Fagbemi, "Corporate social responsibility and financial performance in developing economies: the Nigerian experience", *Journal of Economics and Sustainable Development*, Vol. 3 No. 4, (2012): 44-55.

<sup>26</sup>Jose Moneva and Eduardo Ortas, "Corporate environmental and financial performance: a multivariate approach", *Industrial Management & Data Systems*, Vol. 110 No. 2, (2010): 193-210.

Where CSR denotes corporate social responsibility

#### IV. EMPIRICAL FINDINGS:

The present study analyzes the impact of CSR on the FP of the IBs in Pakistan. Table 1 highlights the descriptive summary.

**Table 1: Results of Descriptive Statistics**

Variables	Mean	S.D	Min.	Max.
ROA	5.253	5.518	-17.36	29.25
ROE	8.134	7.357	-47.35	53.85
NPM	5.332	3.431	-35.342	64.86
CSR	57.321	1.75	62.45	81.34
Risk	0.064	0.05	0.006	0.264
Size	20.65	1.584	17.73	24.47

The table depicts that the mean of ROA is 5.253 which indicates that the operating efficiency of the Islamic banks is high and the return on equity is 8.134 which is high and shareholders are getting a high return on their investment. The table also provides the standard deviations of the variables. ROE was found more volatile with the coefficient of the standard deviation of 7.357 which indicates that the investment of shareholders is very risky.

**Table 2: Correlation Matrix**

Variables	ROA	ROE	NPM	CSR	Risk	Size
ROA	1					
ROE	0.314	1				
NPM	0.215	0.241	1			
CSR	0.17	0.15	0.142	1		
Risk	-0.13	0.005	0.001	0.006	1	
Size	0.041	0.126	0.142	0.213	0.218	1

Table 2 demonstrates the results of the correlations among the concerned variables. The correlation between CSR and ROA was computed positive. Moreover, there was a positive correlation between CSR and ROE which presents that as the CSR activities increase, the return on equity also increases. Turning out to the control variables, Size and ROA have a positive correlation. However, a negative correlation between the Risk and ROA was occurred. The study found no multicollinearity and employs the probit regression to find the effect of CSR on the FP of the IBs in Pakistan.

**Table 3: Results of Probit Regression**

Variables	Coefficient	P-Value
CSR	-0.0047	0.831
Risk	0.485	0.421
Size	0.421	0.000***

Table 3 shows the outcomes of the probit regression model that measures the propensity. The “\*\*\*” shows the significance level at 1%. The table represents that the Islamic banks having a larger size perform more social responsibility as compared with the low. The table exhibits a positive effect of the CSR and the FP. The outcome shows that the financial performance of the Islamic banks increases by participating in CSR activities.

## V. CONCLUSION:

The foremost aim of this study is to examine the impact of CSR and FP of Islamic banks in Pakistan by applying the probit regression model. The study determines a positive influence of CSR on the FP of the Islamic banks in Pakistan. The study concludes that Islamic banks can get a competitive advantage through CSR activities. The CSR may be used as a tool to attract customers and which become an instrument to raise the FP of the IBs. This study contributes to the existing literature by analyzing the impact of CSR on FP of IBs in the Pakistani context. The study provides some important implications as well. The managers need to practice CSR activities for the well-being and betterment of the environment and society.

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