Extending Our Understanding of Islamic Banking through Questioning Assumptions and Drawing Unprecedented Comparisons

by

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Abstract:

This thesis challenges two key assumptions made in the current Islamic banking literature. Firstly, this thesis challenges and empirically invalidates the assumption that all Islamic banks are indistinguishable from their conventional counterparts and are thus equally unIslamic. To do so, this thesis uses the profit and loss sharing (PLS) criteria, which is central to the philosophy of Islamic banking and is the key principle differentiating Islamic from conventional banking, in theory and practice. By investigating variation in PLS levels between Islamic banks and comparing with conventional banks with and without Islamic windows, this thesis illustrates that the Islamic banking industry does not comprise a homogeneous group of banks that are all indistinguishable from their conventional counterparts. Rather, a typology of Islamic banks exists, comprising of three distinct groups of banks, each one following a different business model. While one group can genuinely be considered indistinguishable from conventional banks, another group shows clear evidence of pursuing PLS-oriented strategies in formulating its asset portfolio, differentiating itself from the purely debt-based intermediation model adopted by conventional banks. As such, empirical evidence shows that some Islamic banks are, in practice, operating closer to the PLS principle and can thus be considered more Islamic than others. Further investigation illustrates that the institutional environment matters for the provision of ideal PLS Islamic financing instruments.

Secondly, this thesis overcomes two methodological issues to compare the corporate social performance (CSP) of Islamic and conventional banks. In doing so, this thesis challenges the second identified assumption from the literature, that religion-specific category of corporate social responsibility (CSR) is particular to Islamic banking, and invalidates it on conceptual, theoretical and empirical basis. A novel CSP Index based on the evidence-based disclosure criteria, comprising of 6 dimensions and 25 social performance indicators is constructed and complemented with three Social Performance Quantitative Indicators (SPQIs) to compare the CSP of Islamic and conventional banks. From this comparison, this thesis concludes that, contrary to the industry’s claims and expectations held of it, Islamic banking does not offer an ethical alternative to
conventional banking. Differences in the level and composition of CSP between the two industries are more subtle and require a nuanced approach to be studied.

**Key words:** Islamic Banking, Profit-and-Loss Sharing (PLS), Transaction Cost Analysis, Cluster Analysis, Corporate Social Responsibility (CSR), Corporate Social Performance (CSP), Content Analysis, Legitimacy Theory, Stakeholder Theory, Institutional Theory, Gulf Cooperation Council (GCC)
Dedication

Dedicated to

my mother, Mrs Fehmida Navid

&

my father Mr Muhammad Navid,

for your unconditional love,

unwavering support &

innumerable sacrifices
Acknowledgements

I begin by thanking the One without whom none of the successes in my life would ever have happened. The One who stood by me through the brightest and the darkest moments of my life and continues to do so; watching over, giving hope and courage when I need it and bringing me down to earth when I stray too far off course; the One who gave me strength to continue through all the struggles and blessed me with more and better than I ever deserved. For all the successes, the jubilations, the struggles, the failures, the perseverance, the lessons, the growth and much more, it is to God that I owe my greatest thanks, yet neither my words nor my emotions can ever duly thank Him.

Of the greatest gifts He blessed me with, are the people with whom I have shared my PhD journey. While there are far too many people to name individually in this short note, I would like to thank, first of all my supervisors: Professor David S. Saal, for his unwavering support, encouragement and unimaginable patience, which has been a constant source of strength since the first day of my PhD till its completion and Dr Karligash Glass for her constant support and pragmatic advice that has helped me through this project. I would also like to thank Professor Tom Weyman-Jones, Dr Anthony Glass, Professor Alan Lowe, Dr Carola Wolf and the participants at the seminars and conferences where this work has been presented for their valuable feedback that helped shape this work. I am also very grateful to both my internal and external exminers, Dr Alessandra Ferrari and Professor Barbara Casu for their comments that greatly improved my thesis.

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also like to thank Dr Jonathan Unwin, Dr Raffaele Bertone and Dr Jennifer Quick for the excellent care they have provided during my PhD years.

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List of Abbreviations

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions
CBIW: Conventional Banks with Islamic windows
CIBAFI: General Council for Islamic Banks and Financial Institutions
CIMA: Chartered Institute of Management Accountants
CSP: Corporate Social Performance
CSR: Corporate Social Responsibility
FSA: Financial Services Authority
GCC: Gulf Cooperation Council
GSIFI: Governance Standard for Islamic Financial Institutions
IAH: Investment account holders
IAIB: International Association of Islamic Banks
IDB: Islamic Development Bank
IFA: Islamic Fiqh Academy
IFI: Islamic financial institution
IFSB: Islamic Financial Services Board
IIFM: International Islamic Financial Market
ILM: International Islamic Liquidity Management Corporation
IIRA: International Islamic Rating Agency
IMF: International Monetary Fund
IPDS: Islamic private debt securities
IRR: Investment risk reserve
JIB: Jordan Islamic Bank
KFH: Kuwait Finance House
KLD: Kinder, Lydenberg, Domini Research & Analytics
LIBOR: London Interbank Offered Rate
LMC: Liquidity Management Centre
NBFIs: Non-banking financial institutions
OIC: Organization of the Islamic Conference
Pbuh: Peace be upon him
PER: Profit equalisation reserve
PLS: Profit-and-loss sharing
PwC: PricewaterhouseCoopers
SME: Small and medium enterprises
SPQI: Social Performance Quantitative Indicators
SPV: Special purpose vehicle
SQR: Sharia Quality Rating
SRI: Socially responsible investment
SSB: Sharia Supervisory Board
UAE: United Arab Emirates
UK: United Kingdom
UKIFS: UK Islamic Finance Seretariat
UN: United Nations
US / USA: United States of America
WTO: World Trade Organisation
# List of Abbreviations: Bank Names

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Chapter 1

Introduction

1.1 Introduction

1.1.1 Why Study Islamic Banking?
Islamic banking has developed from a niche to a prominent feature of the international financial sector since its inception in the 1970s. The industry has flourished over the last four decades, becoming one of the fastest growing segments of the global banking market. With a compound annual growth rate of 38.5% (2004-2011) (IFSB, 2013), Islamic banking assets worldwide crossed the $1 trillion mark in 2011 (Reuters, 2012). The industry has truly become an international financial phenomenon, with more than 600 Islamic financial institutions spread across 70-plus countries (ADB and IFSB, 2015). The industry has become “systematically important” in some and “too big to ignore” in other markets (Hasan and Dridi, 2010, p.33). The Gulf Co-operation Council (GCC) nevertheless, remains the centre of the Islamic financial industry. The region houses the biggest and the largest collection of Islamic banks worldwide. 14 of the top 20 Islamic banks comprising 55% of the global Islamic banking assets are located in the GCC. In Saudi Arabia, Islamic banking now represents over 50% of total banking assets (Ernst & Young, 2012). Given its pivotal role in the Islamic banking industry, this thesis focuses on the GCC region.

1.2 Research Questions
Two aspects of Islamic banking need to be considered for a holistic understanding of this phenomenon. First, is the financial aspect, which in theory is premised on the principle of profit-and-loss sharing (PLS). Second, is the social aspect of Islamic banking, which in theory translates into the promotion of social and developmental goals (Warde, 2000). This thesis considers both aspects of Islamic banking. In doing so, it questions two key assumptions that have been identified from the current literature, one relating to each aspect of Islamic banking. These are introduced below, leading to the research questions this thesis aims to answer.
1.2.1 The Financial Aspect of Islamic Banking

The emergence of Islamic banking in the 1970s started a global debate, raising questions such as: How different is Islamic banking from conventional banking? Does it offer a genuine alternative? And is it even ‘Islamic’? Almost half a century later, these questions still hold enormous significance for research, the global banking industry and policy-making, as they question the legitimacy of a multibillion-dollar industry that is rapidly increasing its presence worldwide. Given their importance, these questions have already received considerable academic interest. Repeatedly, however, the same conclusions have been drawn in the literature i.e. Islamic banking is “not very different from conventional banking” (Chong and Liu, 2009, p.125); Islamic banks “do not operate much differently from conventional banks” (Aggarwal and Yousef, 2000, p.118); Islamic banks follow a business model that appears to “not be too different” from their conventional counterparts’ (Beck et al., 2013, p.445); there are “merely superficial differences” between Islamic and conventional banks (Zaman and Movassaghi, 2002, p.2429) and that Islamic banking offers “merely a semantic difference” from conventional banking (Kuran, 2004, p.10), as it relies on “shari’a arbitrage”, the difference in language, contractual forms and transaction structures, (El-Gamal, 2006, p.20) to create a “de jure distinction” from conventional banking without offering a de facto alternative to the interest-bearing loan contract (Khan, 2010, p.806). Thus, the entire Islamic banking industry has been dismissed as simply “indistinguishable from conventional banking” (Khan, 2010, p. 805).

Although the literature appears to have reached a definitive conclusion, this thesis will provide new insights that challenge our current understanding of Islamic banking and illustrate using empirical evidence how these earlier conclusions are not fully valid. In doing so, this thesis challenges the implicit assumption that the abovementioned conclusions rely upon. By dismissing the entire industry, the current literature implicitly assumes that Islamic banking industry comprises of a homogenous group of banks that are all indistinguishable from their conventional counterparts and thus equally un-Islamic. Does the Islamic banking comprise of a homogenous group of banks or are there subgroups, some differentiable from conventional banks while others are not? To answer this, one must first understand the criteria upon which the conclusions thus far have been drawn which at their core relate to the concept of profit-and-loss-sharing (PLS), the significance of which is explained below.
Background

Islamic banking exists to provide alternative forms of financial services that are consistent with the sharia\(^1\). The prohibition of riba, commonly translated as a ban on interest, is considered to be the central tenet of the Islamic financial system (Iqbal and Tsubota, 2006). Providing interest-free financial services has therefore become the *sine qua non* of Islamic banking. The alternative to interest-based lending that the theory of Islamic banking propagates is profit-and-loss-sharing (PLS), i.e. an equity-based form of financial intermediation. The entire theoretical model of Islamic banking is based on the principle of PLS. PLS exists in contractual agreements where two or more parties pool resources for investment purposes and share the resulting profits and losses at pre-specified ratios (Dar et al., 1999). The contracts of musharakah (equity partnership) and mudarabah (silent partnership) premised on this PLS principle are considered “the real and ideal instruments of Islamic financing” (Usmani, 2004, p.12).

Despite its centrality to Islamic banking, in practice Islamic banks rely predominantly on non-PLS instruments. These are criticised precisely for being a “*cumbersome form of interest*” (Kuran, 1995, p.162), as they rely on “otherwise unnecessary SPVs [special-purpose vehicles] or the addition of superfluous financial transactions” to gain religious legitimacy through establishing structural differences from conventional interest-bearing counterparts (El-Gamal, 2006, p.21). Such ‘sharia-compliant’ alternatives are argued to be forms of legal tricks, where contractual techniques permitted under sharia, are employed in such a way to overcome rulings on that which is prohibited (El-Diwany, 2010 p. 122). Two of the most prominent financing methods, murabahah (cost-plus-credit-sale) and ijarah (lease), which on average exceed more than 80% of Islamic banks’ asset portfolio (Iqbal and Mirakhor, 2002), are criticised heavily as legal ruses, designed to circumvent the prohibition of riba and replicate interest-based debt finance contracts (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal 2006; Zaman 2008; Khan 2010, El-Diwany, 2010). Due to their reliance on such non-PLS instruments which conform to the letter but not the spirit of the sharia, Islamic banks are widely criticised to be operating no different from their

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\(^1\) Sharia is considered to be God-given set of instructions (divine guidance) on how to live one’s life and thus encompasses all aspects of a Muslim's life including beliefs, laws and morals. It stems from the holy book of Islam (the Quran) and the example of the Prophet of Islam, Muhammad (peace be upon him), see chapter 2 for details.
conventional counterparts whilst supporting only a *de jure* Islamic identity (Khan, 2010).

Thus, the lack of PLS financing (musharakah and mudarabah contracts) is at the core of the criticism of Islamic banking. While the extant Islamic banking literature has criticised Islamic banks for relying on the controversial non-PLS instruments, the extent of variation in PLS financing levels across different Islamic banks and the potential reasons for such differences have largely been neglected thus far. Are some banks operating closer to the principle of PLS than others? If so, why? This question has not been considered in the literature as yet and is the subject of investigation in this thesis.

By answering this question, the above-mentioned assumption of homogeneity in Islamic banks can be tested. As banks adopt more PLS, they not only “become more Islamic” (Azmat et al., 2015, p.254) but also different to conventional banks which operate on debt-based lending. Thus, by investigating variation in PLS levels between individual banks, one can assess if the Islamic banking industry comprise of homogeneous group of banks that have negligible levels of PLS and therefore are all indistinguishable from their conventional counterparts. To be able to address this however, it is first important to understand why the Islamic banking industry diverged from its PLS oriented theory towards non-PLS alternatives. Therefore the following two questions will be addressed sequentially in the first part (chapter 3 and 4) of this thesis.

1. How and why has the Islamic banking industry diverged from its PLS-oriented theory towards non-PLS oriented practices?
2. Are some Islamic banks operating closer to the principle of PLS than others, and therefore can be considered more Islamic? If so, what factors enable some banks to provide more PLS financing than others?

**1.2.2 The Social Aspect of Islamic Banking**

The 2008 financial crisis has reignited the debate about ethics in banking and finance (Wilson, 2009). An increasing focus is now being paid to the alternative, ethical forms of banking and comparisons are being drawn between the ethical and conventional banking models (see Paulet et al., 2015 for a recent comparison). Islamic banking bears an ‘ethical identity’, due to its philosophical roots in religion (Haniffa and Hudaib, 2007; Aribi and Arun, 2015). In the four-year period following the onset of the financial
crisis, Islamic banking assets grew at an average rate of 17% per annum, 2-3 times faster than the rate of their conventional counterparts (Ernst & Young, 2014; BBC News, 2014). Naturally, the industry attracted a lot of attention and there is much interest in comparative studies of Islamic and conventional banking. A significant part of the extant literature however has focused on comparing banking models, financial and operational performance including efficiency and productivity, default rates and risk as well as the impact of the financial crisis on the profitability, asset growth, stability and resilience of Islamic and conventional banks (see e.g. Abdul-Majid et al., 2010; Hasan and Dridi, 2010; Srairi, 2010; Beck et al., 2013; Bourkhis and Nabi, 2013; Mobarek and Kalonov, 2013; Johnes et al., 2014; Baele et al., 2014; Saeed and Izzeldin, 2016). None thus far, to the best of my knowledge, have conducted a systematic comparison of Islamic and conventional banks corporate social performance (CSP) in the period immediately after the financial crisis.

Comparison of Islamic and conventional banks’ social performance is not only timely in light of the renewed search for ethical alternatives, but also an opportunity to test the claims made by and expectations held of Islamic banks. Society at large and especially customers and investors choosing Islamic banking for secular ethical and particularly religious reasons expect Islamic banks to incorporate social objectives into their policies and uphold Islamic ethical values, to fulfil not only an economic and religious but also a social role (Maali et al., 2006; Belal et al., 2015). This is because Islamic banks claim to provide banking services in accordance with the sharia, the objective of which is to ‘promote the welfare of people’ and establish social justice (Chapra, 1992; Aribi and Gao, 2010; Kamla and Rammal, 2013; Aribi and Arun, 2015). According to Islamic principles, all commercial activities are subject to the moral objectives of sharia. Islamic banks are therefore required to not only abide by the prohibitions of riba which regulate the nature of Islamically-permitted financial arrangements but also embed the Islamic ethical values within their operations (Usmani, 2004). To operate in line with sharia values, Islamic banks are expected to have broader social goals therefore profit maximisation should not be the sole objective of these financial institutions and offering social value should form an essential part of the industry’s value proposition (Ali et al., 2013; Warde, 2000, 2010; Belal et al., 2015).

Accordingly, social objectives have been declared an essential, inseparable feature of Islamic banking, and Corporate Social Responsibility (CSR) a requirement for Islamic
banks to follow the principles of Islam in their entirety (Maali et al., 2006; Dusuki, 2008; Warde, 2010; Farook et al., 2011). Given the importance attached to social goals it is no surprise that Islamic banks are “expected to be more socially responsible than their conventional counterparts” (Haniffa and Hudaib, 2007, p.101).

Such expectations have been long recognised by Islamic banks who acknowledge that adherence to sharia has social and ethical implications for their activities (Maali et al., 2006; Kamla and Rammal, 2013). Islamic banks have been keen to claim themselves as providers of an ethical alternative for all, leveraging their religious identity to distinguish themselves from conventional banks on ethical and social grounds, and marketing their services as not only a religiously-compliant alternative for Muslims but also a “desirable” one for non-Muslims wishing to invest and save their money ethically (Kuran, 2004; Visser, 2009; Kamla and Rammal, 2013 p. 924). Such marketing claims are somewhat unsurprising given the industry’s continued growth rests on its ability to attract a client base beyond the Muslim niche and its selling points in a global secular market lie in highlighting the universally-acknowledged ethical values of the Islamic philosophy, the consensus between Islamic principles and international standards regarding socially responsible business practices¹ and the social value the industry offers (Abu-Tapanjeh, 2009; Williams and Zinkin, 2010; Warde, 2000, 2010). Given this context, it is interesting to note that neither the claims made by Islamic banks nor the expectations held of them have been tested so far. Do the present-day Islamic banks really offer an ethical alternative to their conventional counterparts by demonstrating superior social performance? This question is as yet unanswered.

The need to ask such a question arises due to a healthy scepticism about the claims made by Islamic banks. One must acknowledge that Islamic banks do not always show evidence of operating in accordance with the underlying sharia principles or the ideals propagated in theoretical models. As ethical recommendations in sharia are not legal requirements, there exists the possibility that Islamic banks following purely the letter of the law may be less inclined towards social initiatives which are costly to undertake. Notably, even if Islamic banks attach greater importance to social goals than their conventional counterparts, without a thorough comparison it is not possible to conclude ex ante that Islamic banks social performance would be superior to their conventional counterparts especially in the post crisis period. The pressure faced by the international banking industry to demonstrate a socially responsible business profile, addressing their
obligations towards society, has substantially increased since the financial crisis (Jizi et al., 2013). In the current environment, the banking industry is not only facing a loss of credibility but also heightened customer dissatisfaction and a general loss of trust by society (Bravo et al., 2012). The need to improve public image and maintain operational legitimacy is therefore of utmost importance. As CSR is recognised to be one of the direct routes to establishing an ethical corporate identity (Balmer et al., 2007; Bravo et al., 2012), heavy emphasis has been placed on CSR in the banking industry in recent years (Pérez and Rodriguez del Bosque, 2012). Detailed disclosures have been made in banks annual reports in an attempt to demonstrate their commitment to social and ethical concerns and alignment of corporate behaviour with societal expectations (Bravo et al., 2012). Under such circumstances, a thorough comparison is required to determine in what ways Islamic and conventional banks social performance differs, if at all.

Finally it must also be recognised that such a comparison is important not only for Islamic banking stakeholders but also the international community. The importance and influence of Islamic banking worldwide is likely to rise in the future as Islamic banking assets are estimated to grow at an average rate of 19.7% per year to 2018, moving from an “esoteric” to a “global” asset class (The Economist, 2014). Issues related to and claims made by Islamic banks are therefore no longer relevant only for Muslims. Nevertheless, even as the industry moves beyond a niche market, much of Islamic banking is concentrated in developing and emerging economies, where the banking sector plays a key role in enabling socio-economic development. Issues of social justice, women empowerment, global development, poverty eradication especially through inclusive financing and environmental sustainability are major concerns worldwide (Kamla and Rammal, 2013). The UN Millennium Development Goals² are a key example of the importance attached to such issues and the commitment made by the international community to overcome these. The role of banks regarding their developmental, social and environmental contributions is receiving considerable attention as these social issues become hot topics in the development and globalisation literature (Belal et al., 2015). Thus, it is vital that a banking industry which claims to provide an ethical financial alternative (Visser, 2009) is evaluated and compared against

² See http://www.un.org/millenniumgoals/bkgd.shtml for details
the status quo, for if there is such a banking alternative which exists, is financially viable and growing then it should receive a welcome call by not just those turning to it for religious reasons but also those committed to the betterment of society.

Recognising the importance of such a comparison, it is apt to ask why it has not been conducted thus far. The absence of a comparative study in the extant literature which addresses the above question can be appreciated in light of the challenges that it presents. A meaningful comparison between Islamic and conventional banks requires that a single research instrument is used to assess and compare the two industries’ social performance. The current Islamic banking literature however assumes that CSR premised on the values of sharia implies a category which is ‘particular’ to Islamic banks, comprising of social activities required specifically from Islamic banks to demonstrate their sharia compliance and fulfilment of sharia’s moral obligations (Belal et al., 2015). Given the presence of such a ‘particular’ CSR category, which is essentially considered incomparable, how can Islamic and conventional banks’ social performance be compared? Notably, even if a valid comparison could be drawn, the challenge of measuring corporate social performance still remains. Corporate social performance (CSP) is a concept closely related to CSR (Orlitzky et al., 2011) as it refers to the ‘the outcomes and actions resulting from a firms’ socially responsible behaviour’ (Wood, 1991; Van der Laan et al., 2008). In the conventional CSR literature, ethical ratings issued by rating agencies such as KLD3 are often used as a measure of an organisation’s CSP. For Islamic banks however, such third-party ethical ratings do not yet exist. Instead research on CSR in Islamic banking literature is largely normative and analytical as oppose to empirical (Farook et al., 2011). Importantly, the limited number of empirical studies which exist focus on measuring and analysing the volume, presence and/or type of social disclosure (e.g. positive/negative disclosure) in Islamic banks’ annual reports, often against a predetermined benchmark disclosure index, to understand Islamic banks reporting behaviour, as opposed to examining and comparing social performance (see e.g. Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2011; Kamla and Rammal, 2013; Aribi and Arun, 2015; Belal et al., 2015). A

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3 Kinder, Lydenberg, Domini Research & Analytics (KLD) is a leading ethical rating agency. It rates companies’ social performance using a rating criteria based on the company’s strengths and concerns against seven qualitative screens, each one focusing on a particular social indicator. These seven areas include: community, corporate governance, diversity, employee relations, environment, human rights and product quality and safety.
research instrument which measures and compares Islamic and conventional banks’ CSP therefore needs to be constructed.

Given this background, the following questions are posed in this thesis and will be addressed in the second part of the thesis (chapters 5 and 6).

3. Can a single research instrument be used to compare the corporate social performance (CSP) of Islamic and conventional banks?
4. How does the corporate social performance (CSP) of Islamic and conventional banks differ?

1.3 Thesis Structure
To answer the research questions posed above, this thesis is divided into two parts. Part 1 comprises of Chapters 2, 3 and 4. These focus primarily on the financial aspect of Islamic banking. Chapter 2 provides foundational knowledge for the readers by briefly introducing the key Islamic concepts and terms that are relevant for the issues discussed in this work. Chapter 3 addresses the first research question posed in this thesis while chapter 4 addresses the second research question. Part 2 of the thesis comprises of Chapters 5 and 6 which focus on the social aspect of Islamic banking and address the third and fourth research questions respectively. A summary of each chapter is presented below.

Chapter 2 introduces the key concepts including the three main prohibitions of Islamic law which are particularly relevant for the financial aspect of Islamic banking. First, the meaning and scope of the term ‘sharia’ is covered in detail. This is followed by an explanation of the prohibition of ‘riba’. The prohibitions of ‘gharar’ and ‘haram’ industries are covered more briefly. Practical implications of these prohibitions for Islamic banking are explicitly stated. By addressing and clarifying the most common misconceptions held about these terms and concepts, this chapter provides the foundational knowledge readers will require to engage with the discussions presented in chapters 3 and 4.

Chapter 3 addresses the first research question posed in this thesis as it provides a detailed account of the development of Islamic banking and explains how and why the industry deviated from its PLS-oriented theory to non-PLS oriented practices. The
chapter begins by explaining why the European commercial bank could not develop as an indigenously-Islamic institution within the context of medieval Islamic societies and describes more briefly how the conventional banking was transported to the Muslim countries and the roots of the Islamic banking movement. This is followed by a description of the theoretical model of Islamic banking. An in-depth account of the three different phases Islamic banking underwent in its transition from theory and to reality is then presented. Controversies related to Islamic banking products as well as the sharia certification process are also discussed at length. Finally a four-part analysis explains why the divergence between theory and practice of Islamic banking was inevitable, by discussing: transaction costs, impact of the institutional environment, incompatibility between the theoretical model of Islamic banking and the roles of a commercial bank and finally the inconsistency between principles of commercial banking and Islamic finance. The chapter concludes that no present-day Islamic commercial bank can be fully consistent with Islamic principles and raises the question whether some banks could be considered more Islamic than others, setting the motivation for the question addressed in chapter 4.

Chapter 4 focuses on addressing the second research question posed in this thesis and asks whether all Islamic banks can be considered equally Islamic. In doing so, it questions the implicit assumption made in the current literature which dismisses all Islamic banks as simply indistinguishable from conventional banks, assuming that PLS levels are negligible in all banks. This chapter investigates the variation in PLS levels between Islamic banks by using two measures of PLS. It also calculates PLS levels for conventional banks with and without Islamic windows and compares these with Islamic counterparts. The chapter is divided in three parts. The first part presents a cross-sectional study, where PLS levels between Islamic banks and conventional banks with and without Islamic windows are compared using a single year’s data to focus on the variation that exists between banks as opposed to changes occurring over time. Results from this analysis show that Islamic banking industry does not comprise a homogeneous group of banks; rather there is considerable variation in PLS levels between individual banks. A typology of Islamic banks is identified on the PLS criteria; which illustrates that some banks are indeed following a more PLS oriented business model and thus can be considered more Islamic than others. The second part of the chapter extends this analysis by examining multiple years’ data (2009-2012) and uses
cluster analysis to validate the typology of banks identified. Results confirm the presence of three distinct groups within the Islamic banking industry and that group membership is predominantly stable. Finally, part 3 investigates why some Islamic banks can have higher PLS financing levels than others by estimating the relationship between PLS financing level and banks-specific characteristics identified from the literature, controlling for the differences in institutional environment across countries.

Chapter 5 addresses the third research question raised in this thesis, i.e. whether a single research instrument can be used to assess and compare the CSP of Islamic and conventional banks. At its core, this question relates to two issues. First is the issue of incommensurability between Islamic and conventional banks’ CSR, which arises from the assumption that religion-specific CSR is a category particular to Islamic banks, as asserted in the current literature (Belal et al., 2015). Second, is the issue of measurement i.e. how can the CSP of Islamic banks be measured? By addressing both these issues sequentially, this chapter develops a multidimensional CSP Index, comprising of 25 social performance indicators (SPIs), which is then used to compare the CSP of Islamic and conventional banks in chapter 6.

Chapter 6 addresses the fourth and final research question posed in this thesis as it investigates how the CSP of Islamic and conventional banks differ. To do so, the chapter first uses the CSP index constructed in chapter 5 to compare the level and composition of CSP between Islamic and conventional banks. Using the dichotomous scoring method widely used in the current literature, CSP scores are generated for banks and comparisons are drawn between individual banks and across the two industries. In drawing comparisons, the chapter asks two questions. First, do Islamic banks, on average, have higher CSP scores than conventional banks? Second, how does the composition of CSP differ between Islamic and conventional banks? E.g. are the most/least popular CSP dimensions and social performance indicators the same? For these questions, the difference over the 2009-2011 period is also examined to identify: firstly, if and how the level and composition of CSP has changed within both industries and secondly, how the changes compare across the two industries. To further extend the literature on Islamic and conventional banks’ CSP comparison, the chapter also complements the dichotomous CSP score method with quantitative measures of selected social performance indicators developed in chapter 5, for which monetary or impact data could be collected from banks’ annual reports. Termed as Social
Performance Quantitative Indicators (SPQIs), these assess the extent to which a bank engages in a particular CSR activity, allowing for greater differentiation between individual banks and a more comprehensive comparison between the Islamic and conventional banking industries.

The next chapter will now provide an introduction to the key Islamic concepts, including the three main prohibitions of Islamic law, which are especially relevant for the financial aspect of Islamic banking discussed in this thesis.
Chapter 2

Introducing Sharia, the Key Islamic Prohibitions and their Implications for Islamic Banking

2.1 Introduction

Islamic banking is attracting much interest from both the global financial industry and academia. Research papers on the topic of Islamic banking have increased considerably in the last decade. Arabic terms such as ‘sharia’ and ‘riba’ are no longer alien to the non-Islamic finance specialists. Indeed, the terms ‘sharia-compliant’ and ‘riba-free’ are often used synonymously to describe the Islamic banking industry. But what do these terms mean?

Sharia is commonly translated as Islamic law and the prohibition of riba, which is the central tenet of the Islamic financial system, as a ban on interest (Iqbal and Tsubota, 2006). Albeit the most common translations, these are not only inaccurate but also unfair oversimplifications which limit one’s ability to fully comprehend the notion of ‘Islamic’ banking and the controversies and criticisms of the industry’s products and practices. Thus, despite a rise in research studies on the topic, there are still a number of common misconceptions held about key concepts underlying Islamic banking which deserve clarification. Without appreciating the depth of the underlying Islamic concepts and prohibitions, the more nuanced arguments and discussions on the complex issues concerning the Islamic banking industry may not be clear or even accessible to the reader. A meaningful discussion of Islamic banking therefore requires a move away from shallow one-or-two word translations of these terms.

The purpose of this chapter is to provide the reader with an understanding of the central Islamic concepts, including the three main prohibitions of Islamic law, which are particularly relevant for the financial aspect of Islamic banking. To achieve this, section 2.2 begins with a detailed discussion of the meaning and scope of sharia. Section 2.3 explains the three prohibitions. Riba is discussed at length, given its central role in the theory of Islamic banking. More concise descriptions of the other two prohibitions are
also presented, thereby defining the terms ‘gharar’ and ‘haram’. The implications of these prohibitions for Islamic banks are also explicitly stated. Section 2.4 concludes the chapter. In meeting its purpose, this chapter addresses and clarifies the most common misconceptions held about the key concepts discussed and by doing so provides the reader with the foundational knowledge required for the issues discussed in this thesis, especially in chapters 3 and 4.

2.2 The Sharia

Sharia is often inaccurately translated as ‘Islamic law’. This translation is not only problematic for reasons discussed below, it is also not in line with the linguistic foundations of the word (Kamali, 2008). The Arabic word ‘sharia’\(^4\) literally means the “way to water”, which in the harsh Arabian Desert referred to the only certain path of survival (Janin and Kahlmeyer, 2007, p.1). In religious terms, sharia refers to “God’s appointed way”, the path which leads to salvation and felicity in this world and the hereafter (Kamali, 2008, p.2). Practically, sharia is “a way of living one’s life”, an all-embracing way of thinking and being (Norcliffe, 1999, p.37; Ezzati, 2002). In the Islamic context, sharia is viewed as a God-given set of “instructions” which define the way Muslims are to live and practice their faith, the means through which they can conform to the will of God\(^5\) (Norcliffe, 1999, Ezzati, 2002, p.79).

The sharia is based on two theological sources: the Quran and the Sunnah (Janin and Kahlmeyer, 2007; Kamali, 2008). Muslims believe the Quran (Holy Book of Islam) is the literal word of Allah (God), which was revealed to the divinely-guided final Prophet of God, Muhammad (peace be upon him, henceforth pbuh\(^6\)). The Sunnah is the sayings and practices of Prophet Muhammad (pbuh), which expand upon and explain the Quranic teachings\(^7\). Record of the Sunnah has been preserved through oral traditions,

\(^4\) The precise English spelling (transliteration) of the Arabic word is ‘shari’ah’, but in the interest of simplicity, the commonly used, much simpler spellings are used in this work.

\(^5\) The “literal definition of Islam is “peace [attained] through submission to the will of Allah [God]” (Zepp Jr., 2000, p.xxxv). The sharia is the means through which one can conform to the will of God and achieve the state of a Muslim i.e. “one who is at peace through submission to God” (Norcliffe, 1999, p.1).

\(^6\) Pbuh is the acronym for ‘peace be upon him’. These words follow the mention of the Prophets of Islam as a gesture of respect.

\(^7\) The Quran itself confirms the Sunnah as a source of prescriptive guidance for Muslims. For example it states “And We revealed to you (O Muhammad, pbuh) the message (the Quran) that you may make clear to the people what was sent down to them” (Quran 16:44) and “Indeed in the Messenger of Allah
known as the ahadith (sing. hadith). Unlike the Quran, the ahadith do not exist in a single book. Two of the six most authentic books of ahadith are Sahih al-Bukhari and Sahih Muslim, the authenticity of which is considered second only to the Quran (El-Diwany, 2010).

The Quran and the Sunnah contain guidance on all aspects of a Muslim’s life. There is no distinction made between acts commonly seen as religious and those considered secular. The economic, social and legal affairs of Muslims and their society are therefore as much part of the religion as praying. Thus, the sharia encompasses both the spiritual and the material life of Muslims, at an individual and collective level. It not only comprises the essential values, articles of faith and moral teachings which define the Islamic belief but also specifies the rules which underpin their socio-economic and legal systems to be in accordance with God’s will. Accordingly, Islam as a religious belief system and sharia as the way of implementing it, provide a comprehensive framework for organising society, its institutions as well as guidance for the behaviour and conduct of individuals operating within that institutional and social context. Muslims therefore cannot compartmentalise their lives into secular and religious dimensions and the sharia influences decision-making in all spheres of their private and public life including the design of their society’s financial systems (Presley and Sessions, 1994; Norcliffe, 1999; Rice, 1999; Lewis, 2001; Tinker, 2004; Kamla et al., 2006; Ayub, 2007; Dusuki and Abdullah, 2007; Dusuki, 2008; Iqbal and Lewis, 2009; Shanmugam and Zahari, 2009; Aribi and Gao, 2010; Khan and Karim, 2010).

Contrary to the above, sharia is often considered a legal-code rather than a framework of life (Norcliffe, 1999). This misunderstanding stems from a focus on the legal injunctions specified within the sharia. Law is indeed an integral part of the sharia. The

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8 The Sunnah of Prophet Muhammad (pbuh) has been preserved through the ahadith. The hadith (singular form) is a chain of dependable oral traditions relating to the actions and words of Prophet Muhammad (pbuh), with the record of the original narration going back to the Prophet’s companions (Warde, 2000; El-Diwany, 2010). The six most authentic books of hadith are: Sahih al-Bukhari, Sahih Muslim, Sunan an-Nisa’i, Jami’ at-Tirmidhi, Sunan Abi Dawud and Sunan Ibn Majah. These books are named after the compilers who collected and verified the authenticity of thousands of hadith relating to the actions and sayings of Prophet Muhammad (pbuh) before adding to their collections. For a summary on the science of hadith, see El-Diwany (2010).

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(Prophet Muhammad, pbuh) you have a good example to follow” (Quran 33:21). Note that references from the Quran refer to the chapter number followed by the verse number e.g. Quran 33:21 refers to the 21st verse of the 33rd chapter. Following the example of Kamla et al. (2006), a number of different English translations of the Quran have been used to convey the best explanation of the original Arabic text. The main translations used include Sahih International and Muhsin Khan, available also at www.quran.com.
Quran itself contains approximately 350 verses with a legal significance covering topics as varied as the rules of commercial transactions, inheritance, marriage, dietary regulations and even the rights of the poor, amongst others (Kamali, 2008; Iqbal and Lewis, 2009). However, it is often overlooked that law is only a constituent part of the sharia which at its core is primarily concerned with the Islamic dogma, particularly the belief in one God, its unwavering stress on morality and their integration in one’s personal conduct (Kamali, 2008). The overly legalistic tendency to define sharia as law and Islam as a “law based religion” has therefore come at the expense of the moral teachings of Islam (Kamali, 2008, p.6), and has resulted in the failure to acknowledge sharia as a “system of morality” which is primarily concerned with maintaining high ethical standards (Janin and Kahlmeyer, 2007, p.31).

Viewing sharia as purely a legal system has also created an arbitrary and inappropriate division between the spirit and the letter of sharia law. To understand the spirit of sharia requires a study of its underlying objectives. As Al-Ghazali⁹ (a prominent 11th century Muslim scholar) famously summarised, the objective of sharia is to promote human welfare, which lies in the safeguarding of five necessities; faith, life, intellect, wealth/private property and lineage/family institution (Kamla et al., 2006; Kamali, 2008; Aribi and Gao, 2010; El Diwany, 2010; Aribi and Arun, 2015). To protect these, certain activities are prohibited in the sharia¹⁰. For example, to protect wealth/private property, sharia lays down comprehensive rules of law governing economic transactions including the prohibition of riba (see section 2.3.1). Sharia prohibitions are therefore underpinned by ethical concerns, the preservation of the essential moral values of Islam (Kamali, 2008) and are aimed at ensuring the wellbeing and happiness of human beings in this world and the hereafter (Ayub, 2007). Failure to focus on these objectives leads to incorrect interpretations of the sharia. This is particularly relevant for the discussion of fiqh (Islamic jurisprudence) since legal rules derived solely on the basis of the letter of the law can potentially violate the spirit of sharia law, thereby defeating the purpose for which they are established. As Al-Shatibi (the renowned 14th century legal scholar) explained, the letter of the sharia law is not the end itself but the means to achieving the benefit the law intends. Therefore, one who meets the letter but

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⁹ Al-Ghazali is a prominent and respected 11th century Muslim theologian, jurist and philosopher.
¹⁰ For example, to preserve life, abortion and murder are prohibited in the sharia; to preserve the family institution, adultery and fornication are prohibited whilst to preserve the intellect, alcohol and other narcotics are prohibited (Ayub, 2007; Shakir, 2015).
not the substance (i.e. spirit) of the law does not follow the sharia (El-Gamal, 2006). Recognising this is particularly relevant for understanding the controversies surrounding Islamic banking products discussed in chapter 3, as is the distinction between sharia and fiqh.

The equivalence drawn between sharia and fiqh is a notable misconception which needs to be addressed. Often used interchangeably, the terms sharia and fiqh are not identical (Kamali, 2008). For Muslims, both the Quran and Sunnah are an eternal form of guidance (Warde, 2000). Principles specified directly in these sources, including those governing commercial activities, are timeless and universal. Some principles, however, require further clarification in their applicability to contemporary situations, examples of which cannot be found in Islamic history, such as modern banking practices. This is where fiqh, the interpretation of sharia, plays an important role. Fiqh (literally “in-depth understanding”) refers to Islamic jurisprudence, the body of detailed legal codes developed by Islamic jurists to address new and specific issues not explicitly mentioned in the Quran and the Sunnah (Hassan and Lewis, 2007; Abdul-Rahman, 2010, p.68). The sources of fiqh, also known as the secondary sources of Islamic law, include ijma (the consensus of Muslim jurists) and qiyas (analogical deduction) based on ijtihad (independent reasoning by Islamic jurists to establish new legal rules) (Ayub, 2007; Hassan and Lewis, 2007; Visser, 2009; Abdul-Rahman, 2010). Legal opinions issued by Islamic jurists/scholars are known as fatwas (Janin and Kahlmeyer, 2007; Kamali, 2008).

Islamic law is therefore made up of two components: the sharia and the fiqh; distinction between which is important to note. As sharia contains divine law from the Quran and Sunnah, both of which are unalterable, the sharia itself does not change. Fiqh, on the other hand, is man-made law, the application of sharia to new and specific problems, needs and circumstances which arise within different societies at different times. Some aspects of the fiqh rulings therefore can and do change over time depending on society specific circumstances (Abdul-Rahman, 2010). Thus, legal rulings (fatwas) derived from fiqh i.e. the secondary sources of law are not indisputable as are the divine injunctions specified in the sharia (Iqbal and Molyneux, 2005). The former can also never override the sharia therefore anything prohibited or permitted in sharia cannot be
altered by the fatwas issued by jurists/scholars\(^\text{11}\). Together, the combination of sharia and fiqh give Islamic law both permanency and flexibility. While the core Islamic principles and values specified in the sharia remain constant, the scope for adaptation to changing socio-economic environments enables accommodating developments and advancement in the law as per society’s needs (Warde, 2000; Shanmugam and Zahari, 2009).

Naturally, there can be differences amongst jurists/scholars in interpreting the sharia based on their intellect, knowledge, experience and local circumstances. The resulting varying interpretation of sharia has given rise to different schools of fiqh\(^\text{12}\). Distinctions, even if minute, across the fiqh schools e.g. in interpreting the strictness of a sharia rule, can give rise to different fatwas on the same matter across countries, regions and even within countries, depending on which school of fiqh or scholar is followed (Warde, 2000; Shanmugam and Zahari, 2009; Abdul-Rahman, 2010). This has important implications for the Islamic banking industry due to the classification of sharia rules.

The sharia is broadly divided into two categories. Ibadaat (the ritual acts of worship) concern the relationship between mankind and God while muamalat (civil transactions) concern the relationship between humans (Janin and Kahlmeyer, 2007). Banking is governed by the rules of fiqh-al-muamalat i.e. Islamic jurisprudence concerning all matters other than acts of worship (this covers economic, political and social issues). Unlike ibadaat, fiqh-al-muamalat follows the ‘Principle of Permissibility’ i.e. all activities are permissible unless specifically prohibited by the sharia (El-Diwany, 2010). Since evidence on modern banking practices cannot be found in Islamic history, scholars need to interpret the sharia prohibitions specified for commercial transactions and their implications for banking activities. The Islamic banking industry therefore relies predominantly on fatwas issued by scholars through recourse to secondary

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\(^{11}\) In deriving new legal rulings or allowing potential deviation from existing norms, Muslim jurists are guided by the principle of maslahah i.e. public interest/welfare which is in line with the objective of sharia. Furthermore, the principle of darura (necessity) and urf (custom/common practice) are also considered by jurists. Customary practices, as long as they do not violate the sharia are respected and in case of necessities, sharia rules including prohibitions are temporarily suspended to alleviate hardships (Warde, 2000; Ayub, 2007).

\(^{12}\) The four main schools of fiqh (Islamic jurisprudence) in orthodox Sunni Islam are Hanafi, Shafi’i, Maliki and Hanbali. The Shia Muslims have their own different schools of jurisprudence (Warde, 2000; Shanmugam and Zahari, 2009; Abdul-Rahman, 2010).
sources of Islamic law, particularly ijtihad, to determine the validity of the industry’s products and practices (Siddiqi, 2001).

For banking, the most important sharia prohibitions are of riba and gharar (defined below), which specify the difference between all valid and invalid Islamic contracts and transactions (El-Gamal, 2006). Further to these is the prohibition of any involvement in haram (religiously prohibited) industries e.g. breweries (Chapra, 1992; Warde, 2000; Zaher and Hassan, 2001; Ayub, 2007; Visser, 2009; El-Diwany, 2010). Given their significance, these prohibitions and their implications are discussed below.

2.3 Key Prohibitions and their Implications

2.3.1 Riba
The prohibition of riba, commonly translated as a ban on interest or usury, is the most well-known principle of Islamic finance. Providing interest-free financial services is therefore considered to be the sine qua non of Islamic banking (Khan, 2010).

Translating riba as simply interest, however, is not only inappropriate but also misleading. Not all forms of what economists call interest e.g. the mark-up charged in credit sales and leases are prohibited in Islam. Furthermore, some transactions with an effective zero-percent interest rate, e.g. the exchange of £100 today for £100 in a year’s time, are forbidden on the grounds of riba. More importantly, the riba prohibition applies not only to monetary but also non-monetary transactions i.e. the exchange of goods, as long as the goods exchanged belong to the same genus e.g. salt-for-salt (El-Gamal, 2006; Ayub, 2007; Nyazee, 2009, 2016; Visser, 2009; El-Diwany, 2010).

Drawing direct equivalence between riba and interest is therefore clearly erroneous. So what exactly is riba?

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13 Riba is explicitly prohibited in the Quran and the Sunnah. Verses related to riba in the Quran are: 2:275-279; 3:130; 4:161 and 30:39 (for order of revelation, discussion and hadith on riba, see Ayub, 2007).

14 The most well quoted hadith on the definition of riba is: “Abu Said al Khudri reported that the Holy Prophet (pbuh) said “Gold is to be paid for by gold, silver for silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment made hand to hand. He, who makes an addition to it or asks for an addition, deals in riba. The receiver and the giver are equally guilty” Hadith reported in Sahih Muslim, No.4064 (El-Diwany, 2010, p.103).
The word riba literally means ‘increase’ or ‘excess’, and refers to an unlawful gain which arises from inequality of counter-values exchanged in a commutative transaction (for detailed discussion see Warde, 2000; El-Gamal, 2006; Ayub, 2007; Nyazee, 2009, 2016; Visser, 2009; El-Diwany, 2010). This excess (riba) is “revealed in two ways: excess in quantity or amount and excess from the benefit of delay” (Nyazee, 2009, p.52; 2016). One or both features therefore exist in a riba transaction; an increase in the amount of one counter-value over the other and/or a delay in settling one or both of the counter-values15 (El-Diwany, 2010). On a superficial level, the delay in repayment does not appear to create inequality in the values exchanged, however, £100 (or 1 ounce of gold) today is not worth the same as £100 (or 1 ounce of gold) in a year’s time. Islamic law therefore recognises the time value of money (and other commodities) and takes into account that the change in values over time can potentially create unjustified gain for either party (El-Gamal, 2006; for other examples see, Nyazee, 2009, 2016; El-Diwany, 2010).

The scholarly debate on riba has a long tradition and is still ongoing (see Warde, 2000 and Visser, 2009) however, it is important to note the rationale underlying the riba prohibition. Simply, sharia prohibits the exchange of unequal amounts of the same good and delay in settling the counter-values because such transactions are seen as inflicting injustice upon one of the counterparties (El-Diwany, 2010). The ban on riba therefore is aimed at establishing justice and fairness and preventing exploitation in business transactions, by eliminating all forms of unjust and unfair exchanges, especially “inequity in exchange”16 and more specifically the expropriation of wealth in credit transactions (Presley and Sessions, 1994; Kuran, 2004; Siddiqi, 2004, 2006; Iqbal and Molyneux, 2005; El-Gamal, 2007, p.320-1; Salleh et al., 2011, 2014).

15 There are two types of riba. The first feature noted above refers to riba-al-fadl (riba of increase) which prohibits the trading of two goods from the same kind in different quantities, whilst the second feature refers to riba-al-nasia (riba of delay) which prohibits time-delay to occur in settling the counter-values, and therefore requires that when the same good is exchanged, the counter-values are settled on spot (El-Gamal, 2006; Nyazee, 2009, 2016; Visser, 2009; El-Diwany, 2010, p.99-108).

16 According to Ibn Rushd (a famous Muslim jurist and philosopher, 1198 C.E.) the prohibition of riba is aimed at eliminating “excessive inequity … [which] in certain transactions is achieved through equality”. Two fungible goods of the same genus and quality need to be exchanged in equal amounts, and when quality difference exist or when the goods exchanged are of two different types then the ratio of goods traded should be determined by the ratio of their prices. The prohibition of riba therefore ensures justice by eliminating the option of disadvantageous trade for one party; and enhances efficiency by ensuring that the quantity of goods traded occur at ratios determined by the ratio of market prices (El-Gamal, 2006, p.52-3).
Implications of the Riba Prohibition

Lending can only be for Charitable Purposes

The prohibition of riba applies directly to money-for-money exchanges i.e. loans. The standard interest-bearing loan contains both riba conditions mentioned above, i.e. it contains both a surplus and a delay in the counter-values exchanged. Even an interest-free loan fails the riba prohibition due to the delay in repayment. Importantly, this implies that “all loans, with or without interest are prohibited” under Islamic law (Nyazee, 2009, p.76). Thus, in a pure Islamic financial system, a ‘loan’ per se, with a fixed repayment period, cannot validly exist (Nyazee, 2009, 2016).

The only valid loan under Islamic law is ‘qard hasan’; literally, “a goodly loan”, or sometimes called an interest-free benevolent loan (Nyazee, 2009, 2016; El-Diwany, 2010, p, 178). Qard hasan, however, differs from the conventional interest-free loan on three grounds. First, qard hasan is altruistic in nature, where the lender advances money to help a financially needy person. Second, no benefit (monetary or non-monetary) is permitted for the lender. Finally, no fixed repayment date can be stated for qard hasan as the amount loaned is returned at the borrowers’ convenience. Notably, in qard hasan, the delay in repayment is not considered riba. This is because under Islamic law, qard hasan is a contract of charity and not a contract of exchange. These legal technicalities, i.e. the contract forms, do matter since riba only applies to the latter contract types. Drawn up as charitable contract, a loan is possible under Islamic law and the rule of riba doesn’t apply. Essentially, in qard hasan, the usufruct of money is given in charity by the lender. Lending therefore is considered a charitable act in Islam and is not permitted for profit-making (Nyazee, 2009, 2016; El-Diwany, 2010).

To appreciate this, it is important to acknowledge the concept of money in Islam. The sharia prohibits charging a rent for money because from an Islamic perspective money does not have any intrinsic utility; it does not represent a commodity and is seen only as a medium of exchange. Money is essentially a store of value which “represents the monetised claim of its owner to property rights”. These rights are transferred when money is loaned. As no surplus is generated through the mere act of lending, there isn’t any additional property over which the lender can have claims. Interest repayments are therefore seen as an encroachment on the existing property rights of the borrowers and are deemed unjust (Presley and Session, 1994, p.586; Usmani, 2004; Rehman, 2010).
Legitimate Return is earned through Effort and Risk-Sharing

The sharia draws a distinction between money and capital. Money is potential capital, unable to produce a return on its own. Transformation into capital requires money to be supplemented with enterprise i.e. active productive effort, risk taking and the know-how of effectively combining other factors of production to generate additional wealth. On this incremental wealth (profits), both the borrower and the lender have a residual claim since both contribute to the generation of it. Any return on funds extended by the financier therefore needs to be “commensurate with work effort” (Presley and Session, 1994; p.586).

If a financier cannot take an active role in managing the funds, the commercial risk of the funded venture needs to be shared. This is because any guaranteed return which is independent of the venture’s outcome is considered riba since it equates to ‘money-now-for-more-money-later’ which is prohibited (Zaher and Hassan, 2001; Iqbal and Tsubota, 2006; Ayub, 2007). The prohibition of riba therefore requires risk-sharing between the financier and the user of funds. This condition is met in equity financing where profits and losses are shared between the contracting parties. Since profits are determined ex-post, they reflect the creation of additional value from the funded venture and are subject to real economic risks. These risks are shared by all parties in a profit-and-loss-sharing arrangement, resulting in more equitable returns during good and bad times (Zaher and Hassan, 2001). Such a financing approach is in line with both the objective of sharia and the riba prohibition which aim to establish equity and justice in society and business transactions (Chapra, 1992; Siddiqi, 2004, 2006; Iqbal and Molyneux, 2005; Ayub, 2007). Riba-free financing therefore equates to profit-and-loss-sharing (PLS) which is achieved through equity partnerships.

Implications for Islamic Banks

Advancing a loan does not present a viable option for Islamic banks as the loan contract contains elements of riba. To earn a return legitimately, Islamic banks need to share the risk i.e. profits and losses of the business/project funded. This is achieved by entering

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17 In an interest-bearing loan arrangement, the lender receives a predetermined rate of return which is independent of the funded venture. The interest rate reflects the perceived risk associated with the borrower’s creditworthiness and not the funded venture. Even in a variable interest rate arrangement, the lender does not face or share the commercial risk of the venture as is required because the interest rate charged varies with the market rate and not the risk/outcome of the funded venture. Thus both fixed and variable interest rate loans are not consistent with the riba prohibition.
PLS arrangements (i.e. equity partnerships) with the funded parties. Under such arrangements Islamic banks’ return on investment is a pre-determined profit-share which is distinguishable from a fixed return\(^{18}\). Crucially, the relationship between the bank and the funded client becomes one of partnership and not the borrower-lender relationship common in conventional banking.

### 2.3.2 Gharar

Gharar is often translated as risk, speculation or uncertainty; however, translating gharar simply as uncertainty or risk can also be misleading as all commercial activities entail some degree of both. Islam does not prohibit risk. On the contrary, returns from commercial transactions are justified only when the associated risk is incurred.

Gharar exists in transactions that are conditioned upon uncertain events and covers excessive risk taking and speculative behaviour e.g. gambling (maysir). In contracts, gharar refers to a lack of clarity and uncertainty relating to the contractual terms and its basic elements, e.g. the subject matter, its price, and the rights/obligations of either party. The concept of gharar also connotes deception, fraud and cheating as it relates specifically to the exploitation of others through uncertainty or incomplete information\(^ {19}\). The prohibition of gharar, therefore, aims to eliminate commercial contracts and transactions which use asymmetric information as the basis for exploitation as well as those where either party earns a return purely on the basis of chance, e.g. through gambling which undermines the value of productive effort. This is because under sharia, any return earned needs to be not only economically but also morally justified (Warde, 2000; Ebrahim and Rahman, 2005; El-Gamal, 2006; Ayub, 2007; Visser, 2009).

**Implications for Islamic Banks**

The prohibition of gharar leads to a ban on transactions and contracts containing excessive risk, speculation and uncertainty. Any financial product and transaction which lacks material finality, i.e. does not have a direct or indirect link to a real economic transaction, and is used to earn a return purely through speculation is also

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\(^{18}\) Islamic economists argue that because Islamic banks’ returns are tied to the performance of the funded venture under such a financing system, it creates incentives for Islamic banks to seek out the most productive and profitable projects, leading to a more efficient allocation of resources (Iqbal and Molyneux, 2005).

\(^{19}\) Distinction between minor and major gharar based on cost-benefit analysis is important, since only the transactions suffering from major gharar are banned (El-Gamal, 2006).
prohibited. In relation to banking, the prohibition of gharar translates into a ban on short sales, derivatives, futures, forward contracts, discounting of bills and any form of speculative transactions that are akin to gambling (Usmani, 2004; Ayub, 2007; El-Hawary et al., 2007; Visser, 2009; Khan, 2010).

2.3.3 Haram Activities
Haram (religiously prohibited) activities refer to those that are either explicitly banned by the Quran and Sunnah, are judged to be inconsistent with the ethical values and objectives of the sharia or are identified as harmful for society. These include industries such as alcohol, pork-related products, gambling, pornography, tobacco, narcotics, companies involved in oppressive regimes (i.e. abusing human rights) and/or environmental degradation as well as industries failing to meet the riba and gharar prohibitions such as conventional banking and finance (Dusuki and Abdullah, 2007).

Implications for Islamic Banks
Engagement in haram industries either through production, distribution, financing or investment does not present a lawful source of income, since one cannot profit from something immoral within the bounds of sharia (Rehman, 2010). Islamic banks therefore cannot legitimately invest in or finance haram industries. Instead, Islamic banks are required to run a sharia screening process to design their asset portfolios, similar to the approach commonly adopted by socially responsible investment and ethical funds (Iqbal and Molyneux, 2005). As the screening criterion is rooted in the principles of sharia, it represents a ‘moral filter’, which Islamic banks in their role as an intermediary are required to exercise to ensure that financial resources are allocated away from activities which are incompliant with sharia and harmful for society (Chapra, 1992; Rehman, 2010).

2.4 Conclusion
This chapter introduced the key concepts and prohibitions of Islamic law which are directly relevant for the financial aspect of Islamic banking. The meaning and scope of sharia and the prohibition of riba have been discussed at length due to their importance and relevance for the discussions presented in the upcoming chapters. More concise descriptions of the prohibition of gharar and haram industries were also presented and the implications of all three prohibitions for Islamic banks were explicitly stated.
In introducing the key concepts, particular care was taken to address common misconceptions. Thus, the reader can now appreciate why sharia is more than Islamic law, riba more than simply a ban on interest and gharar more than uncertainty and risk. Inaccurate and oversimplified translations such as these hinder the ability of the reader to fully comprehend the complex issues which affect the Islamic banking industry particularly the reasons for certain criticisms of its products and practices which are discussed in the next chapter. By addressing the most common misconceptions, it is hoped that this chapter has provided a sound foundation which will make discussions presented in next chapters more accessible to the reader.

Chapter 3 will now describe the development of Islamic banking, with a focus on explaining how and why the industry diverged away from its PLS-oriented theoretical model. Discussions in the next chapter will illustrate how the interpretation of sharia as simply law and a focus on the letter not the spirit of sharia law led to the development of highly controversial products and practices. It will also show how riba has, since the beginning of modern Islamic banking, simply been translated as a ban on interest, but ironically, despite this misinterpretation, current Islamic banking products fail to even comply with this limited standard. The importance of recognising the difference between fiqh and sharia will also aid in understanding some critical issues discussed in the next chapter. Finally, the next chapter will also highlight how varying interpretations of sharia by different scholars affects the Islamic banking industry.
Chapter 3

Understanding the Development of Islamic Banking: Divergence between Theory and Practice

3.1 Introduction

Islamic commercial banks are the subject of enquiry in this thesis. These institutions claim to provide banking services in accordance with the sharia. Abiding by the sharia prohibitions described in chapter 2 is therefore a necessity for these institutions’ religious legitimacy. Of the three prohibitions mentioned, riba has undoubtedly received the most attention in the Islamic banking literature and is considered to be the central tenet of Islamic finance (Iqbal and Tsubota, 2006). To avoid riba, Islamic economists have promoted financial intermediation on the principle of profit-and-loss-sharing (PLS), which is the basis for the theoretical model of Islamic banking. Contrary to this theoretical premise, Islamic banks in practice rely predominantly on non-PLS (debt-based) financial instruments. These are, however, heavily criticised by many as completely un-Islamic arrangements, designed to circumvent the sharia prohibitions and replicate interest-bearing debt contracts by complying with the letter over the spirit of sharia law (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal, 2006; Zaman, 2008; Khan, 2010; Khan, 2010a). Despite this criticism, 80-90% of Islamic banks’ asset portfolio on average is in non-PLS form (Iqbal and Mirakhor, 2002; Warde, 2010). Thus, there is significant divergence between the PLS-oriented theory and the non-PLS-oriented practice of Islamic banking.

How and why has the industry developed this way? The purpose of this chapter is to answer these questions. To achieve this, a detailed account of Islamic banking’s development, from its conception to present-day practices, is presented followed by a four-part analysis explaining why the divergence between theory and practice was inevitable. In doing so, this chapter will argue that no Islamic commercial bank can be fully compliant with the sharia because commercial banking, which by definition
operates on a fractional reserve basis and intermediates by converting risk-free deposits into credit, is inherently inconsistent with the principles of Islamic finance.

To support this argument, section 3.2 begins by describing the financial institutions which operated in the medieval Islamic world and explains why a European-style commercial bank did not and could not have developed as an indigenously-Islamic institution. The circumstances which transported conventional commercial banking to the Muslim world and started the Islamisation movement, leading to modern Islamic banking are then briefly introduced. This is followed by a description of the theoretical model of Islamic banking in section 3.3.

Section 3.4 provides an in-depth account of the three phases of Islamic banking’s development since its emergence as a conceptual idea in the mid-twentieth century. The key political, economic and social factors which shaped the industry are highlighted. Financial initiatives which emerged as precursors to Islamic banking during the first phase are described to illustrate how these institutions, which operated according to Islamic finance principles, did not follow the standard commercial banking model. In contrast to these, modern Islamic banks which began operations during the second phase were specifically designed to emulate conventional commercial banking. As will be explained, it was indeed the goal of replacing conventional commercial banks which led to modifications made to the theoretical model of Islamic banking and the development of controversial non-PLS financial products. The initial proposed modifications and the process of their approval is covered in some detail to highlight that replication of commercial banking practices was possible only by compromising on religious values. Although religiously questionable, non-PLS instruments enabled the industry to grow to its current scale internationally. Factors aiding the growth and internalisation of Islamic banking, including the efforts of selected countries which have become industry leaders, are covered in the final phase along with a discussion of the global, country-level and regional growth rates recorded by the industry. Other notable characteristics of the current industry are also discussed. Finally, the changing nature of Islamic banking literature over the years and how intentions underlying the Islamic banking movement morphed, to reach a stage where the form-over-substance approach to designing sharia-compliant products has become the accepted norm, will also be highlighted throughout section 3.4.
Controversies associated with Islamic banking practices specifically related to the most popular products are explained in section 3.5. Although the prohibition of riba was interpreted narrowly as simply a ban on interest during the industry’s development, this section will illustrate how current Islamic banking products fail to even comply with this limited standard. This section ends with a discussion of the controversies surrounding the sharia certification process with a brief evaluation of the steps taken by the industry to address these issues.

Section 3.6 then provides the four-part analysis explaining the divergence between theory and practice. The first two subsections focus on why non-PLS financing instruments have been favoured. The sources of higher transaction costs associated with PLS financing are explained and the impact of the institutional environment within which Islamic banks operate is discussed. The final two subsections expand the scope of analysis and consider the divergence between theory and practice more broadly. In the first of these, it will be argued that the theoretical model of Islamic banking propagated in the literature is not a model of commercial banking. Divergence from this model was therefore inevitable as Islamic banks aimed to replicate and replace their conventional counterpart. The final subsection, by bringing together key points from earlier discussions, will argue that the commercial banking institution is inherently inconsistent with sharia principles. Therefore Islamic commercial banks would have necessarily deviated from the Islamic principles and any theoretical model based on such principles. The more consistent alternative and recent proposed reforms for the industry are also discussed in this subsection, leading to policy recommendations. Finally section 3.7 concludes the chapter. Please note, that the thorough descriptions presented in this chapter serve a dual purpose. In addition to supporting the chapter’s aim and central argument, these also provide the background for issues discussed later in the thesis, primarily in chapter 4.

3.2 Historical Context

From its advent in seventh century Arabia, Islam spread outward in all directions throughout the Middle East to Asia, Africa as well as Europe. From the seventh to the fourteenth centuries, while Europe faced its Dark Ages, the Islamic civilisation
experienced its Golden Age\textsuperscript{20}, characterised by rising economic strength, advancement in knowledge, technology, and culture. Significant contributions were made in the fields of science, mathematics, economics, law, philosophy and literature amongst others (Warde, 2000).

On the financial front as well, the Islamic world was far ahead of the West, having developed a wide variety of credit institutions by the mid-eighth century. Historical records from the ninth to the eleventh century show evidence of complex quasi-banking activities in tenth century Iraq, an extensive ramified system of proto-banking in eleventh century Egypt and North Africa as well as widespread use of credit instruments which preceded their conventional counterpart. The latter included the suftaja (bill of exchange/letter of credit), as well as the ruq’as and sukuk (akin to modern-day cheques) \textsuperscript{21}. Many of the complex financial instruments commonly used and accepted as part of commercial life in the Islamic world were later adopted by the West (Udovitch, 1975). Famous examples include the sakk (singular of sukuk, referring to financial certificate) which is considered to be the root of the French/English word cheque (Warde, 2000; El-Gamal, 2006) and the mudarabah, a profit-and-loss sharing (PLS) financing arrangement developed to support the financial needs of merchants along major trade routes, which later became known as the ‘commenda’ in Europe (Harris, 2009). Although extensively used and discussed in religious and legal documents in the first two centuries of Islam, the mudarabah reached Europe centuries later with the oldest records found in Northern Italy in the late 11\textsuperscript{th} and 12\textsuperscript{th} centuries (Harris, 2009, see also references within). Other financial practices and similar credit techniques to those developed during the earliest medieval period in the Islamic world also began to appear in the West several centuries later, some as late as the 13\textsuperscript{th} century. Thus, the widespread use of complex financial instruments in the early Islamic world is attested to be at least three to four centuries earlier than anything comparable appearing in medieval Europe (Udovitch, 1975).

\textsuperscript{20} The Golden Age of Islam is approximated to be between the seventh to the tenth centuries in the Middle East and eleventh to the fourteenth centuries in Spain and the North African region (Warde, 2000).

\textsuperscript{21} The ruqa’s (literally notes) were used in short distance and local trade as orders for payments, delivery and as promissory notes. These complemented sakks (literally a “written documentation of financial liability”) and were used as instructions for transfer or deposit of funds and for payments of a variety of bills. Both operated as close equivalents of modern-day cheques (Udovitch, 1975; Shanmugam and Zahari, 2009; El-Gamal, 2006, p.195, see also references within).
Despite this four century head start, the Islamic world did not develop independent banking institutions, of the kind present today. Indeed the developments in the Islamic world preceded the emergence of standalone institutions devoted to banking, the foundations of which were laid in 12th century Europe and then firmly established by 14th century Italian commercial banking houses. From the 14th to the 16th centuries, this European banking model, which operated by converting deposits into credit, became more elaborate and has ever since followed an upward trend in complexity, size and influence, proceeding to the present day complex banking and financial institutions (Udovitch, 1975; Warde, 2000).

Such an institution however did not and could not have developed in the Islamic world. As Udovitch (1975) explains this was due to a number of factors, including the socio-economic structure of Islamic economies and rules governing financial transactions. In the Islamic world, financial services were provided through two institutions: money-changers and merchant bankers, although some of their functions overlapped. The former were a reliable source of international coinage and their evaluation, facilitating the interchangeability of gold and silver coins, used then as currency. In commercial centres such as Alexandria, money-changers occupied their own special bazaars, akin to Wall Street, which served as the nerve centres of financial exchange. Profits were primarily earned in form of a fixed transaction fee for each exchange.

Merchant bankers were involved in a variety of proto-banking activities, from issuing bills of exchange (suftajas), accepting deposits (although no interest was paid on these) to acting as a clearinghouse for payments through extensively using ruqa’s and sukuk as well as money-changing for those with significant involvement in international trade. Despite their extensive banking operations, no individual was exclusively a banker. Instead, all banking activities undertaken by merchant-bankers were an extension of their commercial endeavours, related directly or indirectly to the trade in commodities (Udovitch, 1975). This was an important factor in the development of financial institutions in the Islamic world. In line with the gharar prohibition, all financial transactions were linked to a real economic activity through either trade of goods, production or investment in commercial ventures. Thus, there was no need for a standalone financial institution as financial activities were never autonomous but rather always conducted as a subset of commerce (Warde, 2000).
Credit provided to support the financial needs of merchants, domestic households, agriculture and industry primarily came in the form of credit and prepayment sale contracts as well as profit-and-loss sharing (PLS) arrangements. Credit sales were not only an indispensable source of credit supporting long-distance international trade but also an important source of profit, fully consistent with Islamic law. The sale of an item on credit for a higher than spot price is permitted under Islamic law, as the difference in price is considered a legitimate compensation to the creditor for the absence of capital, the risks involved and the benefit the buyer is able to receive through the use of the goods before full payment is made (Udovitch, 1975; Usmani, 2004; Visser, 2009). This encouraged widespread use of credit sales which explains why the prohibition of riba was observed to a considerable extent at the time, without retarding commercial activities. In keeping with the riba prohibition, investment in trade and industry was based on PLS arrangements, particularly the mudarabah and its variants, which were used as flexible alternatives to the interest-bearing loan contract. Usurious transactions were not the norm and the use of traditional Islamic loan contract i.e. qard hasan (interest-free benevolent loan) was insignificant in commerce (Udovitch, 1975).

The relationship between deposit and credit was also very different in the Islamic world. The European bank developed as an intermediary which converted deposits into credit. In the Islamic world, this form of financial intermediation i.e. the conversion of deposits into return-generating loans was not possible as there was a disconnection between deposit and credit functions. In the Islamic world, deposits were held in form of trust. The contract of wadiah (safekeeping) was used which neither involved payment of any fee or compensation either to the depository or the depositor, nor permitted the depository to use the deposited funds. The function of this contract was restricted to safeguarding of money/goods deposited. This ensured that credit/investment and deposit activities were kept separate and within narrow confines. This was in sharp contrast to the European experience where the depository could not only use the deposited funds for its own commercial endeavours, generating credit, but also paid a premium to the depositors for this privilege. The latter, which developed into a deposit banking system continuing to this day, could clearly not be established in the Islamic world (Udovitch, 1975; Warde, 2000).

In addition to the legal framework and financial structure, the social context was also an important factor. Credit, banking and commercial institutions in the Islamic world were
primarily reliant on a close-knit network of personal and communal relationships. Granting of credit was primarily based on the status and reputation of the parties concerned and was embedded in intricate albeit informally-structured but nonetheless an effective network of personal-social relationships. Merchant banking activities outside of such a network were rare (Udovitch, 1975; Warde, 2000). As Udovitch argues, these exact social-personal relations, which ensured successful and effective functioning of merchant banking and credit activities during the medieval period, were also the factors which confined their elaboration, development and growth into independent organisational forms. The complexities, unpredictability and slowness of communication between distant geographical locations limited the scale of economic activities at the time to numerous intimate circles, the integration of which into a much larger independent structure was precluded by the reliance on strong social networks. Thus, the socio-economic structure of the medieval Islamic civilisation did not lay down the foundations to construct economic institutions which could exist independently of the intricate social network on which economic life was based (Udovitch, 1975). With no individual specialising in banking, a disconnection between deposit and credit functions, and financial relationships predominantly embedded in personal and communal ties, the European style independent deposit banking system could not and did not develop in the medieval Islamic world.

Although not indigenously developed, the European banking model did firmly establish itself in the Islamic world. This was possible due to changes in world economic powers. As Europe exited the Dark Ages, it underwent a huge transformation through the stages of the Renaissance, Reformation, Enlightenment, Industrial Revolution, and Imperialism. In contrast, the Islamic world began to experience a break from it celebrated past as well as developments in the West, resulting in prolonged period of stagnation followed by decline between the fifteenth and the twentieth centuries (Warde, 2000). By the nineteenth century, a huge gap between the West and the Muslim world had developed which was followed by most of the Muslim world falling under colonial rule (Iqbal and Molyneux, 2005).

The economic, political and cultural impact of Western ascendancy has been of significant importance in shaping the Muslim world. By the late nineteenth century, Western models of economics, law, politics and education were imposed on most Muslim countries which underwent, along with Westernisation, a thorough process of
secularisation. The role of religious scholars was significantly reduced while that of publically elected representatives was enhanced. This period was also critical for the financial sector, as the traditional Islamic financial institutions were replaced by western counterparts. The European interest-based model of commercial banking, which was first transported to most of the Muslim world through trade, became firmly established through colonisation. Muslim countries’ banking sectors thereafter began operating on the conventional interest-based banking model (Warde, 2000; Maali and Napier, 2010).

The mid twentieth century brought about another notable change. With the fall of the British Empire in colonial India and the creation of Pakistan, a separate independent state for South-Asian Muslims, a movement to revive Islamic norms in the economic domain ignited. Contributions from South-Asian scholars, especially the writing of Maulana Mawdudi (1903-1979), which gave rise to the term ‘Islamic Economics’ became of significant influence22. Following Mawdudi’s seminal work, an abundance of literature was produced on Islamic economics, with the largest contributions made by Pakistani scholars23. Driven by the establishment of a separate sovereign state based on religious identity, Pakistan became the pioneer of the Islamisation24 movement (Wilson, 1983; Kuran, 1996; Warde, 2000).

The Islamic economics doctrine which appeared in the postcolonial era, as Kuran (1995, 1996, 2004) has extensively argued, was driven largely by “cultural rather than economic concerns” (Kuran, 1996, p.438). Aimed at re-establishing the importance of religion in the economic domain, it emerged as an instrument to create, protect and strengthen the religious identity of South Asian Muslims which at the time was considered threatened by western influence. It therefore lacked scientific rigour and was primarily normative. Few contributions in the literature proposed solutions for modern-day economic problems. Instead the focus was firmly placed on establishing an ‘Islamic’ approach towards economics (Kuran, 1996). Two features became dominant

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22 Influential figures in the Arab world include Sayyid Qutb and Baqir Al-Sadr (El-Gamal, 2006).
23 Despite Saudi Arabia being the birthplace of Islam and the Arab Peninsula being the centre of the earliest Islamic civilisation, the only serious debate about applying Islamic principles to economics in modern times took place in Pakistan and not the Middle East. Unsurprisingly so, as Pakistan is the world's only country which was founded explicitly for the purpose of providing Muslims a state to govern themselves in accordance with Islamic principles (Wilson, 1983; Kuran, 1996; Warde, 2000).
24 Islamisation refers to the process of desecularising the state including the legal, political and economic systems to bring these in line with the Islamic principles (Haniffla and Hudaib, 2010).
in the literature. First, the prohibition of riba, translated within narrow confines as a ban on interest, which took centre stage and second, the emphasis on social justice in Islam, which translated into socio-economic development being one of the primary goals of an Islamic financial system (Chapra, 1985).

With the ban on interest taken as the central precept, the challenge was to Islamicize the existing interest-based banking system. However, without examples of modern-style banking institutions in the Sunnah (Prophetic tradition) and Islamic history, religious scholars trying to create an indigenous, ‘authentic’ brand of Islamic economics, and particularly banking, struggled to reconcile legal sources with demands of the modern world. Scholarly efforts within the realm of fiqh (jurisprudence) expanded. An unprecedented level of ijtihad\(^25\) (juristic inference) was undertaken to devise a financial system which would be consistent with both religious principles and the modern economy (Warde, 2000). Scholars relied on qiyas (analogical reasoning) through reference to legal precedents\(^26\). Documents of classical fiqh were searched for contractual arrangements which could be used either directly or in modified form as alternatives to modern-day conventional financial products (El-Gamal, 2006). The classical texts provided abundant examples of trade and investment contracts; the former comprising of a variety of sale contracts including mark-up and credit sale, leasing as well as other trade-based contracts and the latter consisting of PLS arrangements including the mudarabah and its variants (including musharakah). Majority of scholars promoted the idea that interest was to be replaced by PLS mechanisms, creating alternative bank–business and depositor–bank relationships based on equity partnerships rather than the usual borrower-lender relationship in conventional banking (Warde, 2000; Ayub, 2007).

With no indigenous Islamic precedent, Islamic economists at the time took the existing conventional commercial banks as the blueprint for an ‘Islamic’ version of the banking institution, leaving the structure of the bank in terms of its role and nature of

\(^{25}\) Recall from chapter 2, ijtihad refers to independent reasoning undertaken by Islamic jurists to establish new legal rules. It is used to address contemporary issues for which an explicit directive from the Quran and the sunnah cannot be found (Ayub, 2007).

\(^{26}\) In premodern times, jurists/religious scholars used a variety of different legal tools to derive new laws including istislah (benefit analysis) and istihsan (public interest). In modern times, however, scholars have primarily focused on the rule ‘ijtihad through qiyas’ i.e. drawing juristic inferences solely on the basis of analogical reasoning through reference to legal precedents (El-Gamal, 2006).
assets/liabilities intact. Although unintentional, this as will be shown below, became one of the fundamental contributors in the divergence between the theoretical model and the practice of Islamic banks (see sections 3.4.2 and 3.6). To appreciate the discrepancies between theory and the practice of Islamic banking it is important first to understand the theoretical model of Islamic banking and the developmental phases the industry underwent. These are presented in the following two sections.

3.3 Islamic Banking in Theory

The earliest literature on modern Islamic banking dates back to the 1940s, with theoretical models appearing in the mid-1950s and further conceptual developments made throughout the 1960s to 1980s. Theoretical models of Islamic banking were devised with the aspiration to eliminate interest and replace it with PLS mechanisms on both the asset and the liability side of a bank’s operations (for a summary of these models see Iqbal et al., 1998; Ahmed, 2002; Iqbal and Molyneux, 2005).

The traditional Islamic contracts of mudarabah (silent partnership) and musharakah (equity partnership) premised on PLS terms were particularly highlighted27. Commonly known under the label of ‘PLS financing’, these contracts were and still are considered to be “the real and ideal instruments of Islamic financing” (Usmani, 2004, p.12). At its simplest, Islamic banking was envisioned as operating on a two-tier mudarabah basis i.e. raise funds from depositors and supply capital to customers on a mudarabah (PLS) basis. Thus, the bank would enter two agent-principal relationships; acting as the agent for the depositors on the liability side and as the principal (capital provider) for businesses on the asset side (Uzair, 1955; Al-Arabi, 1966; Siddiqi, 1968, 1983a, 2006; Chapra, 1982, 1985, 2007; Iqbal et al., 1998; Warde, 2000; Zaher and Hasan, 2001; Ahmed, 2002; Usmani, 2004; Iqbal and Molyneux, 2005; Obaidullah, 2005; El-Gamal, 2005).

27 There is evidence to suggest that mudarabah and musharakah predate Islam (Udovitch, 1970). Islamic traditions also provide references of mudarabah being used by Prophet Muhammad (pbuh), more than 15 years before his prophethood, as he travelled to Syria for trade, being the travelling partner of Khadija (his-wife-to-be) who was the capital provider (Hasan, 1989; Kahf and Khan, 1992). However, as Harris (2009) notes, the mudarabah was developed fully by the Arabs to support the long-term caravan trade routes linking south Arabia and the Mediterranean and thus is recognised as an “indigenously developed Arab-Islamic institution”, which leaves little debate over its Muslim origins. Whilst the origins of these financing modes is beyond the scope of this study, it is recognised that the long history of their use in Islamic tradition, and their use being attributed to the Prophet (pbuh) himself, are important factors establishing their superiority over other modes of financing within the Islamic economics literature.
2006; Ayub, 2007; Iqbal and Lewis, 2009). The two-tier mudarabah model is illustrated in figure 3.1 and described below.

Figure 3.1: The Two-tier Mudarabah Model

<table>
<thead>
<tr>
<th>Two-tier Mudarabah Model of an Islamic Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>PLS financing</td>
</tr>
<tr>
<td>- Mudarabah</td>
</tr>
<tr>
<td>- Musharakah</td>
</tr>
<tr>
<td>(Bank shares the profits and losses of businesses/ventures financed)</td>
</tr>
</tbody>
</table>

3.3.1 Asset side

Profit-and-Loss-Sharing (PLS) Financing

According to the two-tier mudarabah model, the primary financial instrument used by an Islamic bank to provide financing to its clients is the mudarabah contract. In addition to this, Islamic banks would also use musharakah financing.

Mudarabah is often translated as silent partnership or trust financing. In this contract an Islamic bank acts as the capital provider (principal), financing an enterprise or a particular project as a sleeping equity partner and therefore does not take part in the management of funds (the bank holds no control rights in this contract). The financed client/entrepreneur (agent) brings his/her expertise and entrepreneurial skill to the partnership and manages the funded venture. Profits arising from the venture are shared according to an agreed ratio, whilst losses are borne solely by the capital provider (the bank), unless caused by the entrepreneur’s negligence. The financial loss falls only on the capital provider because according to sharia, one cannot lose what one has not contributed. In case of a loss, the capital provider loses his investment and as there is no return generated, the entrepreneur losses his/her effort and time. Musharakah is an equity financing contract where Islamic banks finance an enterprise or a particular project as an equity partner, sharing the profits and losses of the venture. Profits can be shared at any pre-specified ratio, but losses are shared in proportion to the capital.
invested by each party. This contract gives each partner including the Islamic bank the
right to participate in management of the invested funds, although this right need not be
exercised28 (Warde, 2000; Khalil et al., 2002; Kuran, 2004; Usmani, 2004; Ayub, 2007;
Shanmugam and Zahari, 2009; Visser, 2009; El-Diwany, 2010; Khan, 2010).

3.3.2 Liability side

Profit-and-Loss-Sharing (PLS) Deposits

According to the theoretical two-tier mudarabah model, Islamic banks accept deposits
on the basis of a mudarabah contract (silent partnership), where depositors are the
providers of funds (principal) on whose behalf the Islamic bank (agent) invests. These
PLS deposits are placed in investment accounts, named as such because these resemble
investment funds operating on a risk-sharing basis (Visser, 2009). Accordingly, Islamic
banks can neither guarantee the nominal value of these deposits nor pay a guaranteed,
fixed return to the depositors as this constitutes riba. Profits are shared between the
bank and the depositors according to a pre-determined ratio, whilst losses are borne by
the depositors. PLS deposits are therefore similar to equity capital and carry loss
absorbing capacity, making the depositors (the investment account holders) quasi-
shareholders of the Islamic bank (Khan, 1986; Lewis, 2001).

Given the nature of PLS deposits, Islamic banks are envisioned as a “cross-breed of
commercial and investment banks”, which share some characteristics of commercial
banks in terms of ownership where depositors do not own the bank nor have voting
rights; and investment intermediaries as investment account holders share the banks’
risk and are paid a percentage of the its profits (Chapra, 1985, p.154; Ahmed, 2002).

3.4 Islamic Banking: From Theory to Practice

The transition of Islamic banking from theory to reality took a number of social,
political and economic developments in the Muslim world (Warde, 2000). The
evolutionary process is broadly divided into three periods: 1940s – 1970, 1970s – 1990
and 1990s – present. These developmental phases are described below.

28 A counterpart to these arrangements do not exist in standard conventional commercial banks but does
so in universal banks which also hold equity stake in financed firms. In conventional finance, merchant
banking and venture capital is the equivalent of PLS arrangements (Warde, 2000; Iqbal and Lewis, 2009).
3.4.1 Phase 1: 1940s – 1970

During the 1940s – 1970, the conceptual and political foundations for Islamic banking were laid down. The Islamisation movement which gained momentum in the post-colonial era encouraged research into the concept of an Islamic financial system and theoretical models of Islamic banking were developed throughout the 1950s and 60s (Siddiqi, 2006; Billah, 2007). In the 1960s, pan-Islamism\(^2\), the defining political movement for Islamic banking began and gained substantial support by the end of the decade (Warde, 2000).

The earliest literature on Islamic banking highlighted the conceptual struggle with several incoherent proposals and inconsistencies (Visser, 2013). The idea of partnership between the bank and its clients was constant but the exact conditions of this partnership were not. Qureshi (1946) for example mentioned loss sharing, but not profit sharing while Ahmad (1952) left the nature of partnership undefined. Uzair (1955) however, systematically invoked the mudarabah contract as the basis for interest-free banking and his work is widely considered as the first reference to the structure of two-tier mudarabah model (El-Gamal, 2006). Al-Arabi (1966) advanced the idea of two-tier mudarabah, adding that an Islamic bank could not only invest depositors’ but also its shareholders’ funds in this manner. He emphasised the distribution of profit-and-loss sharing between parties to be in strict accordance with the sharia (i.e. the traditional mudarabah contract, described in section 3.3.1). Irshad (1964) however, suggested a 50-50 profit-and-loss share between the parties, contradicting the sharia principles. Finally, a detailed outline was produced in 1968 by Siddiqi (1968, 1983a) which elaborated on the two-tier mudarabah model to include the use of both mudarabah and musharakah. Siddiqi argued that such a PLS banking system would become a viable alternative to conventional interest-based banking. The issue of consumption loans however was underplayed and not adequately addressed (Ariff, 2001).

\(^2\) Pan-Islamism is the political movement which propagated unifying the world’s Muslim as a single nation, based on the idea of solidarity amongst the Islamic ‘ummah (community) bounded by common religious beliefs. It was sponsored by King Faisal of Saudi Arabia in opposition to the pan-Arabism movement promoted by the Egyptian president Gamal Abdel Nasser. The latter was a movement against western colonialism which promoted Arab and Third World solidarity as well as the ideas of nationalism, socialism and secularism. This position was at odds with Saudi Arabia which has always been a conservative monarchy with strong links to the West (Warde, 2000; Haniffa and Hudaib, 2010).
Independently of these developments, a number of private initiatives applying Islamic finance principles appeared in Pakistan, Egypt and Malaysia, although not all were successful (Warde, 2000; Rehman, 2010). Chronologically, the Pakistan initiative came first with a local interest-free credit network founded in the late 1950s. Set in a rural location, the institution was financially supported by a few pious landlords willing to deposit funds without a return to advance credit in form of qard hasan to other much poorer landowners for agricultural development. A fixed administrative fee was charged to cover the institutions’ operating expenses. The institution quickly grew popular with no shortage of borrowers. However, with a shortage of loanable funds and staff and lack of autonomy over lending decisions, it did not survive beyond the early 1960s\(^\text{30}\) (Wilson, 1983; Warde, 2000).

As the Pakistan initiative came to an end, a similar institution was founded in the rural area of the Nile Delta in Egypt. Founded by Dr Ahmed el-Naggar\(^\text{31}\) who was highly influenced by German mutual savings and loan associations, the Mit Ghamr Savings Bank began operations in 1963. The bank focused on addressing the financial needs of rural Egyptians underserved by the conventional banking system by offering interest-free loans, on which a small administrative fee was charged. Unlike the Pakistan initiative, however, the depositors and borrowers in Mit Ghamr belonged to the same group. To receive an interest-free loan, borrowers had to place a minimum amount with the bank for at least a year, which ensured the bank did not face a shortage of loanable funds. Loans were given for a variety of economically productive activities\(^\text{32}\) and were primarily short-term (1 to 3 years). In line with Islamic teachings, which condemn hoarding, emphasis was placed on the circulation of funds and thus no grace period was permitted on repayments. The bank primarily earned a return by engaging in industry and trade directly or via partnerships and financing businesses on PLS basis (Wilson, 1983, 1995; Warde, 2000; Tripp, 2006; Billah, 2007; Rehman, 2010).

\(^{30}\) On the one hand, depositors viewed their payments in the bank as a one-time initiative which led to a shortage of loanable funds. On the other hand, depositors took significant interest in how the bank loaned out the funds, leaving the bank officials with very little autonomy over lending decisions. Recruitment problems with potential employees unwilling to work in an uncertain countryside initiative resulted in shortage of staff. Together, these problems led to a loss of enthusiasm and finally the closure of the institution. Outstanding loans were treated as bilateral arrangements between landlords which were mostly paid off during the early 1960s (Wilson, 1983).

\(^{31}\) Ahmed al-Naggar later became the Secretary of the International Association of Islamic Banks (IAIB) (Warde, 2000).

\(^{32}\) These included agricultural improvements including irrigation systems, the purchase of farm animals and machinery, sewing machines and even housebuilding (Wilson, 1983).
Mit Ghamr was a success. Unlike the conventional commercial banks, Mit Ghamr was highly regarded and trusted by the local rural population. It effectively harnessed funds from farmers, small-scale traders and landowners who, as devout Muslims concerned about dealings in riba, had abstained from using the conventional banking sector (Wilson, 1995). At its peak, the bank operated via nine branches, had 250,000 depositors with deposits amounting to almost 2 million Egyptian pounds (Warde, 2000). The bank also contributed significantly towards socio-economic development particularly the reduction in rural indebtedness as it gave countryside borrowers an alternative to local moneylenders who charged excessively high interest rates (Wilson, 1983). Despite its success, the bank came to a controversial end. Although not completely shut down, the bank was nationalised by the government, taken over by the Nasser Social Bank with its base moved to Cairo and its original countryside operations hampered (Wilson, 1995; Warde, 2000).

Another prominent initiative, Tabung Haji (Pilgrims Fund Board), a Malaysian savings and investment institution, began operations in 1963. It was created to help Malaysian Muslims save and build their wealth for the annual Islamic pilgrimage to Makkah (the Hajj). With its purpose linked to an act of worship, all investments made by Tabung Haji were naturally required to be sharia compliant. The institution operated on the PLS model. Focused on the mass retail market, it pooled small savings, invested in a variety of projects and shared the profits with its customers. The underlying approach adopted was consistent with Islamic ethos, favouring savings and growth of wealth through investment in productive activities and discouraging debt, in contrast to the conventional banking system which promotes personal debt. With its strong roots in the community, a clear business structure and government support, Tabung Haji continues its operations to this day (Siddiqi, 2006; Rehman, 2010, Haniffa and Hudaib, 2010).

The rural population was quite suspicious of all outsiders, particularly educated urbanites. Very few individuals had any experience of commercial banks which were seen as “alien institutions”. Mit Ghamr on the other hand, achieved significant personal support from the locals who considered it their own. The bank’s staff which comprised of educated Muslim enthusiasts with previous banking experience, gained confidence of the conservative countryside community as they were seen to be devout Muslims worshipping alongside the locals and sharing similar moral values (Wilson, 1983, p. 76).

The exact reasons for the bank's nationalisation are unclear. Some suggest the bank faced financial challenges and struggled to cover administrative expenses, increase salaries and therefore was unable to recruit additional staff. Others however argue that the bank was commercially viable but unpopular with the government, seen as a potential political threat and was also unpopular with the Central Bank of Egypt and state-owned banks who had concerns over how the bank was regulated. Given Mit Ghamr’s popularity, its closure would have led to widespread discontent and thus the Egyptian government decided, after much debate and delay, to nationalise it in 1972 (Wilson, 1983, 1995; Warde, 2000).
These institutions are important precursors to modern Islamic banks and although some attribute the roots of contemporary Islamic banking to these institutions and particularly Mit Ghamr (Billah, 2007); it is important to note that none of these institutions were actual formal banks. Commercial banking activities including transactional services and short-term placements were never considered a part of these institutions’ aims (Warde, 2010; Haniffa and Hudaib, 2010). Instead, these were nonbanking financial institutions (NBFIs) which were established to address very specific needs of the local Muslim community in line with Islamic principles (Rehman, 2010). Independently-led and geographically distant, these initiatives did share a number of characteristics. First, despite their adherence to Islamic principles, none of these institutions made explicit reference to the religion to claim an Islamic identity. Second, as demand-driven initiatives, they focused on a genuine financial need. Finally, religiously inspired, these initiatives made significant contribution to socio-economic development. Accordingly, these are recognised as some of the earliest modern-day initiatives, which led by “sacred intentions”, embodied the true spirit of sharia and Islamic finance (Warde, 2000; Rehman, 2010; Haniffa and Hudaib, 2010, p.87).

3.4.2 Phase 2: 1970s – 1990

The 1970s was the defining decade for Islamic banking. Conceptual ideas became reality as the first commercial Islamic bank was established in 1975. Two politico-economic developments were crucial for this: pan-Islamism, which became an almost unstoppable force by the mid-1970s and the rise in oil prices, which quadrupled during 1973-74. Together these provided both the political and the financial support required to move forward the Islamic banking agenda. From the pan-Islamism perspective, the establishment of an Islamic banking system was a symbol of restoring religious values in the secular economic domain35 (Warde, 2000; Billah, 2007; Haniffa and Hudaib, 2010). Until the 1970s, with no Islamic banking institutions, the Muslim world had become accustomed to operating on a conventional interest-based system. Although religiously objectionable, interest was accepted by society at large as an economic reality. Nevertheless, considerable sections of the populace including many businessmen abstained from dealing with conventional banks whilst many devout

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35 Arguably, for Saudi Arabia, a strong ally of the West, it was also the route to establishing itself as the custodian of the world’s Muslim population and the survival of its monarchical regime (Haniffa and Hudaib, 2010).
Muslims with banking accounts refused interest payments on their savings (Wilson, 1995, 2009; Warde, 2000). The rise in oil prices however created an unprecedented need for banking services throughout the Gulf Cooperation Council (GCC)\textsuperscript{36}, particularly for the business community. To prominent Arab businessmen, this provided a unique opportunity and the financial resources to establish religiously compliant banking institutions (Wilson, 1995; Haniffa and Hudaib, 2010).

In 1975, Dubai Islamic Bank (DIB), the first of its kind, was created in the United Arab Emirates (UAE) by a group of reputable businessmen with strong social-political ties to the Royal family (Wilson, 1995; Haniffa and Hudaib, 2010). Before the end of the decade, similar banks appeared both within and outside of the GCC. These included Kuwait Finance House (KFH: 1977)\textsuperscript{37}, Faisal Islamic Bank in Sudan and Egypt (1977), Jordan Islamic Bank (JIB: 1978) and Bahrain Islamic Bank (BIB: 1979). Development continued into the 1980s with Qatar Islamic Bank (QIB: 1982) and Bank Islam Malaysia Bhd (1983) being launched (Wilson, 1995, 2009; Warde, 2000; Billah, 2007). Islamisation however was not limited to individual banks. During this time, three countries, starting with Pakistan (1979) and shortly followed by Iran and Sudan (1983) pursued full Islamisation of their banking systems by explicitly banning interest (Warde, 2000).

The pan-Islamism movement also led to the creation of a number of important transnational institutions starting with The Organization of the Islamic Conference\textsuperscript{38} (OIC) which held its first meeting in 1970. At its 1974 summit, the OIC members voted to create an International Islamic Development Bank\textsuperscript{39} (IDB), which was to become the cornerstone of the global Islamic banking system, promoting trade and development in the Muslim world. In 1977, the OIC established the International Association of Islamic

\textsuperscript{36} The Gulf Cooperation Council (GCC) comprises of six Middle East countries which are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

\textsuperscript{37} The institution’s abbreviated label and the year it was established are presented in the parenthesis.

\textsuperscript{38} The OIC was established with 30 founding members. It currently comprises of 57 member states, 56 of which are also a member of the United Nations. The 1972 charter of the OIC specifies its objective is to strengthen cooperation and solidarity amongst its member states. It promotes the idea of unifying the world’s Muslims into a single body and considers itself their representative voice (see, www.oic-oci.org for details).

\textsuperscript{39} IDB was founded with 44 member countries with Saudi Arabia being the largest shareholder. It began operations in 1975. The aims of IDB included: provide funds to the member countries on PLS and fee-based arrangements to promote and finance trade and development in the Muslim world, act as a clearinghouse for payments between Muslim countries, provide training and assistance in establishing additional Islamic institutions and to manage zakah (religious tax) funds (Warde, 2000).
Banks (IAIB), designed to be the advice and coordination mechanism for the newly established Islamic banks. The Islamic Fiqh Academy (IFA), the largest representative body of sharia scholars in the world with representation from all Muslim countries, which passes fatwas on various issues including Islamic banking, was created in 1981. All of these were based in Jeddah as Saudi Arabia continued to lead the pan-Islamism movement (Warde, 2000; Wilson, 2009).

Domestic politics however was extremely influential in the development of Islamic banking. Saudi Arabia, which was actively promoting Islamic banking in the international sphere, was extremely reluctant in issuing domestic Islamic banking licences. This was due in part to the fear of exposing and attracting attention to the interest-based conventional banking system, which was firmly established in the Kingdom despite an official prohibition of interest (Warde, 2000; Tripp, 2006; Wilson, 2009). In 1985, the Islamic Fiqh Academy urged Muslim countries to assist the formation of Islamic banks and forbade the use of conventional banks for Muslims where the Islamic alternative was available. Although neither injunction produced immediate results, these did make it difficult for any Muslim government to explicitly oppose the development of Islamic banking (Warde, 2000). Al Rajhi Bank, the first Saudi Islamic bank and currently the largest in the world, was finally issued an Islamic banking license in 1987. With Al Rajhi launched, five of the six GCC states had established local Islamic banks. Oman however remained the exception. For political reasons, the country did not issue any Islamic banking licences until very recently (Wilson, 2009).

Islamic banks created during this period were very different from the NBFIs of the 1950s and 60s. These were supply-driven enterprises, designed specifically to be a substitute for the conventional commercial bank. Their target clientele was also very different from the rural population. As a major oil producing region with a limited agricultural industry, microfinance-style credit unions were not relevant in the GCC, particularly as affluence had spread throughout the region with rising oil prices. The focus was therefore placed entirely on serving business clients and the middle-upper

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40 As part of its role, the IAIB published the Handbook of Islamic banking, which written by Islamic scholars was designed to be the practical guide for Islamic banks (Warde, 2000; Haniffa and Hudaib, 2010).

41 Bank Nizwa, the first Islamic bank in Oman opened in 2013.
class citizens (Wilson, 2009). Furthermore, these institutions claimed an explicit Islamic identity promoting their operations on the basis of sharia-compliance. However, as these were managed by bankers with experience of conventional banking and very limited knowledge of fiqh, a credible mechanism providing assurances on sharia compliance was needed. This need was addressed by banks rather than the state, as each institution began building relationships with well-known sharia scholars, seeking approvals for their products and activities. For sharia scholars, this was an opportunity to regain influence in post-colonised societies. The mutual need gave rise to Sharia Supervisory Boards (SSBs, further details in section 3.5.3) and the culture of fatwa-seeking in Islamic banking (Wilson, 2009; Haniffa and Hudaib, 2010).

With no precedent however, neither sharia scholars nor the Islamic bankers and economists of the time had any firm ideas on how an Islamic commercial bank would operate in practice. These were uncharted waters for all parties involved and the stakes were high. If any of the initial ventures failed, it would cause significant damage to the Islamic banking movement. With high uncertainty there was considerable hesitation from the IDB, which did not undertake a single financial transaction for almost the first two years. It remained largely inactive trying to identify how to practically provide sharia-compliant financing without taking on unwarranted risk (Kahf, 2013; Visser, 2013).

Strong political and financial support led to a proliferation in research on Islamic banking and economics (Warde, 2000). As Wilson (1997, in Warde, 2000) notes, more has been written on Islamic economics during the 1970s-1990s than in the previous 1400 years of Islamic history. During this time Islamic economists increased their efforts to strengthen the case for Islamic banking using empirical evidence, logic and scientific theory rather than relying on assertions from religious text. Further elaborations were also made to the Islamic banking model. Mohsin (1982) for example presented a framework for Islamic banks incorporating characteristics of commercial, development and merchant banking, designed for the capitalist environment. Al-Jarhi (1983) proposed that Islamic banks providing commercial banking services should separate between current account (demand deposits) and investment account deposits, with a 100% reserve requirement imposed on the former. While, Chapra (1985) in addition to propagating the PLS principle, emphasised the social aspect of Islamic banking suggesting that these institutions should serve public rather than individual

44
interests. He envisioned Islamic banks as a crossbreed of commercial, investment and merchant banks which would prioritise socio-economic development as opposed to profit maximisation. Using PLS principles, these banks would rely on project evaluation to extend funds rather than non-participatory methods which rely on strong collateral as in conventional banking. Although important, these efforts nevertheless were conceptual in nature and came much later than the developments made by industry professionals.

Practitioners followed a more pragmatic approach as it became clear that the theoretical two-tier mudarabah model had left several issues unresolved, particularly from a practical perspective (Warde, 2000). Of the material produced, the most influential was by the late Dr Sami Hamoud, a Jordanian economist with 22 years of conventional banking experience. Hamoud’s background heavily influenced his view of how an Islamic bank should operate and the products it should provide. Hamoud’s vision was to create a bank which would operate on the European banking model and compete directly with its conventional counterpart by providing the same banking facilities, without violating the precepts of Islamic law (El-Gamal, 2006; Maali and Napier, 2010).

Hamoud rightly identified that mudarabah and musharakah (PLS) did not provide substitutes for the interest-bearing consumption loan offered by conventional banks. He therefore searched for a sharia-compliant alternative. His solution was a modified version of the traditional Islamic contract named murabahah. Traditional murabahah is a spot sale contract where goods are sold for cost-plus agreed mark-up price. The modified murabahah proposed combined two sale contracts and a binding promise, and worked as follows: clients wishing to obtain finance for an asset specify to the bank their desired asset and supplier; bank then purchases the asset on behalf of its client for cash by entering a spot sale contract with the supplier and sells the asset to its client for cost-plus-mark-up price with deferred payment by entering a credit sale contract. Prior to entering this arrangement, the client commits to purchasing the asset from the bank. This structure replicated an interest-bearing loan transaction but was argued to be

42 This was a contract designed to emphasise transparency in trade as the purchaser was made aware of the cost paid by the seller to the original supplier and could judge if the mark-up charged was inequitably high (Maali and Napier, 2010).
sharia-compliant as none of the individual components explicitly involved interest (Maali and Napier, 2010).

Until Hamoud’s suggestion, this form of murabahah was unknown to the Islamic banking industry (Maali and Napier, 2010; Visser, 2013). Sharia scholars approved the arrangement on the basis of it being an asset-based transaction, where banks earn a return (mark-up) arising from the sale of actual goods, rather than profiteering through the extension of credit. Another supporting element was the precedent of credit sale contracts used abundantly in medieval Islamic societies to fulfil domestic and industrial credit needs. As mentioned earlier, sharia permits charging a higher than spot price in credit sale contracts and thus the mark-up was considered a valid form of profit (Udovitch, 1975; Usmani, 2004; Visser, 2009). Nevertheless, the lack of PLS and proximity to interest-bearing loan contract raised genuine concerns and thus sharia scholars permitted the structure only as an ‘exception’ to assist banks meet their client’s needs for occasions where PLS may not be suitable. The permission was aimed at supporting the transitional, introductory period of Islamic banking, allowing banks to build resources and experience to become viable institutions. It was expected that murabahah will be used temporarily until banks develop and move towards PLS-consistent alternatives (Rehman, 2010; Warde, 2010).

Following Hamoud’s recommendation, the first murabahah transaction was undertaken by IDB in August 1976 (Kahf, 2013; Visser, 2013). Certified as sharia compliant, murabahah quickly became popular and began to dominate Islamic banking. Newly-established banks relied on murabahah right from their inception (Wilson, 2009). By the end of 1980s, murabahah accounted for almost 70% of Islamic financing, reaching around 90% in some Islamic banks (Maali and Napier, 2010).

Hamoud also proposed modifications to the mudarabah contract applying to the liability side of the two-tier mudarabah model. Hamoud’s proposal was aimed at creating a close substitute of the conventional deposit system. His proposals relaxed several conditions of the original mudarabah contract. The most important one which attracted much debate was the issue of guaranteeing deposits held in investment accounts. Under the traditional mudarabah contract, the capital sum cannot be guaranteed. Hamoud however argued for an explicit guarantee of depositors’ funds. He also proposed Islamic banks create ‘investment risk provisions’ by setting aside 20% of the profits made per year.
from investments using customer deposits to cover any losses which would otherwise be passed on to the depositors. He tried to put forth his case based on religious reasoning. The Fatwa Committee evaluating these proposals in Jordan did not accept the proposal of providing an explicit guarantee and argued the religious reasoning provided did not hold. To the Committee, the idea of transferring part of the profit from one year to another, which would benefit depositors who had not contributed to the original investment, was also problematic as the traditional mudarabah requires profit-sharing only between the contractual parties. Nevertheless, persistence paid off and a compromise was made. Hamoud conceded to the Committees’ view on explicit guarantee whilst the Committee, by permitting investment risk provisions, ensured depositors would never have to face the situation of losing their deposits. In his role as JIB’s general manager, Hamoud considered investment account deposits as guaranteed and operated the bank on that basis (Maali and Napier, 2010).

With such modifications made within the first few years of Islamic banking, the two-tier mudarabah model never fully materialised. For those with aspirations of a genuine PLS alternative to the conventional banking system, the evolution of Islamic banking from theory to reality was extremely disappointing (Warde, 2000). Islamic economists criticised these developments as a complete deviation from the spirit of sharia and the vision of Islamic banking which endorsed risk-sharing between parties through PLS mechanisms (Siddiqi, 1983b).

At the core of this deviation was a conflict in values which was evident in Hamoud’s proposals. His vision of the Islamic bank had to be both sharia compliant and replicate conventional banking practices. The latter however violated sharia principles, particularly the prohibition of riba. To appease sharia scholars reporting on Islamic banks’ compliance, Hamoud had offered financial structures such as the modified

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43 Hamoud’s proposals relied upon mixing opinions from the different schools of fiqh (recall from chapter 2, there are four main schools of fiqh in orthodox Sunni Islam; the Hanafi, Shafi’i, Maliki and Hanbali). Hamoud’s view was that adopting opinions from a single school did not provide the foundations for an internationally acceptable Islamic banking system. According to Hamoud, the modified murabahah was acceptable under Shafi’i school of fiqh whilst extracting provisions from the profits arising from investment account deposits was acceptable to the Maliki School. This approach was considered undesirable by most scholars on the Fatwa Committee in Jordan, who firstly did not agree with the mixing of schools and secondly were predominantly from the Hanafi School (Maali and Napier, 2010). Subsequent debates have questioned whether Hamoud rightly interpreted the provisions made in the Shafi’i and Maliki School to support his proposals. Nyazee (2009), for example has argued that Hamoud misunderstood the original work by the great Islamic scholar al-Shafi’i and therefore his proposed modified murabahah is not valid even under Shafi’i school of fiqh (Visser, 2009).
murabahah which sequenced valid Islamic contracts in a formation that replicated prohibited conventional practices i.e. interest-based lending (Maali and Napier, 2010). In sharia terminology such arrangements are known as hiyal (sing: hila; ruse/legal trick), which refer to the use of lawful means, voluntarily and knowingly, to override sharia prohibitions and achieve unlawful objectives thereby defeating the spirit of sharia law (Warde, 2000; Rehman, 2010).

The approval of the murabahah structure relied on a very specific approach to defining religious compliance (discussion on the meaning of sharia and difference between sharia and fiqh presented in chapter 2 are particularly relevant here). The term ‘sharia’ in sharia-compliance was reduced to ‘law’, rather than the more accurate ‘framework of life’. Consideration of the spirit (objectives) of sharia and its prohibitions were overlooked as focus was put on compliance with the letter of the law. The law itself was interpreted in a very confined and literal manner. Riba e.g. was defined simply as interest and since murabahah technically involved a ‘mark-up’ not interest, the transaction was deemed sharia compliant. Finally, emphasis was placed on the contractual form rather than the economic substance of the transaction. Since the individual contracts comprising the overall transaction complied with the ‘interpreted’ letter of sharia law, the structure was approved.

The approval of modified murabahah and mudarabah deposit system however divided opinions. These approvals were based on fatwas and therefore came within the realm of fiqh where secondary sources of Islamic law such as ijtihad and qiyas are used by scholars to create legal rulings approving or disproving the validity of products/transactions under Islamic law. Fatwas however are disputable as these are man-made laws and this is where the disagreement over the validity of these products arose from. For many Islamic banking practitioners and sharia scholars, compliance with the letter of the law was an acceptable solution, however for others such compliance at the cost of the overall transaction defeating the spirit of the sharia law, by mimicking interest-based conventional finance, was completely unacceptable (Visser, 2013). The latter opinion sided with notable scholars from Islamic history e.g. Al-Shatibi who clearly explained, as was highlighted in chapter 2, that the letter of sharia law is not the end in itself and therefore one who meets the letter but not the substance (spirit) of the law does not follow the sharia (El-Gamal, 2006). Thus, opposing views emerged on Islamic banking and its progress. Many considered Islamic banking a
success as the industry appeared to be a viable alternative to conventional banking. Others however were discontent with this success and growth coming at the cost of religious compromises and dilutions of values (Maali and Napier, 2010).

The approval of murabahah, nevertheless, was a game-changer for the Islamic banking industry. It started the practice of Islamic banking products being developed on the basis of compliance with the letter rather than spirit of sharia and a focus on contractual form over the economic substance of transactions. Furthermore, it shifted focus from PLS contracts to modified versions of traditional trade-based contracts found in Islamic traditions, leading to development of non-PLS financial instruments. In the 1980s, sharia scholars approved an even more controversial financial instrument, called commodity murabahah, which involved short-term trading of commodities, allowing banks to replicate unsecured loans to serve their corporate clients (El-Gamal, 2006).

By the end of this phase, secular goals took precedence over “the ardent sacred intentions” which had in part initiated the Islamic banking movement (Warde, 2000; Haniffa and Hudaib, 2010, p.89). Focus shifted from creating ‘sharia-compliant alternatives’ to ‘sharia-compliant replications’ of conventional finance as the industry aimed for growth. In this regard, a key development was the collapse of oil prices in 1986. This led to a sharp reduction in the revenues of oil-rich GCC states with significant economic, social and political consequences across the Muslim world. As governments experienced financial difficulties, the bargaining position of Islamic bankers grew stronger and the industry expanded. GCC-based Islamic banks spread their operations and influence beyond domestic borders, entering markets such as Turkey44. The industry’s previous reliance on oil funds was no longer a dominant factor for its continued growth. Instead growth was achieved through replication of conventional products using structuring strategies which departed from the spirit of sharia (Warde, 2000; Rehman, 2010).

44 Turkey for example despite its secular government of the time welcomed Islamic banking groups (such as Al-Baraka and Faisal Group) to establish Islamic banks (called special finance houses) in the country. To promote their launch, special privileges were granted including exemptions from the country’s banking legislation (see Warde, 2000 for details).
3.4.3 Phase 3: 1990s – Present

Growth and internationalisation have been the central themes of Islamic banking since the 1990s. As figure 3.2 illustrates, global Islamic banking assets have grown substantially, from less than $200 billion in the late 1990s to over $1.2 trillion in 2012.

Figure 3.2: Growth in Global Islamic Banking Assets (1998-2012)

A number of politico-economic factors have been particularly influential for the industry’s growth. By the 1990s many of the Muslim countries were heavily indebted and dependent on external financial support. To obtain aid from institutions such as the World Bank or International Monetary Fund (IMF), or to join the World Trade Organisation (WTO), governments of developing and emerging economies had to embrace the ideology of structural reforms. The ‘Washington Consensus’, which represented the standard reform package promoted by the IMF and World Bank exported policy prescriptions such as: privatisation, deregulation, liberalisation of trade and financial markets and free flow of investment and capital, to countries across the world. This was a departure from the conventional economic policy prescriptions that were in place before the 1990s. The ‘Washington Consensus’ was a term coined by John Williamson in 1989. It refers to a set of 10 specific economic policy prescriptions which comprise the ‘standard reform package’ promoted by U.S.-based institutions including the IMF and World Bank for crisis wracked developing countries. Although not originally intended, the definition of Washington consensus has been broadened and is often considered synonymous with neo-liberalism (Williamson, 2004; Haniffa and Hudaib, 2010).

Sources: Booz & Company45 (2008, 2011); IFSB (2013, 2014); PwC (2013); UKIFS (2013); KFH Research (2014)

45 Renamed as ‘Strategy&’ since 2014, subsidiary of the Pricewaterhouse Coopers (PwC) Network.
46 ‘Washington consensus’ is a term coined by John Williamson in 1989. It refers to a set of 10 specific economic policy prescriptions which comprise the ‘standard reform package’ promoted by U.S-based institutions including the IMF and World Bank for crisis wracked developing countries. Although not originally intended, the definition of Washington consensus has been broadened and is often considered synonymous with neo-liberalism (Williamson, 2004; Haniffa and Hudaib, 2010).
globe including the Muslim world. Although it reached the Muslim world much later than the West, neoliberal ideology has been universally adopted since the 1990s and thus reshaped Muslim economies (Warde, 2000). The GCC-based Islamic financial institutions (IFIs) have been a major beneficiary of neoliberal policies which have occurred in tandem with the internationalisation of capital. Since the 1990s, GCC-based IFIs took on an increasingly global perspective, expanding their operations through subsidiaries and representative offices throughout the Muslim and non-Muslim world47. These expansions have led to “a new form of Islamic capitalism” emanating from the GCC, affirming its status as the global centre of Islamic finance (Wilson, 2009, p.3).

Flexibility in international regulation has also aided this expansion. In the UK, for example the Financial Services Authority (FSA) made several concessions48 to accommodate Islamic banks, providing stimulus for growth of the industry in the UK and Europe (Ayub, 2007). Other changes have also been viewed positively. Abolition of the 1933 Glass Steagall Act (USA) in 1999, which separated commercial and investment banking activities, led to conventional financial institutions reinventing themselves as conglomerates combining traditional commercial banking, investment banking, securities trading and insurance activities under one group. The Islamic banking industry welcomed this increased diversity (Iqbal and Molyneux, 2005). For those propagating Islamic banks to be a crossbreed of investment and commercial banks (Mohsin, 1982; Chapra, 1985), this development was considered favourable for the eventual materialisation of their vision of Islamic banking.

Another two factors, technology and the 2007–08 financial crisis have aided Islamic banks’ global presence. During this phase, technological advances led to revolutionary changes in the international financial markets with a dramatic increase in innovation. Securitisation of loans and financial assets has become an especially notable feature of conventional finance and increasingly so of Islamic banking. Such advances have

47 The largest Saudi Islamic bank, Al-Rajhi for example has established subsidiaries in Malaysia whilst DIB has rapidly expanded its branch network throughout Pakistan. KFH on the other hand has expanded throughout Singapore, Turkey and even as far as Australia (Wilson, 2009).
48 This includes flexibility over the treatment of Islamic banks deposits, and stamp duty paid on Islamic mortgages. Islamic mortgages involve two sale contracts: purchase of the house by the bank from original owners and resale to its client. The FSA has allowed, despite there being two sale contracts, that stamp duty is to be paid only once (Ayub, 2007)
facilitated the creation of tailor-made Islamic financial products, which could be marketed not only to Muslim but also non-Muslims in highly interconnected financial markets. Islamic banks have therefore increased their efforts to innovate products which meet international financial standards and are credit-rated similar to their conventional counterparts. Currently, Islamic finance is no longer accessible only in Muslim countries. Instead, a large Islamic financial market has been established in the world’s global financial centres such as London (Wilson, 2009).

The debate on ethics in finance since the 2007–08 financial crisis has been particularly beneficial for Islamic banking. To increase their presence in the global secular market, Islamic banks have leveraged their religious identity, particularly the commonality between Islamic ethics and international standards on corporate social responsibility, to distinguish themselves from conventional banks on ethical and social grounds. Thus, in recent years Islamic banks have keenly marketed their services as not only a religiously-compliant alternative for Muslims but also an ethically desirable one for non-Muslims (Abu-Tapanjeh, 2009; Williams and Zinkin, 2010; Visser, 2009; Kamla and Rammal, 2013). This has resulted in an expansion of Islamic banks client base beyond the Muslim niche, supporting the industry’s growth.

Growth within the Muslim world has also been notable. In Muslim countries, the support for rapid Islamisation of economic and political domains has reinvigorated since 2001. For Muslim governments, supporting Islamic banking has been a politically low-risk and low-cost option to fulfil the demands of their societies. Thus, the industry in present times has benefited from ever greater political support (Warde, 2010; Haniffa and Hudaib, 2010).

Nine Muslim countries particularly have established themselves as the core Islamic finance markets. These comprise 5 of the 6 GCC nations, namely: Bahrain, Kuwait, Qatar, Saudi Arabia and UAE and 4 non-GCC nations which include: Indonesia, Malaysia, Pakistan and Turkey. Combined, these countries constitute 95% of the global
Islamic banking assets excluding Iran and Sudan which officially recognise their entire banking system as ‘Islamic’.49 (Ernst & Young, 2014).

As figure 3.3 shows, growth of Islamic banking assets over the 2008 – 2012 period in these 9 core markets far outpaced their conventional counterparts. In Saudi Arabia Islamic banking assets grew at a compound annual growth rate (CAGR) of 23%, more than twice that of conventional banking assets which grew at 11%. Similarly, in Kuwait, Malaysia, Indonesia and Pakistan Islamic banking assets have grown at more than twice the CAGR of their conventional counterparts; while in the UAE Islamic banking assets recorded a CAGR of 15%, three times larger than the CAGR for conventional banking. Strong growth in Indonesia, Pakistan and Turkey has been particularly notable over this five-year period with Islamic banking assets recording a CAGR of 41%, 32% and 29% respectively compared to only 16%, 14% and 17% for conventional counterparts. Although growth rates have been similar in Qatar, Islamic banking assets still outperformed their conventional counterparts.

Figure 3.3: Growth in Islamic and Conventional Banking Assets in 9 Core Markets (2008-2012)

Several factors have contributed to the strong growth of Islamic banking in these core markets. Firstly, demand for Islamic banking products has been on the rise in these

49 Although Pakistan initiated the Islamisation movement in the early1980s, by the third phase of Islamic banking’s development, the country has officially recognised a dual-banking system where both Islamic and conventional banks operate.

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countries. Islamic banks have vigorously marketed their products, leveraging on religious compliance as their unique-selling point and drawing on the pro-Islamisation sentiment and political support, to compete directly with conventional counterparts in these dual-banking jurisdictions (Warde, 2010; Haniffa and Hudaib, 2010). As a result, there has been an increase in awareness and preference for sharia-compliant alternatives amongst these countries population (KFH Research, 2014; IFSB, 2014). Secondly, Islamic banks have expanded by providing sharia-compliant trade financing products to support these countries’ growing network of trade linkages. With economic growth, affluence in these countries has also increased leading to greater economic participation by the majority Muslim population. The 2007-2008 financial crisis and resulting liquidity crunch affecting Western banking institutions has also been a contributing factor, which enabled Islamic banks to emerge as an alternative for both Muslims and non-Muslims and thus expanding their clientele. Finally, along with ever-stronger political support, improved regulatory support for the industry has also sustained the growth momentum in these countries (KFH Research, 2014).

A notable exception to the double-digit growth rate trend is Bahrain, where domestic political disturbance contributed to slow and even negative growth in the banking sector (IFSB, 2014). The source of this political unrest lay in ‘The Arab Spring’[^50], the series of protests that began in Tunisia in December 2010 and spread rapidly to other North African and Middle Eastern countries. Although sustained street demonstrations took place in Kuwait and Oman, Bahrain was the worst affected country in the GCC, where protests were fuelled by sectarian divide between the Sunni and the Shia Muslims. Protests led by the Shia dominant Bahraini opposition began in February 2011. Within a month the ruling monarchy declared a three-month state of emergency and imposed martial law. Protests continued as 2011 became a year of constant unrest, the worst faced by the country since the 1990s. Unsurprisingly, the economy suffered with a direct impact on the banking industry (BBC News, 2011; Reuters, 2011, 2012b). Despite the political unrest and economic slowdown, Islamic banking industry showed

[^50]: The Arab Revolution, popularised under the term ‘The Arab Spring’ by Western media, was a series of democratic uprisings which originated in Tunisia in December 2010 and rapidly spread to other North African and Middle Eastern countries including Egypt, Libya, Yemen, Syria, Jordan, Iraq, Bahrain, Kuwait and Oman amongst others. Reasons for the protests and their outcomes differed in each country. While the regimes were toppled in Tunisia and Egypt as a result of the protests, in Bahrain the protests did not threaten the monarchy but were rather fuelled by tensions between the Sunni and the Shia Muslims (BBC News, 2011; Reuters, 2011, 2012b).
resilience and still outperformed its conventional counterpart recording a positive CAGR of 1% compared to negative growth (-7%) in conventional banking assets.

Amongst the 9 core markets, as figure 3.3 shows, Islamic banking assets have grown considerably faster in the non-GCC nations than their GCC counterparts, except for Malaysia. The level of Islamic banking penetration and the size of potential market are key reasons behind this. In all 5 GCC countries and Malaysia, Islamic banking constitutes 20% – 50% of the domestic market share. By comparison, Islamic banking constitutes 5.5% in Indonesia, 5.9% in Turkey and 9.5% in Pakistan. These are also the most populous Muslim countries in the world with Indonesia and Pakistan being the top two respectively. Given the significant potential for growth, these countries have attracted attention from both domestic and foreign Islamic banking institutions. Several well-established GCC-based Islamic banks have rapidly extended their subsidiary networks throughout these countries to capture part of these fast growing markets. As a result, Islamic banking assets are growing rapidly and given the aforementioned factors supporting the industry, growth in Islamic banking is expected to continue at these high rates in these countries as the industry’s market share continues to strengthen (Ernst & Young, 2014).

When examined at the regional level as well, the strong growth in South and South East Asia is apparent. In the post financial crisis 2009-2012 period, global Islamic banking assets (excluding Iran) grew at a CAGR of 18%, as figure 3.4 shows. In comparison, Islamic banking assets grew by 25% in South East Asia (which includes Malaysia and Indonesia) and 22% in South Asia (which includes Pakistan). In contrast, the GCC recorded a CAGR of 15% over the same period, while the rest of the world (ROW, which includes Turkey) almost matched the global CAGR at 19%.
Despite relatively slower growth, the GCC remains the most important region for Islamic banking. As figure 3.4 illustrates, the bulk of global Islamic banking assets (excluding Iran\textsuperscript{51}) are concentrated in the GCC. As a region, the GCC accounts for more than two-thirds of the global Islamic banking assets. It also dominates other regions in terms of the domestic market share that Islamic banking holds. In the GCC, Islamic banking comprises 33% of the overall banking assets, while in South East Asia (ASEAN), South Asia and ROW Islamic banking constitutes 14%, 12% and 5% respectively. The GCC is also home to the biggest and the oldest Islamic banks as well as the largest collection of Islamic financial and regulatory institutions worldwide and thus remains at present the global centre of Islamic banking and finance (Ernst & Young, 2014).

\textsuperscript{51} Global Islamic banking assets reported in figure 3.4 exclude Iran, which officially recognises its entire banking system as ‘Islamic’. As a country, Iran constitutes over 40% of global Islamic banking assets. As a predominantly Shia country, Iran follows slightly different rules due to differences in interpretation of Islamic law between Shia and Sunni scholars and thus is considered by industry analysts to have a unique domestic Islamic finance industry (Ernst & Young, 2014).
Barring country and regional differences, globally Islamic banking has grown strongly in this third phase of its development, although the industry’s growth has followed a completely different path than was originally envisioned. Islamic banking, being a product of the pan-Islamism movement, was expected to be a unified industry, organised and guided by the IAIB and IDB. It was expected that there would be a unique single model of Islamic banking and its regulatory framework which would be transported across the Muslim world. Developments since the 1990s however, shattered this illusion. As Islamic banking spread, it became an increasingly diverse and multipolar industry. Banks organised under the IAIB, which enjoyed a monopoly in the previous era, became only a constituent part of the much larger and diverse group of institutions, many of which did not belong to the IAIB. The influence of IAIB and IDB diminished as that of national considerations in promoting and regulating Islamic banking increased (Warde, 2000).

In terms of regulation, Bahrain and Malaysia have played critical roles in modernising the Islamic banking industry by establishing standard-setting and industry coordination bodies. Amongst the earliest and most notable is the Accounting and Auditing Organization for Islamic Financial Institutions\(^52\) (AAOIFI: 1991)\(^37\) based in Bahrain, which develops and publishes industry-specific standards on accounting, auditing, governance, social responsibility, ethics and sharia governance. With the turn of the millennium, the number of such support institutions rose considerably to include amongst others: the International Islamic Financial Market (IIFM: 2002), the International Islamic Rating Agency (IIRA: 2002) and the Liquidity Management Centre (LMC: 2002), all based in Bahrain and the Islamic Financial Services Board (IFSB: 2002) based in Malaysia (Hassan and Lewis, 2007). Given their location, it is clear that the geo-economics of Islamic banking has shifted from pioneers of the previous era which included Saudi Arabia and Pakistan, to Bahrain and Malaysia, which have become regional Islamic finance centres in their own right (Warde, 2000; Haniffa and Hudaib, 2010).

\(^{52}\) AAOIFI is an international Islamic standard setting corporate body. It was established in 1991 to develop and publish accounting and auditing standards to be adopted by Islamic financial institutions (IFIs) worldwide. These standards are adopted by several Middle Eastern countries, and authorities in several other countries have published guidelines based on these standards. The organisation aims to integrate the peculiarities of Islamic finance and provide specific guidance for IFIs in order to raise confidence of those using IFI’s financial statement and services (AAOIFI, 2010).
Malaysia has emerged as an interesting pole of Islamic finance in this period, with a considerably different politico-economic environment and religious traditions than the pioneers of Islamic banking. Albeit a Sunni Muslim country, Malaysia predominantly follows a different school of fiqh than the GCC and Pakistan. Malaysia’s approach to Islamic banking has also been considerably different, characterised by pragmatism and innovation. In Malaysia, Islamic finance has been an integral part of its government’s economic growth ambitions. Throughout the 1990s, the government encouraged creation of Islamic equivalents of state-of-the-art products used in conventional finance. However, in its pursuit to modernise Islamic finance, Malaysia has been criticised for cutting too many corners and its definition of religiously acceptable products as too lax. Mahathir Mohammed (Malaysia’s Prime Minister, 1981-2003) was known to show impatience with sharia scholars discussing the technicalities of religious compliance, accusing them of being too harsh and instead encouraged scholars to adopt innovative approaches, exploring previously untested sharia concepts (Warde, 2000).

Through its highly pragmatic and what many consider a lax approach towards religious compliance, Malaysia has made significant contribution in modernising Islamic finance, particularly in pioneering the development of an ‘Islamic capital market’ which was to use specifically designed sharia-compliant bonds. The first sukuk (Islamic bond) was issued in Malaysia in 1990 (Warde, 2000). The sukuk market however was almost dormant for a decade, but this changed in 2001, when the first US-dollar denominated sukuk was issued by the Central Bank of Bahrain. The GCC has played a significant role in internationalising the sukuk market. Since 2011, record-levels of corporate and sovereign sukuk have been issued particularly in the GCC, which along with Malaysia has one of highest concentrations of sukuk issuances in the world. With globalisation of Islamic finance, even non-Muslim countries including the UK, USA, France and Germany and conventional financial institutions e.g. Goldman Sachs have issued sukuk. The global sukuk market is flourishing, with an estimated $130 billion worth of issuances in 2013 (IIFM, 2014).

Notably, the expansion of Islamic banking has brought greater diversification and even fragmentation in the industry (Warde, 2010). Despite the nation’s efforts, and its position as a regional leader, Malaysia is not considered the international hub of Islamic finance particularly because of the difference in sharia traditions relative to the GCC. Many Malaysian certified Islamic products are not considered sharia-compliant in the
more religiously-conservative GCC. Trading in debt, for example, is considered
incompliant with sharia as it fails the riba prohibition. Islamic private debt securities
(IPDS) however have been certified as sharia-compliant by Malaysian scholars
following a more liberal interpretation of sharia. Scholars in the remaining Muslim
world including the GCC continue to disagree\textsuperscript{53} (Warde, 2000; Khan, 2010).

The distinct lines between Islamic and conventional banking have certainly blurred
since the 1990s. The most notable aspect of this has been the emergence of Islamic
windows\textsuperscript{54} i.e. dedicated branches and subsidiaries owned by conventional banks which
offer Islamic commercial and/or investment banking services (Rehman, 2010). Several
of the largest conventional financial institutions such as Citigroup, HSBC, Lloyds and
Deutsche bank etc. own Islamic windows. As early as 1996, Citicorp had established an
Islamic subsidiary in Bahrain. The role of local conventional banks however has been
significant in expanding Islamic windows. Now almost every local conventional bank
in the Muslim world particularly the GCC, offers some type of Islamic financial service
(Warde, 2000).

There is also increased convergence between Islamic and conventional banking
products and practices. Not all practices adopted by Islamic banks however have
negative connotations. For example, to avoid haram industries, Islamic banks use
screening criteria similar to that used by socially responsible investment (SRI) funds
(Iqbal and Molyneux, 2005). Nevertheless, the practice of replicating conventional
products through structuring strategies, which started in the previous era, has not only
continued but intensified since the 1990s. Technological advancements and a greater
alliance between Islamic bankers, sharia scholars and governments have facilitated
innovation of extremely controversial products such as tawarruq (tripartite/quadripartite
sale), a liquidity management tool designed to provide sharia-compliant cash financing,
which was first undertaken by Saudi banks in 2000 (see section 3.5.1). Since then

\textsuperscript{53} Sharia does not permit sale of debt at negotiated prices. Trading a debt obligation equates to a money-
for-money transaction and therefore needs to be at par value. Any increase or decrease is tantamount to
riba. Majority of the contemporary sharia scholars hold this view. The Islamic Fiqh Academy (which
represents scholars from all Muslim countries including Malaysia) has unanimously prohibited sale of
debt. Malaysian scholars nevertheless continue to approve the sale of debt securities by referring to the
Shafi’i school’s ruling permitting sale of debt. However what these scholars do not highlight is that the
Shafi’i scholars only permitted such a transaction when the debt is sold at par value (Usmani, 2004).

\textsuperscript{54} The Islamic Financial Services Board defines an Islamic window as a branch or unit in a conventional
financial institution which is dedicated to providing sharia compliant financing, investments and fund
management services (IFSB, 2007).
tawarruq has become extremely popular especially in the GCC (Dabu, 2007; Ahmad et al., 2017). Islamic banks now offer sharia-compliant equivalents of almost all conventional banking products and services.

In growing their product range, secular goals including profit-maximisation and growth, have wiped out the sacred intentions which played at least some role until the previous era (Haniffa and Hudaib, 2010). Sharia arbitrage is now the standard process whereby: financial products prohibited under Islamic law are first identified, an Islamic analogue is then created using classic Islamic contracts keeping the original Arabic labels which, along with differences in contractual form, adds credibility to the Islamic identity of the products whilst achieving sufficient similarity between the Islamic structure and the conventional counterpart being replaced to ensure the product is consistent with the regulatory framework of the target markets (El-Gamal, 2006). This form-over-substance approach to defining and designing sharia-compliant products, aiming to circumvent rather than comply in any meaningful way with sharia injunctions, is now the accepted norm of the industry (El-Gamal, 2006; Iqbal and Lewis, 2009). The debate on compliance with the letter vs. spirit of sharia has largely become an academic exercise as opposed to the industry’s concern.

The nature of the Islamic banking literature produced during this period has also changed, reflecting the opposing opinions on the industry. Practitioner and industry-supported literature focused on practicality, regulation, strategies to expand market shares and development of new Islamic products through financial engineering. This literature promotes Islamic banking as a success given its record high double-digit growth rates (Ernst & Young, 2012; IIFM, 2014). Academic literature however, particularly since the 1990s has been more critical of the developments in the industry. Prominent critics such as Kuran (2004), El-Gamal (2006) and Khan (2010) have dismissed the entire Islamic banking industry as nothing more than a branding exercise. Even the earliest advocates of Islamic banking and notable Islamic economists have criticised the industry for failing to fulfil the necessary conditions laid down by the sharia, concluding that Islamic banking today neither reflects the principles of Islamic finance nor has progressed in accordance with the original goals of aiding socio-economic development (Siddiqi, 2006; Chapra, 2007). Criticism has also come from
modern-day sharia authorities. Sheikh Taqi Usmani\textsuperscript{55} (a renowned present-day sharia scholar and chairman of the Sharia Council of AAOIFI) has on several occasions raised concerns over Islamic banks’ breach of sharia principles in the use of murabahah and sukuk (Usmani, 2004, see section 3.5 for details).

Naturally such criticism raises important questions: Why are Islamic banks’ products/practices controversial and given their criticism, how are these sharia-certified? The next section addresses both questions. First, the most popular products used by Islamic banks and their criticisms are described. Second, issues regarding reliability of SSBs and sharia-certification process are presented with an evaluation of the steps taken by the industry to address them.

### 3.5 Islamic Banking in Practice

#### 3.5.1 Controversies on the Asset Side

In theory, the asset portfolio of Islamic banks comprises of PLS contracts. In practice however, Islamic banks use a variety of non-PLS financial instruments. The two most popular non-PLS financing modes are murabahah (cost-plus-credit-sale) and ijarah (leasing), which on average comprise more than 80% of Islamic banks’ asset portfolio and thus are considered the backbone of modern Islamic banking (Iqbal and Mirakhor, 2002). Other relatively less common financing modes include salam (prepayment sale), istisna (sale order for manufactured asset), musawamah (sale with no mark-up disclosed), bai-al-muajjal\textsuperscript{56} (credit sale), and qard-hasan (interest-free benevolent loan)\textsuperscript{57}. To provide cash financing facility to their customers or to manage their own liquidity needs, Islamic banks use commodity murabahah (short-term cost-plus-credit-sale-of-commodities), tawarruq (tripartite/quadripartite sale) and/or bai-al-inah (buy-back-sale). To meet the need for debt-like investment instruments, Islamic banks also

\textsuperscript{55} Sheikh Taqi Usmani is one of the leading scholars in Islamic finance. He is the chairman of the International Sharia Standard Council of AAOIFI, the vice chairman of the Islamic Fiqh Academy and holds positions on several sharia boards of Islamic banks.

\textsuperscript{56} Bai-al-muajjal is also known as bai-bithaman-ajil which simply refers to ‘sale with deferred payment’ i.e. a credit sale; sometimes also called mutajara (Obaidullah, 2005).

\textsuperscript{57} Some Islamic banks provide qard hasan financing to their less well-off customers including small business owners, financially needy farmers and other poor clients. These loans do not generate a rate of return (as no interest can be charged and the borrower is required to repay only the capital amount borrowed). However, banks can (and in many cases do) charge a set commission fee for providing this service. This fee is independent of the amount and period the funds are loaned for (Shanmugam and Zahari, 2009; Visser, 2009).
hold sukuk (Islamic bonds). Ancillary contracts such as ju’alah (service fee), wakala (agency) and kafalah (guarantee) amongst others, form an integral part of the financial arrangements used by Islamic banks. A discussion of each of these contracts and their variants is not only beyond the scope of this thesis, it is also unnecessary as some key contracts are more widely used and keep reappearing in the discussion of other financial arrangements (Visser, 2013). A relatively comprehensive coverage of the controversies surrounding non-PLS instruments can therefore be achieved through a focused discussion of the most popular financial instruments. This is presented below. For details on the traditional Islamic contracts and their use as financial instruments, interested readers should consult: Obaidullah, (2005), El-Gamal (2006), Ayub (2007), Shanmugam and Zahari (2009), Visser (2009) and El-Diwany (2010).

What are non-PLS financing modes and why do they exist?
PLS financing contracts are more suited to business as opposed to consumer finance needs. If a customer wishes to purchase an asset (e.g. a car), Islamic banks cannot enter into a PLS contract nor extend a return-generating loan for this purpose. To accommodate such needs, contemporary sharia scholars have permitted variants of traditional trade-based Islamic contracts which have been modified to facilitate financing activities. These modified contracts create sales-based financing arrangements, which operate on a ‘mark-up’ and deferred payment principle. In these arrangements, Islamic banks purchase the desired asset on behalf of their client and resell/lease it, earning a return by adding a mark-up either to the cost of the asset or in form of a service/management fee (Warde, 2000; Ayub, 2007; Iqbal and Lewis, 2009; Visser, 2009).

Contemporary sharia scholars have sharia-certified these financing arrangements on asset-based basis. As long as the sellers/lessor (Islamic bank) bears the ownership risk of the underlying asset, the profit earned is valid under the sharia. The mark-up charged in the credit sale/leasing arrangement is also considered a valid profit margin as a form of compensation for the risks involved and benefit the buyer is able to receive through the use of the goods before full payment is made (Usmani, 2004; Visser, 2009).

These sales-based arrangements are usually labelled as ‘non-PLS’ or ‘debt-based’ financing modes because there is no risk-sharing between the bank and its customer. A predetermined and fixed rate of return on Islamic banks’ investment (the cost of asset
purchased) is built into the transaction using the mark-up. The amount and schedule of repayments is determined at the contract inception, and thus these arrangements create a regular stream of fixed payments for the bank which are repayable irrespective of the circumstances faced by the customer. Furthermore, as the bank retains ownership of the financed asset until repayments are complete, the control rights of the asset transfer to the bank in case of default (Warde, 2000; Ayub, 2007; Iqbal and Lewis, 2009; Visser, 2009). Such transfer of control rights is the salient feature of debt contracts; PLS (equity) contracts offer no such control rights. Therefore, even beyond the fixed repayments, there is a formal equivalence between these sales-based (henceforth non-PLS) modes and debt financing contracts which differentiate these from their PLS counterparts (Aggarwal and Yousef, 2000).

Murabahah and Ijarah: Non-PLS (Debt-based) Financing

Modified versions of traditional murabahah and ijarah are the most widely used non-PLS financing modes in Islamic banking. These work as follows. Modified murabahah is a cost-plus-credit-sale contract, where an asset is sold at a cost-plus-mark-up price with deferred payment, usually scheduled as regular instalments made over a specified period of time. The traditional murabahah contract requires spot payment and therefore deferred payment is achieved by adding the traditional contract of bai-al-muajjal (credit sale) to the transaction. Modified murabahah (henceforth murabahah)58 is therefore a combination of two contracts in one (Visser, 2009). Murabahah is extensively used by Islamic banks and is an integral component of several other debt-based financial products (see discussion on commodity murabahah and tawarruq arrangements below).

Modified ijarah has many variants, under which Islamic banks purchase and lease assets to receive a regular rental income. In traditional ijarah, the asset remains in the lessor’s ownership that bears the assets’ ownership risk, maintenance responsibilities and expenses, while the lessee bears only the operating costs59. The asset is also returned to...

58 In keeping with the Islamic banking literature and industry practice, the term ‘murabahah’ is used to refer to the modified murabahah contract (cost-plus-credit-sale), while the term ‘traditional murabahah’ refers to the original Islamic contract of mark-up sale with spot payment. Note that sometimes in the literature and industry, the terms murabahah, bai-al-muajjal, bai-al-muajjal-murabahah and bai-bithaman-ajil-murabaha are all used interchangeably to refer to the modified murabahah arrangement (Obaidullah, 2005; Visser, 2009).

59 In conventional operating leases, the asset’s risk, maintenance and related expenses are the lessee’s responsibility which is contrary to the traditional ijarah contract. Furthermore, unlike a conventional...
the lessor at the end of lease period. As Islamic banks do not have any interest in the underlying asset, modified ijarah (henceforth ijarah) is commonly arranged similar to a conventional finance lease ending with the transfer of the asset’s legal title to the lessee. This is achieved through combining traditional ijarah with sale or gift contracts or through promises guaranteeing the transfer of ownership. The latter includes a promise to sell by the bank (call option on the leased asset) or a promise to purchase by the lessee (put option), which is followed by a formal sale contract at expiry of the lease period. The rent (and sale price, if the asset is transferred through a sale contract) is calculated such that Islamic banks receives the principal invested in the asset plus a mark-up (Ayub, 2007; Shanmugam and Zahari, 2009; El-Diwany, 2010).

Murabahah and ijarah are strongly criticised by many for being de facto interest-bearing instruments and therefore completely un-Islamic (Kuran, 1995, 2004; El-Gamal, 2006; Zaman and Movassaghi, 2002; Zaman 2008; Khan 2010). At best, these are considered ‘weak’ forms of Islamic financing relative to superior PLS contracts (Siddiqi, 2002 in Khan, 2010). The latter view relies on the asset-backed argument for justifying these transactions for which the bank must assume the ownership risk of the asset sold/leased (Visser, 2009). Thus, for a valid murabahah, the asset must come into the banks’ ownership and a time lag must exist before the sale is made, so the risk of the asset is borne by the bank. In case of ijarah, the ownership risk including the maintenance costs of the asset must be assumed by the bank and not the lessee (Usmani, 2004; Ayub, 2007; El-Diwany 2010). In practice however, in a murabahah transaction the bank buys the specified asset only after it acquires a ‘legally enforceable promise’ from its client that he/she will purchase the asset from the bank (Shanmugam and Zahari, 2009). The bank’s ownership is therefore symbolic; lasting only a few seconds and the risk exposure is virtually negligible. In ijarah financing, the ownership risk including maintenance and insurance costs are contracted away to the lessee. Not only is the ownership risk removed from these transactions but also the mark-up charged on murabahah and rent on ijarah assets is often benchmarked to the prevailing interest-rate and based on the length of repayment time, replicating the outcome of an interest

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60 The ownership risk and expenses of the leased asset transfer to the lessee under a conventional finance lease. Thus, conventional finance leases are not permitted under sharia, since the traditional ijarah requires the lessor to assume ownership risk of the asset (Ayub, 2007).
bearing loan. Thus, under such arrangements, the bank does not face ownership risk but rather credit risk associated with the borrower and interest rate risk similar to its conventional counterpart. Many academics therefore argue that non-PLS modes are simply ruses, where several interest-free valid contracts are combined to circumvent the prohibition of riba and replicate interest-based debt finance contracts (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal 2006; Zaman 2008; Khan 2010; El-Diwany, 2010). Murabahah, for example, has been concluded to be a modern form of the medieval contractum trinius, which was used to overcome the prohibition of usury set by the Church (El-Gamal, 2006; El-Diwany, 2010; Khan, 2010). Given the additional transactions which have to be added to construct these arrangements, non-PLS financing modes have been concluded as simply a “cumbersome form of interest” (Kuran, 1995, p.162).

Questions have also been raised over the legal validity of non-PLS arrangements which combine two or more contracts in one transaction. Since interdependent contracts are not permitted in sharia, from a strict sharia (legalistic) perspective, experts have argued that the modified non-PLS financing contracts are invalid under Islamic law (Ayub, 2007; Nyazee, 2009a; El-Diwany, 2010). Using the rules of Islamic jurisprudence, Nyazee (2009a) proves the invalidity of murabahah on three different grounds and criticises Islamic banks for failing to even meet the terms of Islamic law.

Furthermore, several scholars have confirmed that the industry’s current practices are not even in line with the conditions on which the modified contracts were originally permitted (Iqbal and Lewis, 2009). Certified as an exception for transactions where PLS options cannot be used, non-PLS modes were not intended to be universal Islamic financing instruments. Therefore their use needs to be restricted only for asset acquisition purposes. In practice, however, there have been cases where murabahah has been used simply to fulfil a client’s need for funds rather than an asset. The widespread use of murabahah is indisputable which has given rise to the term ‘murabahah-syndrome’ to describe the industry’s financing behaviour (Yousef, 2004). Even Islamic economists have concluded the use of non-PLS modes needs to be ‘cleaned’ since the

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61 Nyazee explains that there can be 1) no mark-up stated in a credit sale (bai-al-muajjal), 2) no delay in payment in a traditional murabahah contract i.e. goods are sold at a mark-up for a spot price and 3) a binding promise cannot be used to link a credit sale with a spot transaction. Therefore, the modified murabahah is invalid under Islamic law. For detailed explanation, see Nyazee (2009a).
industry’s current indiscriminate approach is not in line with Islamic principles (Iqbal et al., 1998; Siddiqi, 2006; Chapra, 2007).

Criticism over misuse of these contracts has also been voiced by sharia authorities. As early as 1991, the Federal Sharia Court in Pakistan ruled the contract of murabahah as practiced by the Islamic banking industry was not in compliance with the principle of Islam (Iqbal and Molyneux, 2005). More recently, Sheikh Taqi Usmani, raised concerns over evidence of Islamic banks selling the underlying murabahah asset before it comes into their ownership (as multiple contracts are signed simultaneously) and has pronounced this practice in breach of the sharia principles, since according to Islamic law, one cannot sell that which he/she does not own (Usmani, 2004). As Usmani explains, without observing the strict conditions of the modified contracts, “the whole transaction turns into an interest-bearing loan since changing the label from interest to mark-up, profit or rent without fundamentally changing the nature of transactions does not suffice in establishing actual religious legitimacy” (Usmani, 2004, p.105). In such circumstances, these transactions cannot be deemed Islamic, and the return generated no longer lawful (ibid).

**Commodity Murabahah, Tawarruq and Bai-al-inah: Liquidity Management Tools**

In order to provide a cash financing facility to their customers or to manage their own liquidity needs (including interbank financing), Islamic banks use commodity murabahah (short-term cost-plus-credit-sale-of-commodities) and tawarruq (tripartite/quadripartite sale) or bai-al-inah (buy-back-sale).

Commodity murabahah is used to replicate short-term treasury bills. This transaction uses a murabahah contract where the underlying asset is a commodity e.g. aluminium. Commodity murabahah works as follows. Bank A buys a commodity at a spot price, and sells it to Bank B at a spot-price-plus-mark-up with deferred payment (due between one week to one year, but mostly on a three-month term). Bank B purchasing the

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62 Recall from chapter 2 the prohibition of riba requires that gold is exchanged for gold, silver for silver on the spot and in equal amounts. As these metals were used for currency, this condition ensured that an interest-bearing loan could not be created by trading these metals. In modern times, scholars have exempted many metal commodities such as aluminium and platinum from the rules applying to currency exchanges. Thus, these metals are often used in commodity murabahah, bai-al-inah and tawarruq transactions whereby trade cycles are used to replicate interest-based loans (El-Gamal, 2006).
commodity immediately sells it to another institution or a commodity dealer at the spot price. Through this transaction, Bank A earns a profit (mark-up) while Bank B receives the funds it needs immediately (Shanmugam and Zahari, 2009).

Both bai-al-inah and tawarruq are primarily used as liquidity management tools to meet a bank’s own or its clients’ short-term cash financing needs, to provide financing for short-term working capital and in structuring credit cards (Obaidullah, 2005). Bai-al-inah is a buy-back-sale transaction which involves two back-to-back sale contracts, one spot, and the other credit. In this arrangement, the customer sells an asset (usually a commodity) to the Islamic bank at an agreed price for cash. The bank immediately sells the asset back to the same customer on credit at an agreed higher price (comprising of the cash price plus mark-up). The customer receives cash and the bank makes a profit. This contract also occurs in the opposite direction where, the bank sells an asset (again a commodity) to its customer on credit and immediately buys it back for a lower cash price. The price differential represents the bank’s profit (Shanmugam and Zahari, 2009; El-Gamal, 2006). Classic fiqh literature has discussed bai-al-inah at length and it was viewed as an obvious ruse designed to circumvent the prohibition of riba and legitimise interest-based lending under the guise of trade (El-Gamal, 2006). Thus, bai-al-inah has been declared to be unanimously prohibited in Sharia (Usmani, 2004) and this ruling is internationally followed, except in Malaysia. The prohibition of bai-al-inah is based on two hadiths (prophetic traditions). Most scholars accept the authenticity of these hadith, but a minority do not. On the basis of the latter opinion, some Malaysians scholars have permitted the use of bai-al-inah and therefore it is used by Malaysian Islamic banks. This is however the minority position, as bai-al-inah is prohibited in the GCC and the rest of the Muslim world (El-Gamal, 2006; Shanmugam and Zahari, 2009).

In the Gulf, tawarruq, a variant of bay-al-inah is used. The key difference between bai-al-inah and tawarruq is that the latter includes three or more parties. In a tawarruq transaction, the bank buys a commodity with cash either directly or indirectly from a dealer and immediately sells it to its client for deferred payment. The client immediately sells the commodity for a spot payment and delivery to a third party, usually a commodity dealer, either the same as the original seller (if three-party transaction) or a different dealer with genuine need for the commodity (if four-party transaction). In the latter case, the bank uses a genuine commodity exchange to generate
cash financing for its client by adding two fictitious sales to the transaction. In the former case, the entire sale structure is artificially constructed to generate a cash financing scheme at interest, thereby raising credit with no identifiable link to customers’ need for an asset (Shanmugam and Zahari, 2009; Rehman, 2010). In practical terms, the difference between tawarruq and commodity murabahah is minimal, with the final spot sale in tawarruq being a formal part of the arrangement, which is often undertaken by the bank on behalf of its customer (El-Gamal, 2006).

The permissibility of tawarruq is a contentious issue. Classical scholars recognised that a third or fourth party could be added as an intermediary to bai-al-ina, and thus by analogy tawarruq is also not permitted. Supporters of this view argue that what is permitted under sharia is not based on the contractual form or the number of transactions involved, for sharia does not ban a transaction only to permit it through greater degrees of separation involving higher transaction costs. Some scholars, however, permitted the arrangement given that it contains at least three parties. The latter view is used as the basis for tawarruq’s permissibility in the industry. Notably, selected scholars from only one of the four schools of fiqh permitted tawarruq, with the condition that its use is limited and unsystematic. The others have unequivocally condemned this arrangement (El-Gamal, 2006).

Tawarruq has been permitted by AAOIFI given certain conditions. First, at least three parties must be involved in the transaction so it is not bai-al-inah. Second, the trade must be genuine i.e. physical ownership of the commodity traded should transfer from seller to buyer and the commodity must be sold at current market price, with a time gap between all sale contracts so that each party is exposed to price risk which is the basis for justifying the return. Finally, there should be no prearrangement between the parties particularly regarding the final sale which indicates a clear intention to override the riba prohibition. Similar to the position of classical scholars, AAOIFI does not permit the same agent to undertake the sale contract on behalf of both trading parties to ensure only legitimate sales take place. What is essentially permitted by AAOIFI is a very specific reformed version of tawarruq, known as an ‘unassisted/unorganised tawarruq’
whereby a genuine trader may sell a product purchased on credit, for cash (Obaidullah, 2005; El-Gamal, 2006; Khan, 2010a).

Apart from three parties being involved, none of the other conditions are met by Islamic banks. Firstly, all sales are instantaneous. In practice, tawarruq, bai-al-inah and commodity murabahah transactions are all undertaken using multiple electronic trades from the bank’s premise, with no real commodity ever moving an inch. In many cases, the same stock of commodity is sold and resold many times within a single day, and therefore can be under multiple ownership claims. Justifying the return earned on the basis of ownership risk is therefore out of the question. Clearly there is no real economic activity underpinning these transactions. Trading of commodities through fictitious sales is simply used to lend and borrow at interest and thus these are a case of ‘money-now-for-more-money-later’ arrangements, which explicitly fall under the riba prohibition (Khan, 2010a). Secondly, the sale price agreed between parties is not the market price of the commodity; rather it is the amount the client needs to borrow (Obaidullah, 2005). Finally, Islamic banks (either directly or indirectly through an appointed third party) act as the agent for both the customer and the dealer. Thus the final condition is also not met (El-Gamal, 2006; Khan, 2010a).

The transaction used by Islamic banks is formally known as ‘organised tawarruq’, as the multiple sale structure is pre-organised by the bank. The Fiqh Academy of the Muslim World League banned organised tawarruq in 2003. In 2009, the Islamic Fiqh Academy also passed a ruling banning organised tawarruq (Shanmugam and Zahari, 2009; Visser, 2009; El-Diwany, 2010; Khan, 2010a). Although not explicitly stated, AAOIFI has also effectively, albeit indirectly, banned organised tawarruq by specifying the above-mentioned conditions, which imply that tawarruq by definition cannot be organised (Khan, 2010a). In the case of Islamic banks, tawarruq is marketed as an instrument to meet clients’ cash needs and is therefore always conducted on an organised basis which fails to meet the strict guidelines that have been stipulated by AAOIFI (El-Diwany, 2010; Khan, 2010a).

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63 This allowance is provided for genuine traders who may sell inventory bought on credit on cash basis e.g. a fruit seller who buys stock on credit from the wholesaler in the morning and sells it for cash during the day, hoping to make a profit (Khan, 2010a). For detailed explanation of the joint stance taken on tawarruq by AAOIFI and the Islamic Fiqh Academy, see Khan (2010a).
In each of the three financial arrangements discussed, it is clear that neither the Islamic bank nor its customers are interested in the underlying commodity. Fictitious trading cycles involving credit sales are used simply to generate interest-based loans. These arrangements exploit sharia’s permission to charge higher than spot price in credit sales and the tradition of genuine credit sales which were used in medieval Islamic societies. These structures have therefore been identified as obvious ruses, designed with the intention to circumvent the prohibition of riba. With no genuine link to a real economic activity, these transactions lack materiality and therefore also fail the gharar prohibition. As a result, commodity murabahah, tawarruq and bai-al-inah are considered completely un-Islamic by many academics or at the very least highly controversial by majority of contemporary sharia scholars (Obaidullah, 2005; El-Gamal, 2006; Khan, 2010a).

**Sukuk: Debt Investments**

Islamic banks hold sukuk (Islamic bonds) as part of their investment portfolio to meet the demand for debt-like investment instruments. Sukuk are asset-backed securities which have a similar risk/return characteristic to conventional debt securities (Iqbal and Tsubota, 2006; Ayub, 2007). These are increasingly being used by both governments and corporations to raise finance (Chapra, 2007). The securitisation process involved in the issuance of sukuk is almost identical to the process used in conventional finance with the exception of sharia-compliant financial contracts being involved (Iqbal and Tsubota, 2006; Ayub, 2007). A special purpose vehicle (SPV) is set up by the originator under a mudarabah contract for the securitisation process. The SPV acquires the specific assets collateralising the sukuk and issues certificates representing financial claims on the assets lasting the term of the issue. There are various types of sukuk; each named after the underlying sharia-nominate contract (Obaidullah, 2005). The most common is the ijarah-sukuk which is the first Islamic fixed-income sukuk to have gained global acceptance. Ijarah-sukuk is considered the most efficient, sharia-compliant alternative to conventional debt securities and has become extremely popular especially in the last decade given its tradability and liquidity (Obaidullah, 2005;El-

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64 Securitisation is the process of pooling and repackaging illiquid and nonmarketable assets into tradable investment certificates. It is a process of raising funds secured on expected cash flows arising from a given set of assets. As Islamic financing is required to be asset-backed by definition, there have been plenty opportunities for sukuk issuances (Ayub, 2007).

65 This is also known as a ‘special purpose mudarabah’.

66 Sukuk are formally defined as financial certificates which represent a share in the ownership of tangible assets, their usufruct (earnings) or the assets of a specified investment or project (Ayub, 2007).
Gamal, 2006; Iqbal and Tsubota, 2006; Ayub, 2007; Shanmugam and Zahari, 2009). Ijarah-sukuk is therefore discussed below to illustrate a sukuk structure and related controversies.

Ijarah-sukuk is based on the concept of sale-and-lease-back and works as follows: Suppose the originator (a government or corporation) needs to raise funds amounting to £X. It creates an SPV which issues sukuk (certificates) worth £X to investors. The SPV uses the proceeds to buy a designated asset (usually property, land, machines etc.) from the originator and leases it back for a specified term at £X+Y, representing the principal and rental value. The originator pays rent on the leased asset in regular instalments, which the SPV distributes to the sukuk-holders on a periodic income-distribution basis in proportion to their sukuk holding, after deducting its fees/share. Sukuk-holders receive regular rental income which replicates bond coupons. At the end of the lease period, the originator buys the asset back. Ijarah sukuk offer both fixed and floating-rate payoffs. In the former case, the rent (cashflow) arising from this arrangement is fixed therefore it generates a predetermined rate of return on investment. In the latter case, the rent is based on a benchmark e.g. the LIBOR and revised periodically (Obaidullah, 2005; Iqbal and Tsubota, 2006; Ayub, 2007; El-Gamal, 2006; Shanmugam and Zahari, 2009).

Ijarah-sukuk (and other variations of sukuk structures) are criticised for being no more than costly replications of conventional interest-based bonds which rely on structural differences to gain religious legitimacy (Ayub, 2007; El-Gamal, 2006; Zaman, 2008; El-Diwany, 2010). In the case of ijarah-sukuk, there are three primary issues. The first issue relates to the presence of the prohibited bai-al-ina (buy-back sale) in the ijarah-sukuk structure. There are in fact two elements of bai-al-ina involved. First the originator sells the asset and its usufruct to the SPV. Second, the originator repurchases the usufruct through entering a lease contract and finally the originator repurchases the asset and its remaining usufruct at the lease-end. Thus, the controversies and rulings concerning bai-al-ina discussed earlier also apply to ijarah-sukuk rendering this arrangement impermissible under the sharia. Note that, in this arrangement, the asset price equates to the principal loan amount and the value of the usufruct (rent) represents

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68 LIBOR is the London Interbank Offered Rate.
the interest charged on that loan. Thus, the ijarah-sukuk relies on the addition of an
unnecessary SPV and several contractual agreements to replicate an interest-bearing
debt contract (El-Gamal, 2006).

The second issue relates to benchmarking of rental repayments. Each ijarah-sukuk has a
different underlying asset and therefore at least theoretically each ijarah-sukuk should
have a different rental rate depending on the market for the asset, its depreciation rate
and the overall quality of the collateral. In practice, however, irrespective of the
underlying asset, the rental rate charged is pegged to the interest rate charged on
conventional bonds which have a similar credit rating. Thus, there is no direct
relationship between the rental income generated and the underlying asset. The sukuk is
therefore backed by nothing other than the credit-worthiness of the originator
(government/corporation) as in conventional bonds, and offers mostly fixed or quasi-
fixed returns on investment contrary to the sharia principles (El-Gamal, 2006; Ayub
2007).

The final issue relates to ownership and sukuk-holders’ right to rental income. Sukuk
are defined as certificates which represent proportionate ownership in the underlying
leased asset. This ownership entitles sukuk-holders to a share in the rental income
generated by the asset (Usmani, 2004). With ownership comes the responsibility of
bearing the asset’s risk. With ijarah-sukuk, sukuk-holders are, in theory, exposed to the
market risk of the underlying leased asset and the credit risk which relates to the
originator’s inability to pay the agreed rent. To mitigate these risks in practice, ijarah-
sukuk include a clause whereby the originator undertakes a unilateral binding promise
to buy the leased asset back if it defaults on the rental payments, with the price payable
equating to the outstanding principal amount. This is known as a put option. As this put
option is an integral part of the agreement, the sale of the underlying asset from the
originator to the SPV is not a ‘true sale’ and thus the ijarah-sukuk is not actually an
asset-backed security (CIMA, 2011), which is arguably the distinguishing feature of
sukuk relative to its conventional counterparts. Without genuine ownership risk, sukuk-
holders’ claim on the rental income is not valid under the sharia. In relation to this,
there have been cases of sharia scholars retracting their approval of sukuk. Abdullah ibn
Mani (a respected Saudi scholar) for example withdrew his approval of ijarah-sukuk
issued by the Government of Bahrain, convinced that ownership of the underlying asset
was not completely transferred to the sukuk-holders as is required by sharia (El-Gamal, 2006).

Further concerns have also been raised by other sharia scholars. Sheikh Taqi Usmani, for example, declared in 2008 that up to 85% of the sukuk in existence at the time were not in accordance with sharia rules (Khan, 2010; Davies and Sleiman, 2012). Despite further guidance published by AAOIFI after this announcement, controversies on sukuk structures and their sharia compliance have continued (for examples see El-Diwany, 2010; Khan, 2010). Thus, sukuk are concluded to be simply costly replications of conventional debt securities; a ruse which relies on structural differences to establish religious legitimacy whilst producing transactions involving riba which are specifically banned under the sharia (El-Gamal, 2006; El-Diwany, 2010; Khan 2010).

3.5.2 Controversies on the Liability Side

**Investment Accounts**

In theory, an investment account is the principal deposit product offered by Islamic banks (Obaidullah, 2005). It represents the liability side of the two-tier mudarabah model, where deposits operate on a PLS (mudarabah) basis. In practice however, the PLS principle is never strictly followed. The nominal amount in these accounts is implicitly guaranteed, against the terms of the mudarabah contract (Zaher and Hassan, 2001). Even when Islamic banks make losses, these are not passed down to the investment account holders and the capital sum in their accounts is never written down (Warde, 2000; El-Hawary et al., 2007; Visser, 2009; Khan 2010). This is primarily due to competitive pressures such as withdrawal risk and displaced commercial risk\(^{69}\) as well as regulations which ensure mechanisms are in place to avoid capital loss for investment account holders (IAH) (Zaher and Hassan, 2001; El-Hawary et al., 2007; Schoon, 2010).

Additionally, the expected rate of return on these investment account deposits is implicitly guaranteed and delinked from the bank’s actual profits (Zaher and Hassan, 2001). Instead of sharing profits as they arise, Islamic banks use discretionary reserves

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\(^{69}\) Withdrawal risk is the risk of depositors withdrawing their funds due to lower rate of return being paid than competitor banks. Displaced commercial risk is the risk of divergence in the return on assets and expected returns to be paid on liabilities (El-Hawary et al., 2007).
such as Profit Equalisation Reserves (PER) and/or Investment Risk Reserve (IRR)\textsuperscript{70}, to manage the profits distributed to the IAH. These reserves are essentially used to generate a smooth and stable return for the depositors (IAH), whilst protecting them from the risk of principal loss (Farook et al., 2012). Moreover, the return paid on investment account deposits mimics the interest rate paid on conventional banks’ deposits. Thus, with no real risk sharing, these accounts are similar to the interest receiving saving accounts offered by conventional banks (Kuran 1995; Chong and Liu, 2009).

**Current and Savings Accounts**

In addition to investment accounts, Islamic banks also offer current and saving account facilities for depositors that seek to simply keep their funds at the bank. To comply with Islamic principles, these accounts should operate on a safekeeping/trust basis\textsuperscript{71} because the nominal value of these funds is guaranteed by the bank. As risk-free deposits, no return can be paid on these because that would constitute riba. More importantly, as deposits are held in trust, Islamic banks are not permitted to use these funds for their investment/financing purposes. Current and saving accounts in Islamic banks should therefore, in theory, be treated as full-reserve deposits with no return paid to the depositors. In reality however, Islamic banks reinvest these funds for financing purposes and therefore these account operate on a fractional reserve basis as in conventional banks, violating the conditions of the underlying Islamic contracts in use (Visser, 2009; El-Diwany, 2010).

Often the contracts of qard hasan (interest-free benevolent loan) and wadiah (safekeeping) are used in practice. The use of these contracts however, is problematic from the sharia perspective. Qard hasan is an interest-free charitable loan contract, designed to be extended to assist the financially needy, where only the borrower can benefit. Recall from chapter 2, that with qard hasan any benefit above the capital sum

\textsuperscript{70} PER is created to smooth profit distributions to investment account holders (IAH) and IRR is used to protect them from the risk of principal loss. The PER is created from deductions made to income earned on banks’ investments before profit is allocated to the bank and IAH. The IRR is established using appropriations from the IAH’s share of the profit after the bank’s shareholders’ share has been deducted. Although these reserves are recognised as part of IAH’s equity, the amounts within these reserves may not be distributed to them (Farook et al., 2012).

\textsuperscript{71} The only form of deposit acceptable in classical Islamic traditions is that held on safekeeping (wadiah) basis (Warde, 2000). Recall from section 3.2, deposits in medieval Islamic societies operated on the safekeeping basis.
given to the lender whether monetary or non-monetary is riba. Considering deposits as qard hasan therefore implies any free banking services provided to the depositors would be considered riba, delegitimising such an arrangement. More importantly, Islamic banks do not actually fit the ‘financially needy’ category to which qard hasan can be extended. This contract is therefore delinked from its actual charitable nature simply to mimic current account services in conventional banks and is therefore controversial (Obaidullah, 2005; Schoon, 2010).

Wadiah, on the other hand, is a classical safekeeping contract, where funds are held in trust with ownership and control remaining with the depositor. Under this contract, the bank cannot lawfully use these funds to extend credit or co-mingle with its own capital to use in its day-to-day operations (Schoon, 2010). Any deposits operating on this basis therefore need to be held on a 100% reserve basis (Visser, 2009). To overcome this constraint, Islamic bankers have redesigned the traditional wadiah contract as wadiah-wad-dhamanah (safekeeping with guarantee), which permits banks to use these deposits as loanable funds (Obaidullah, 2005). According to the classical juristic argument, when funds under wadiah contract are used by the depositary (i.e. the bank), the contract is no longer one of safekeeping\(^\text{72}\) but that of a loan i.e. qard (El-Gamal, 2006) and therefore rules and issues related to qard as discussed above apply. A brief discussion in El-Diwany (2010, p.253-4) concludes that sharia legality issues on current accounts remain unresolved.

The use of wadiah contracts for savings accounts is also controversial as it requires a rather “\textit{liberal juristic application of Islamic financial principles}” (Dar, 2007, p.85). In wadiah-based saving accounts, the capital sum is guaranteed and therefore a fixed return cannot be paid as that amounts to riba. Islamic banks therefore pay their depositors ‘gifts’ which are not contractually stipulated in order to avoid the riba prohibition, but as these ‘gifts’ are recurring in nature, and paid on deposits at a certain rate without fail, these are \textit{dangerously close to devouring riba} and therefore understandably criticised (Obaidullah, 2005, p.55).

\(^{72}\) Use of such funds constitutes a violation of fiduciary duties placed upon the depositary under the traditional wadiah contract, and thus the depositary must guarantee the funds for the depositor (El-Gamal, 2006).
3.5.3 Controversies Concerning the Reliability of Sharia Supervisory Boards and Sharia Certification

The Sharia Supervisory Board (SSB) is an important governance mechanism in Islamic banks, aimed at enhancing their religious credibility. The SSB is an independent body of sharia scholars that have expertise in Islamic commercial law. These scholars are employed and remunerated by the Islamic banks and their primary role entails giving fatwas on the sharia validity of the banks’ operations. In theory, the SSB act as religious auditors who are responsible for guiding, advising, reviewing and certifying at the end of each year that the banks’ products, contracts and transactions have conformed to the Islamic principles (Warde, 2010; AAOIFI, 2010). The SSB conducts sharia compliance checks both before and after the launch of a new product (AAOIFI, 2010). All new products therefore require a seal of approval from the SSB. The SSB’s opinion (fatwa) is theoretically binding such that refusal to approve a product implies that it cannot be used by the bank (Warde, 2010).

Besides the SSB, Islamic banks also have an internal sharia auditing team. The internal sharia auditors have a similar role to internal financial auditors except that they evaluate the extent to which Islamic banks transactions and contractual terms comply with the guidelines and instructions of the SSB (AAOIFI, 2010). Thus, the sharia audit team plays a bridging role between the management and the SSB. Final sharia audit results for each year are published as part of the annual reports (for most Islamic banks) and at times include recommendations made by the SSB for future improvements.

A number of issues however, concerning the SSB and reliability of sharia certification have arisen. For example, there’s the issue of multiple board memberships and conflict of interest. Sharia scholars hold positions on numerous sharia boards, including those of competing banks. The top 10 of the 400-plus sharia scholars in the world hold 24-85 board seats each, occupying nearly 40% of all the SSB seats available worldwide.

73 For details on the role of the SSB, the SSB report and the internal sharia review, see guideline issued by AAOIFI particularly: ‘Governance Standard for Islamic Financial Institutions, (GSIFI) 1, 2, 3 and 5 namely: Shari’ah Supervisory Board: Appointment, Composition and Report; Shari’ah Review; Internal Shari’ah Review and Independence of Shari’ah Supervisory Board’ (AAOIFI, 2010).

74 The exposure and influence of these scholars has far greater reach than the number of seats each individual holds. This is because the same scholars also provide their services to consulting companies such as Minhaj Advisory, which caters for the needs of other financial institutions including mutual funds, asset management and real estate companies. Estimations show that the institutional and cross links of the top 3 scholars alone makes up 21% of the entire industry. These top 3 scholars are Sheikh
Furthermore, the same scholars hold positions not only on the boards of regulated banks but also in standard-setting regulatory bodies e.g. AAOIFI and central banks, effectively judging and regulating their own work. Such a system is unsurprisingly criticised for conflict of interest, which remains an unresolved issue in the industry (Davies and Sleiman, 2012).

The high number of cross-memberships is commonly attributed to a severe shortage of qualified sharia scholars; however, it is not the availability but rather the ‘desirability’ of certain scholars which is driving this phenomenon. Although less experienced sharia scholars are mostly available, banks deliberately seek out well-known scholars for their reputation. Deals are made and products sold via the reputation of the scholars certifying them. The bigger the name, the greater the credibility it brings to the institution and its products. This naturally stretches the demand for certain scholars to be far greater than others, leading to multiple board memberships (Fitch, 2011; Davies and Sleiman, 2012).

Multiple memberships however, put unrealistic demands on the scholars’ time, affecting their ability to provide the quality of service (consultation, audit and scrutiny) which is required. Sharia boards are therefore commonly perceived to be mere rubberstamps. Interviews have revealed that the role of SSB in many cases is rather superficial, that the sharia audit process is perfunctory and that SSBs do simply grant rubberstamp approvals to the decisions taken by the banks’ management (Warde, 2010).

There are also more serious concerns relating to the reliability and independence of the scholars’ opinion and banks’ sincerity in attaining sharia compliance. Doubts exist over the sharia scholars’ ability to fully understand the products they certify. Sharia scholars are certainly knowledgeable in Islamic law, however many are not well-versed in finance and therefore may fail to fully understand the economic purpose of the product they’re certifying. The SSB’s judgement can therefore be based on the structure as opposed to the substance of the financial product. Knowing this, product managers who are incentivised to seek rapid approvals, do not always disclose all the necessary information. At other times, major financial institutions simply market products as

Nizam Mohammed Yacoubi, Dr Abu Guddah, and Dr Ali Elgari who prominently feature in GCC banks’ Sharia Supervisory Boards (Ünal, 2010a).
sharia-certified without actual approval. In a recent controversy, it was revealed that Goldman Sach’s base prospectus had publically named three scholars as advisors on the issuance of its $2bn sukuk, even though none of the named scholars had seen the prospectus, nor given their permission for the sukuk to be marketed as sharia-compliant (Davies and Sleiman, 2012). Such practices unsurprisingly create serious doubts over the legitimacy of products advertised as sharia-compliant.

The possibility of rent seeking by scholars combined with the potential lack of integrity on banks’ part makes the sharia certification process even more unreliable. With only 15-20 prominent scholars with ‘rock-star’ status, it is unsurprising that these scholars are well remunerated. In addition to their base pay ranging from $20,000-$50,000 a year, top scholars can earn $1000-$1500 per hour of consultation, annual bonuses of $10,000-$20,000 per board seat, and even six-figure sums (reportedly $150,000-$500,000) for each fatwa issued to certify large transactions in international institutions (Foster, 2009; Khan, 2010; Fitch, 2011; Davies and Sleiman, 2012).

These handsome remuneration packages however raise questions regarding the extent to which certain sharia scholars willingly offer “tailor-made fatwas” to sharia-certify dubious products and practices based “on the most tenuous religious grounds in exchange for money” (Warde, 2010, p.236). It has been suggested that, banks can get almost any financial product/transaction certified as sharia compliant by actively seeking and relying on the validations of accommodating scholars and tempting them with high payoffs (Khan, 2010). Interviews with industry insiders have revealed evidence of such practices, particularly in conventional financial institutions offering Islamic products. As Foster (2009) reports, conventional banks create the same type of financial product for the Islamic market as the conventional counterpart, and keep approaching different sharia scholars for a fatwa until one certifies it as sharia compliant. The product is then marketed as ‘Islamic’. Evidence of such practices has given rise to the ongoing controversial debate on ‘fatwas for sale’ (Warde, 2010).

75 The interview reported in Foster (2009) reads “as one investment banker based in Dubai, working for a major Western financial organisation explains: "We create the same type of products that we do for the conventional markets. We then phone up a Sharia scholar for a Fatwa [seal of approval, confirming the product is Shari'ah compliant]. "If he doesn't give it to us, we phone up another scholar, offer him a sum of money for his services and ask him for a Fatwa. We do this until we get Sharia compliance. Then we are free to distribute the product as Islamic."
In the ‘fatwa shopping’ process, variation in sharia interpretation plays a major role. As highlighted in chapter 2, sharia rules can be interpreted differently by different scholars, some being more lenient than others. The range of disagreements between scholars can lead to ‘fatwa wars’ which banks use to their benefit, by simply choosing the most lenient and ‘creative’ scholar willing to justify what suits the institution’s preferences (Warde, 2010; Foster, 2009).

Varying sharia interpretations and each bank having its own sharia board also make it difficult to arrive at a consensus on sharia-certified products and practices. This has created fragmentation in the Islamic banking industry as there are no uniform rules of sharia certification which apply to the industry as a whole (Tripp, 2006; Warde, 2010). The lack of transparency in how sharia scholars reach their conclusions in the sharia certification process complicates matters further. Rarely do sharia boards disclose their methodology and even then details are not publically published (Davies and Sleiman, 2012). Ultimately, the current controversial certification process not only has a financial but also a moral cost. Not only are the banks using their depositors, clients and shareholders’ funds (and the income generated from these) to make excessive payments to sharia scholars, but the religious validity of the products and service provided is also contentious and potentially incompliant with the religious values of their stakeholders (Warde, 2010).

These issues are well recognised in the industry and several steps have been taken to overcome them, although the effectiveness of such measures is questionable. To address the problem of fragmentation and avoid reliance on fatwas from lone scholars, there have been attempts to create national and even international sharia boards. Malaysia, for example has established a national sharia board. However, since sharia scholars in Southeast Asia tend to be more lenient in interpreting the sharia than the orthodox views held in the Middle East, several rulings passed by Malaysian scholars are not considered valid in the Arab Gulf. Thus, the same sharia-certified products are valid in one market but not in others (Foster, 2009; Warde, 2010). To achieve harmonisation across markets and develop common standards, attempts to benefit from transnational boards have also materialised, with the Islamic Fiqh Academy considered to be the most prestigious international sharia body, passing fatwas on Islamic banking issues. However, as no individual institution is bound by the resolutions/fatwas passed, these aren’t followed internationally. Furthermore, as the Islamic Fiqh Academy is
largely associated with Saudi Arabia, other countries with varying fiqh traditions tend to look towards their own fiqh academies (Warde, 2010). Such institutions therefore have not been very effective in overcoming the fragmentation and establishing standardisation of sharia certification in the industry.

Other initiatives have aimed specifically at increasing confidence in the sharia compliance of individual banks and their products, however these too cannot be considered successful. The Islamic International Rating Agency (IIRA) for example, aims to provide a Sharia Quality Rating, as a reference for the quality of compliance by banks and products marketed as ‘Islamic’. These ratings are designed to be used by financiers and investors in a similar manner to credit ratings (IIRA, 2006). However, not only do banks need to volunteer to be assessed on an annual basis but the results of the review are also not published publicly without the bank’s consent (ibid). It is reasonable to assume that banks with a poor rating will not consent to their rating being published publicly to prevent any negative impact on their reputation and therefore poor ratings are unlikely to appear in the public domain. Thus, a reliable and independent assessment of sharia compliance appears to be rather difficult to find from within the Islamic banking industry.

Finally, in response to the criticism that sharia boards are mere rubberstamps, Malaysia has banned scholars from serving on more than one bank’s sharia board at a time. In the Arab Gulf, however, multiple board memberships are virtually unregulated. Governments and regulatory bodies including AAOIFI and central banks in the Gulf have hesitated in making stricter rules in the industry including the issue of limiting board positions. Attempts at increased regulation have also seen strong resistance from some scholars. Without intervention from regulatory bodies and governments, the steps towards a single board membership and stricter regulation are unlikely to occur (Khan, 2010; Davies and Sleiman, 2012). Globally, the Islamic banking industry is years away from a standardised and transparent sharia certification process. Until then controversies on ‘fatwas-for-sale’, conflict of interest, rent seeking on part of both

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76 The IIRA website puts into question the success of the Sharia Quality Rating (SQR) initiative, as there is neither a list of banks rated nor their ratings. Evidence of only one Islamic bank (namely Jordan Islamic Bank) with a SQR could be found on the website [http://www.iirating.com](http://www.iirating.com) (Accessed 15.01.17). Furthermore, since its inception, the IIRA has developed a focus towards providing credit ratings through a risk assessment of Islamic financial institutions and their financial instruments as opposed to sharia compliance ratings.
banks and scholars continue to plague the industry and raise questions over the religious validity of the industry’s products and practices.

3.6 Understanding the Divergence between Theory and Practice

Islamic banking is riddled with controversies, as the previous section describes. The fundamental criticism of the industry however amounts to one key point: lack of PLS financing, which indicates its failure to develop in accordance with the central philosophy of risk-sharing (Warde, 2000). Given the emphasis on PLS financing in theoretical models, why has the industry turned away from it? This section provides an explanation by discussing first, the transaction costs associated with PLS financing and second, the impact of the institutional environment on these costs. The final two subsections consider the divergence between theory and practice more broadly. In the first of these, it is argued that the two-tier mudarabah model does not serve to fulfil the roles of a commercial bank and therefore divergence from the theoretical model was inevitable. In the final subsection, it is argued that the (European/conventional) commercial banking institution is inherently inconsistent with sharia principles and therefore any Islamic bank aiming to operate as a commercial bank would have deviated from Islamic principles. The more consistent alternative and recent proposed reforms for the industry are discussed, leading to recommendations for how Islamic banks can operate closer to sharia principles.

3.6.1 Transaction Costs: Rationale for the Lack of PLS Financing in Islamic Banks

The lack of PLS financing in Islamic banks can be appreciated through an understanding of the higher transaction costs involved in this mode of financing relative to the non-PLS modes which mimic the standard debt-contract. Building on Coase’s (1960) definition, Dahlman (1979) specifies three types of transaction costs which arise due to imperfect information. These are “search and information costs, bargaining and decision costs, [and] policing and enforcement costs” (p.148). Using Dahlman’s categorisation, the following discussion illustrates why PLS is considered to be the more expensive and therefore the less preferred choice for Islamic banks relative to non-PLS (debt) financing.
Consider first, the case of search and information costs. In order to provide PLS financing, Islamic banks must first seek out reliable investment partners with profitable projects. The ‘quality’ of the investment partner and the project to be financed however, cannot be fully verified ex-ante due to informational asymmetry (the entrepreneurs/managers seeking finance have better information about the risks of the project than Islamic banks). Islamic banks therefore face an adverse selection problem. The terms of PLS contracts exacerbate this issue. To maximise their gain, entrepreneurs seeking to finance projects with high expected profits are likely to opt for non-PLS financing, which leaves them as the residual claimant. Entrepreneurs seeking to finance projects with low expected profits, however, would be keen to finance on PLS terms to minimise their losses in case of failure (recall that losses are shared in a musharakah or borne solely by Islamic banks in a mudarabah arrangement) (Iqbal and Lewis, 2009). In a world of imperfect information with potentially dishonest agents, entrepreneurs with low-quality projects (i.e. with high probability of failure) have an incentive to misrepresent the quality of their proposed project through unrealistic and inflated expected profits. Islamic banks therefore need to expend resources to verify the quality claims. This involves not only checking the past credit history of the potential investment partners, but also the process of project evaluation including a profitability and feasibility analysis (Johnes et al., 2014). Such investigations inevitably raise costs compared to non-PLS financing, where a credit history check of the borrowing party suffices. Making the correct selection also requires that Islamic banks have sufficient information to judge between high and low quality investment partners and projects. However, given poor quality and quantity of informational flows, especially in developing countries where the majority of Islamic banks operate (El Hawary et al., 2007; Khan, 2010), the risks and costs associated with adverse selection are likely to be high. Thus, to economise on search and information costs, Islamic banks facing acute adverse selection problems, especially when competing directly with conventional banks, are likely to prefer non-PLS over PLS financing (Iqbal and Lewis, 2009).

77 Even if entrepreneurs with high quality projects are actively seeking PLS financing and Islamic banks are willing to provide such options, the presence of ‘dishonest’ entrepreneurs tends to drive ‘honest and potentially profitable’ entrepreneurs out the market. The cost of dishonesty therefore is not limited to search and information costs incurred by Islamic banks but also includes the loss incurred from driving genuine PLS financing out of existence (see Akerlof, 1970).
Next, consider the bargaining and decision costs which relate to the process of setting mutually agreeable contractual terms. PLS financing contracts are unstandardized. These client-specific contracts are designed to take into account the characteristics of the individual investment partners and the project under consideration. Accordingly, these contracts incur significant costs during the bargaining process as bank-client consultations are set up to determine contractual terms. Furthermore, to ensure compliance with sharia, all new contracts require approval from the banks’ SSB (Johnes et al., 2014). PLS contracts therefore also incur additional administration costs related to the sharia approval process. This makes PLS contracts costlier and more time-consuming compared to the non-PLS alternatives for which pre-approved standardised contracts exist (ibid).

Finally, policing and enforcement costs are incurred because Islamic banks cannot determine if entrepreneurs will violate the terms of the contract or misappropriate funds ex-post. If such information was available ex-ante, Islamic banks would select only trustworthy entrepreneurs or include stringent contractual terms to limit the scope of contract violation and misappropriation of funds (Dahlman, 1979). However, this is not possible due to informational asymmetry. The entrepreneur has more knowledge of his intentions, capabilities to manage the work and the likelihood of success or failure of the project, relative to the Islamic bank. Additionally, as PLS contracts are better suited to long term projects due to the time diversification effect of equity (Dar et al., 1999), inherent uncertainty regarding the future presents additional problems for writing complete contracts. At the outset, the contracting parties can neither anticipate all future contingencies nor identify suitable adaptations, and therefore are subject to bounded rationality (Simon, 1957, 1972). The best outcome achievable is an incomplete contract. Gaps in incomplete contracts, however, provide scope for opportunistic behaviour i.e. “self-interest seeking with guile” (Williamson, 1975, 1979, 1985) on part of the entrepreneur.

Islamic banks providing PLS financing are therefore exposed to large counterparty risk, especially in the case of mudarabah (El-Hawary et al., 2007) where Islamic banks and entrepreneurs form a principal/agent relationship78. The separation between ownership

78 The principal/agent framework can also be used to compare PLS and non-PLS financing. In a principal/agent relationship as in the case of mudarabah, agency problems arise specifically because
and control i.e. Islamic banks are the residual risk bearers whilst entrepreneurs are the decision-makers, gives rise to conflict of interest (Jensen and Meckling, 1976). Three features of the mudarabah contract extenuate this problem. Firstly, extreme linearity i.e. returns for each party are a linear function of the profits generated from the financed project and therefore are fully dependent on the entrepreneurs (agents) effort and skill level. Since effort levels are unobservable, all benefits of shirking are enjoyed solely by the entrepreneurs. Secondly, discretionary power i.e. entrepreneurs have full control over investment decisions and may prioritise self-interest by misappropriating funds for personal use and/or make sub-optimal investment decisions. The incentive to do this is extremely high when an entrepreneur has secured funding for a low quality project since the full financial loss is borne by the bank. Finally, idiosyncratic uncertainty (risk) i.e. Islamic banks returns are contingent on the entrepreneurs’ claimed profits which may be misreported (Khalil et al., 2002). The entrepreneurs have an incentive to underreport profits not only from the desire to keep a bigger share but also due to discriminatory tax treatments since profits are taxed but interest is exempted as a cost item. The impact of the tax regime can be considerable, as evident from the case of mudarabah companies in Pakistan, which grew considerably before the withdrawal of their tax-exempt status in 1992 (Dar et al., 1999). In developing countries where tax avoidance/evasion is a much more serious problem, Islamic banks face the problem of receiving a share of profit, calculated using the entrepreneurs’ official financial accounts which are created for tax purposes. Without access to the entrepreneur’s true accounts, concerns over potential losses due to dishonesty make non-PLS contracts more desirable (Kuran, 1995; Visser, 2009).

To minimise such agency problems, Islamic banks need to establish suitable incentives and expend resources to monitor the actions of entrepreneurs and enforce contract terms (Jensen and Meckling, 1976). While it is difficult to differentiate more from less contracts cannot be written or enforced costlessly (Fama and Jensen, 1983). The higher agency costs associated with PLS include monitoring costs incurred by the principal, bonding costs incurred by agent (entrepreneur) to signal compliance with contractual terms or to compensate the principal in case of contract violation, and residual loss, which refers to the welfare reduction faced by the principal as agent’s decision diverges from the decision which maximise the principal’s welfare (Jensen and Meckling, 1976). In this work, transaction costs framework is used as opposed to limiting the discussion to agency costs because, Islamic banks, strictly speaking, are in a partnership under a musharakah contract, not a principal/agent relationship. Under musharakah, Islamic banks can hold a management role, and have an impact on the decision making process, therefore the separation of ownership and control does not exist as it does in the mudarabah case.
opportunistic entrepreneurs ex-ante (Williamson, 1979), it is also difficult to design contract terms that minimise opportunistic behaviour. The source of moral hazard therefore lies in the inability of contracting parties to write a complete contract which preserves incentives (Marshall, 1976) and aligns the interest of the entrepreneur with that of the Islamic bank. Allocating a share of the profit to the entrepreneur is one inherent incentive in PLS financing contracts. However, it may not be sufficient in the case of mudarabah as the entrepreneur does not face financial loss or when an entrepreneur knowingly finances a low quality project. Banks may therefore need to set up in-person and on site monitoring systems to verify declared profits from PLS projects which increases costs relative to non-PLS financing (Visser, 2009). Furthermore, in the case of a disputed mudarabah contract, negligence of the entrepreneur needs to be proven, most likely through a lengthy and costly legal process, so that the burden of full loss does not fall solely on the Islamic bank. PLS financing therefore presents significant moral hazard problems and requires intensive monitoring, which inevitably increases costs (Kuran, 1995; Khalil et al., 2002; Visser, 2009).

To summarise, note that agency problems are particularly acute for PLS financing especially in the absence of control rights and state-contingent returns. Mitigating these problems increases costs. The presence of asymmetric information and costly state verification, makes non-PLS (debt) superior to PLS (equity) financing79 (Townsend, 1979; Williamson, 1987) with the preference for the former increasing as agency problems become more severe (Aggarwal and Yousef, 2000). Thus, the over-reliance on non-PLS financing exhibited by Islamic banks is simply a rational response to the informational asymmetry problems and the higher transaction costs associated with PLS financing (Dar et al., 1999; Aggarwal and Yousef, 2000; Kuran, 1995, 2004; El-Gamal, 2007; Visser, 2009; Khan, 2010).

3.6.2 A Broader Perspective on Transaction Costs: Importance of the Institutional Environment

Imperfect information and opportunism alone, although important, cannot be deemed sufficient to explain the lack of PLS financing in Islamic banks. Opportunism and imperfect information lead to moral hazard which creates agency problems. These problems cannot be entirely eliminated by the design of contract terms because opportunistic behaviour cannot be fully punished in the absence of control rights or state-contingent returns. This leaves the Islamic banks with the option of mitigating the agency problems at a cost. However, the cost of mitigation increases with the severity of the agency problems. The presence of asymmetric information and costly state verification makes non-PLS (debt) superior to PLS (equity) financing. The preference for debt financing increases as agency problems become severe. This rational response by Islamic banks to the informational asymmetry problems and the higher transaction costs associated with PLS financing is simply a response to the informational asymmetry problems and the higher transaction costs associated with PLS financing.

79 Although costly-state verification is argued to make “complete risk-sharing [i.e. PLS financing] suboptimal” (Townsend 1979, p.267), it must be appreciated however, that Townsend’s model fails to explain the existence of outside equity (ibid) and that the optimality of debt disappears if dynamic considerations and/or ex-post renegotiations are introduced in the model (Aghion and Bolton, 1992).
bounded rationality are innate characteristics of human nature and affect all complex financial transactions. These are neither new problems nor limited to PLS financing. Furthermore, Islamic economists have argued in favour of PLS financing precisely because of its the long established history in Islamic traditions, as is evident from detailed accounts in classical Islamic jurisprudence and religious texts (Kuran, 2005; Harris, 2009). Mudarabah and its variants were indeed the prevalent modes of financing in early Islamic societies (as highlighted earlier in section 3.2). These were used widely by merchants operating trading caravans throughout the Mediterranean region not only by Muslims in the Middle East but also Jews and Christians. Trading caravans constituted of two parties, the capital investor (principal) who provided goods to be sold, and the travelling party (agent), who travelled to other regions/countries for trade. Informational asymmetry and agency problems existed at the time as well, however these did not hinder the success and dominance of PLS modes (Udovitch, 1970 in Chapra, 2007).

So what can explain the prevalence of PLS modes in early Islamic societies? As Williamson (1985) notes, it is extremely important to locate transaction costs within the larger social context in which they are embedded as culture, customs and norms have a bearing on the size of transaction costs and therefore need to be accounted for. Financing of the trading caravans on a PLS basis was embedded in the early Islamic society as the norm. As Harris (2009) explains, mudarabah80 did not exist simply as a single financing contract but referred to a complex institution, a nexus of contracts which determined several relationships including agency, investment, risk and profit allocation between parties as well as the “creation of a separate pool of assets” (p.610). This also applied to musharakah which was recognised as a variant of the general mudarabah contract, where the travelling party also contributed capital. Several other variants of mudarabah also existed which formed a “complex multilateral system” including, bilateral mudarabah, where the travelling partner in an initial mudarabah became the investing partner in the second; multilateral mudarabah where several capital providers invested in a single mudarabah to benefit from economies of scale, and even the case of a single investor spreading his investments across several

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80 Harris (2009) uses the term commenda which is the European variant for the mudarabah.
travelling trade partners to lower his risk through diversification (see Harris, 2009, p.610-11 and references within).

Moreover, PLS financing did not operate in insolation. There existed a complex network of supportive institutions enabling PLS to work effectively. A strong independent legal system existed to enforce contract obligations, which provided efficient resolution of disputes through the mechanism of qadi (judge) offices supported by the religious scholars. The merchant code of conduct represented an additional independent third-party enforcement mechanism. Travelling partners were required to comply with the merchant code, violation of which was treated as a breach of the mudarabah arrangement. A strong network of learned jurists helped convert this general code of conduct into operating rules and regulation, specifying detailed rules for acceptable behaviour and judgements upon disputed cases. Furthermore, traders belonged to fraternities and guilds, which provided an informal credit rating system as well as an informal mechanism for contract enforcement. If any trader cheated, business relations with him were severed. Continual business provided scope for building up reputational capital, and encouraging more favourable terms of trade for the individual. A well-connected business community network created the environment where trust and cooperation was a recognised commercial practice (Udovitch, 1970 in Chapra, 2007; Harris, 2009).

High levels of trust and cooperation between the principal and agent reduces the need for monitoring, and therefore lowers transaction costs, while legal support reduces enforcement costs (Williamson, 1985). Additionally, as the rules and regulations surrounding the contracts were well-understood by society at large at the time, costs incurred in the contract creation (bargaining stage) were also reduced81. Thus, the existence of supportive institutions reduced transactions costs associated with adverse selection, contract creation, monitoring and enforcement of PLS arrangements.

In contrast, Islamic banks suffered from a lack of such supportive institutions in the early decades and this issue largely continues to the present-day in most Muslim countries (see Iqbal et al., 1998 and Chapra, 2007 for discussion on the institutional

81 A standard mudarabah template contract existed providing a number of default rules, as well as scope for adaptations to the individual needs of the contracting parties e.g. profit shares (Harris, 2009).
needs of Islamic banking). Institutions which meet the specific needs of Islamic banks such as sharia courts to resolve disputes or external credit rating agencies for banks’ investment partners were at the start of Islamic banking missing (Chapra, 2007). This is a direct consequence of historical events. Although the western colonial period lasted less than a century (Nasr, 1999), it left a lasting legacy by transporting the institutional framework of conventional interest-based banking to Muslim countries. Thus, the central banking system and the regulatory environment were designed in accordance with conventional banking needs. This broader operating environment was not altered (and still is only partially altered) to accommodate the emergence of Islamic banks, which at least theoretically, were aimed at using PLS financing modes (Chapra, 2007).

As El-Gamal (2006) notes, when Islamic banking emerged, its products had to be functionally the same as its conventional counterparts to ensure acceptance from regulators. For example, from a conventional supervisory perspective, banks are limited in the amount of risk they can accept on their financing and investment portfolio and that which they can pass onto their depositors (Kuran, 1995). Furthermore, by the time many of the industry-specific supportive institutions were developed in the early 2000s, the practice of form-over-substance had taken root along with the first mover advantage given to practitioners which shaped the methodology of developing sharia compliant financial products for future generations. For many, murabahah has been a well-known and accepted mode of Islamic finance for decades. This norm made it difficult for the entire industry to change course once supportive infrastructure institutions were established (El-Gamal, 2006).

Moreover, in most developing and emerging economies where Islamic banks operate, the level of institutional development generally is not as advanced as in the developed western world. Rapid urbanisation in Muslim countries has occurred “against the backdrop of inefficient legal systems” (Kuran, 1995, p.168). Property rights are poorly defined and protected, the risk of expropriation or intervention from governments is high, corruption is a significant feature of the economy and political stability is often challenged creating an environment of mistrust (Dar et al., 1999; Yousef, 2004; Khan, 2010). Weak legal systems not only make enforcement of contractual terms difficult but also expensive, raising the transaction costs associated with PLS financing.
As Harris (2009) notes, mudarabah was not a single contract that could be adopted in any environment, instead, to work it required a “supportive legal system” (p.616), which cannot be created by Islamic banks themselves. The government’s role in establishing supportive institutions is therefore paramount. Consequently, in recent years, several Muslim countries have moved towards adopting policies which encourage Islamic banking, including the elimination of discriminatory tax regimes which favour debt over equity (Kuran, 1995), and establishment of institutions to support the judicial system for Islamic finance, including Sharia courts, establishment of accounting and auditing standards (e.g. AAOIFI) to enable standardisation of reporting, as well as investment in education and training institutes for development of Islamic banking specific human capital (Iqbal and Molyneux, 2005; Baba, 2007; Iqbal, 2007).

Nevertheless, even where institutions specific to the needs of Islamic banking exist, their role in enabling PLS financing has largely been marginalised as one crucial point, the complementarity of institutions has been unexploited in most countries. Complementarity refers to the extent to which one institution “enhances the usefulness of another” (Kuran, 2009, p.601-2). Institutional complementarity is essential for reforms to have the desired impact (Kuran, 2009). Adoption or transplantation of a single institution in a country does not instantly equalise the enabling contribution that institution makes in another country where it is supported by a strong network of complementing institutions. For example, creation of the Federal Shariah Court in Pakistan has not been successful at imitating the impact of the qadi office in medieval Islamic civilisation for easing PLS transactions because of the weak legal system within which it is placed. The rulings of the Federal Shariah Court are not honoured nor supported by the government rendering its role ineffective in supporting the adoption of PLS by the Islamic banking industry (Iqbal and Molyneux, 2005).

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82 Recall, that the Federal Shariah Court of Pakistan gave a judgement in 1991 that murabahah as practiced by Islamic banks is not in compliance with the tenets of sharia. The Court ordered the government to correct such un-Islamic practices. However, rather than upholding the judgement of the Shariah court, the government filed an appeal against this judgement in the Supreme Court, which also supported the judgement of the Shariah Court. To date, as evident from the practices of Islamic banks in Pakistan, the judgement of the Federal Shariah Court has not been implemented (Iqbal and Molyneux, 2005).
Overall, the institutional environment in which Islamic banks emerged and operate was from the outset, designed for conventional commercial banking. This was not altered sufficiently or quickly enough to support PLS financing, which requires higher institutional support to minimise associated transaction costs. Islamic banks which adopt PLS financing in isolation from a supportive institutional framework stand to incur additional expenses relative to non-PLS (debt) financing and therefore understandably prefer the latter.

3.6.3 Two-tier Mudarabah is Not a Model of Commercial Banking

At a broader level, it must be appreciated that the divergence between theory and practice of Islamic banking was inevitable, quite simply because the two-tier mudarabah is not actually a model of commercial banking. With PLS assets and PLS liabilities, it is the polar opposite of the standard commercial bank which, by design, is an institution that intermediates on debt-basis. Debt liabilities (deposits, treated as loans to the bank) are converted into debt assets (credit i.e. interest-bearing loans). The two-tier mudarabah however, offers an alternative model of financial intermediation based on equity and depicts the structure of venture capital, private equity and mutual funds, which exist as successful institutions alongside, but not in competition with commercial banks in the conventional financial system (El-Gamal, 2007).

By emulating the multilateral mudarabah used by trading caravans in early Islamic societies, the two-tier mudarabah allows collection of savings to benefit from economies of scale on one side and investments across several businesses offering lower risk through diversification on the other. Trading caravans however, operated as an information-sharing ‘coalition of borrowers’ (see Leland and Pyle, 1977; Diamond, 1984; Ramakrishnan and Thakor, 1984; Boyd and Prescott, 1986) overcoming problems of informational asymmetry through a network of fraternity and guild memberships, which provided an informal credit rating system as well as a mechanism for contract enforcement (Udovitch, 1970; Chapra, 2007; Harris, 2009). These did not fulfil the roles of commercial banks.

Commercial banks fulfil several important roles in the economy. By specialising as intermediaries, these banks minimise on transaction costs arising from asymmetric information which would otherwise be faced by individual investors in the market. Banks also act as a signalling medium by providing credit ratings for borrowers and
reflect the quality of their creditworthiness to others in the market through the premium charged on loans. This facilitates efficient allocation of capital. Furthermore, banks lower the costs of transactions (payments and withdrawal of cash), act as providers of liquidity for depositors, and transform savings with high liquidity demand into long term illiquid investments (see Diamond and Dybvig, 1983; Diamond, 1984; Ramakrishan and Thakor, 1984; Bhattacharya et al., 1998; Gangopadhyay and Singh, 2000; see Bhattacharya and Thakor, 1993 for a survey of banking theories).

To abide by the two-tier mudarabah model, Islamic banks need to operate as investment intermediaries, which limit their scope in fulfilling the roles of commercial banks. On the liability side, the role of liquidity provider is especially challenging (Ahmed, 2002). Islamic banks cannot meet the liquidity demand of their depositors when deposits operating on a PLS basis are invested in long-term projects and therefore cannot be readily withdrawn. Furthermore, neither the capital sum nor the return paid on these PLS deposits can be guaranteed as that amounts to riba. Essentially, the PLS deposits (held in investment accounts) are similar to equity capital and carry loss absorbing capacity. Investment account holders are therefore quasi-shareholders (Khan, 1986; Lewis, 2001). Such deposit facilities however do not match the risk preferences of all depositors (Kuran, 1995), especially those seeking safekeeping, liquidity and transaction e.g. payment services (current accounts), and therefore limits the type of depositors willing to place funds with Islamic banks operating on a two-tier mudarabah basis. On the asset side, PLS not only introduces a mismatch in the risk profile of a commercial bank’s asset/liability structure when depositors’ liquidity preferences are taken into consideration (Ahmed, 2002) but also presents higher transaction costs than the standard debt contract, as explained above.

Note that, transaction costs are economised when transactions which differ in their attributes are assigned to governance structures in a discriminating way, thus the “organization form matters” (Williamson, 1985, p.18). In the context of Islamic banking, differences in attributes of PLS and debt financing need to be identified and matched to governance structures which minimise costs associated with these

83 Deposits on mudarabah basis can only be withdrawn at a cost with prior notice (Ahmed, 2002).
84 The firm is seen as a governance structure from the perspective of transaction cost economics (Williamson, 1985).
transactions. Of the three attributes identified by Williamson (1979)\textsuperscript{85}, uncertainty and transaction-specific-investment (i.e. ease of verification) differs significantly between PLS and debt financing. Governance structures, such as the conventional commercial bank, which are designed to economise on transaction costs arising from debt-financing are not the same nor can simultaneously economise on costs arising from PLS arrangements\textsuperscript{86}. Thus, alternative organisation forms are required for PLS-based intermediation. This key point seems to have been overlooked by Islamic economists who, during the twentieth century, attempted to Islamicize the financial system by imposing PLS mechanisms over the pre-existing conventional commercial banking model.

Given the incompatibility, a choice had to be made between the two-tier mudarabah model using PLS and fulfilling the roles of a commercial bank. As explained earlier (in sections 3.3 and 3.4), the aim for modern Islamic banks, from the outset, was to be a substitute for conventional commercial banks. Fulfilling the abovementioned roles was therefore part of these institutions’ objectives. Of course, these couldn’t be achieved through PLS mechanisms and the industry moved towards replication of conventional banking products through sharia arbitrage. Thus, the pursuit to replace conventional commercial banks inevitably led to the divergence between the theoretical model and practice of Islamic banking.

Essentially, the evolution of Islamic banks reflects the conclusions drawn by Williamson (1979) that “the efficient organization of economic activity entails matching governance structures with these [above-mentioned] transaction attributes in a discriminating way” (p. 261). The Islamic banking industry has acted according to this but in reverse. During the transition from theoretical models to practical reality, Islamic banks moved away from PLS towards non-PLS contracts to match the transaction type (debt financing) to a pre-selected governance structure (i.e. commercial bank), which was adopted from the conventional banking system as it pre-existed in Muslim societies and was supported by the broader operating environment in which

\textsuperscript{85} The three transaction attributes identified by Williamson (1979) are uncertainty, frequency of recurrence and investment idiosyncrasy i.e. transaction-specific-investment, which in case of financial markets refers to the ease of verification.

\textsuperscript{86} El-Gamal (2007, p.311) also notes that as most Islamic bankers are ex-conventional bankers, who are trained toward credit risk analysis, but not monitoring of customer behaviour, that the industry adopted debt instruments to capitalise on their skills.
they emerged. It is unsurprisingly then that the financial instruments which Islamic banks have turned to are similar to the standard-debt-contract.

3.6.4 No Islamic Commercial Bank can be Fully Consistent with the Sharia

Why was an incompatible model proposed for Islamic commercial banking? There are potentially two reasons. The first relates to Kuran’s observation that the Islamic economics doctrine arising in postcolonial era lacked scientific rigour (Kuran, 1996). Perhaps, the incompatibility between the two-tier mudarabah model and the roles of a commercial bank was not scrutinised sufficiently and thus Islamic economists of the time naively believed imposing PLS mechanisms to replace interest would not only Islamicize the commercial banking institution but also provide a viable alternative to the conventional counterpart. Certainly, as the two-tier mudarabah does not adequately address issues of current account deposits and consumption loans, the argument that there were gaps in understanding the role of commercial banks seems plausible.

The second, more critical argument, this thesis propagates is that any proposed model would have been incompatible, simply because the (European/conventional) commercial banking institution is inherently inconsistent with sharia principles. As financial intermediaries, Islamic banks need to fulfil two key roles in the economy; intermediate between investors (savers/lenders) and capital seekers (borrowers) and provide transactional and depository services (liquidity). To be in accordance with the sharia, the first role needs to be on PLS basis and the second on a safekeeping (100% reserve) basis. Clearly, both these roles cannot be simultaneously fulfilled using the commercial banking structure which by definition, operates on a fractional reserve basis where funds collected as risk-free deposits are converted into credit. Therefore, Islamic banks which were developed in the 1970s specifically to emulate conventional commercial banks would have necessarily deviated from the Islamic financial principles and therefore any model based on such principles. As Islamic banks continue to operate according to the same structure, it is clear that no present-day Islamic commercial bank can be fully compliant with the sharia.

How can Islamically-acceptable banking services be provided? Close study of the sharia principles particularly risk-sharing (PLS financing) and safekeeping (deposits as trust), call for the separation of investment (intermediation) and commercial
(transactional) banking operations. The two-tier mudarabah model provides a PLS-based solution for the intermediation problem. To provide transactional and deposit banking services however, Islamic banks need to operate as ‘narrow’ banks, which accept deposits only for transactional purposes and maintain 100% reserve, earning a return through offering a range of fee-based services (Nienhaus, 2013). This view contradicts the vision of Islamic banks as a crossbreed of investment and commercial banks promoted by some Islamic economists (Mohsin, 1982; Chapra, 1985). Nevertheless, this idea has support in both history and literature.

Historically, financial services were provided through two separate institutions in the Islamic world. As explained earlier, the European-style commercial bank could not develop in medieval Islamic societies partially because of the Islamic financial principles. There was a clear disconnection between deposit and credit functions, as the former were held on safekeeping basis while investments occurred solely on PLS basis (Udovitch, 1975). The famous precursors to Islamic banking, known for embodying the true spirit of sharia also support the separation idea. NBFIs which operated as mutual credit unions on interest-free basis (e.g. Mit Ghamr) or as saving and investment vehicle operating on PLS basis (Tabung Haji), did not provide commercial banking services (Warde, 2010; Haniffa and Hudaib, 2010).

Some of the earliest Islamic banking literature called for separation between current and investment account deposits, with a 100% reserve requirement imposed on the former (Al-Jarhi, 1983). Others more recently have also suggested that PLS financing, (mutual fund model) should be used for investments and kept separate from deposit banking activities (Zaman and Movassaghi, 2002; El-Gamal, 2007). Mutuality in credit unions is also propagated as it complies not only with religious principles including riba but also secular regulations, specifically designed for such institutions (El-Gamal, 2007). Application of these proposals will take the Islamic financial industry closer to its predecessors which arguably did not suffer from the industry’s current controversies.

To eliminate controversial practices, Nienhaus (2013) argues that separating investment and commercial banking operations and adopting narrow banking principles should be taken as a reform policy for the industry. He argues that through this reform, three problems of Islamic banking can be resolved. First, current accounts will no longer operate on fractional reserve basis and be consistent with the safekeeping principle
under narrow banking. Second, with investment operations separated under a PLS-intermediation model, investment account holders (IAH) will no longer suffer from a ‘deposit illusion’ and thus operate on genuine PLS terms. Finally, under a PLS-intermediation model, the dominance of controversial non-PLS modes will end. Furthermore, he argues that such a separated system will reduce risk of maturity mismatches, make Islamic (narrow) banks safer, and enhance transparency allowing IAH to make informed choices over their preferred risk/return investment packages, whilst diminishing the need for deposit insurance and capital requirements. Indeed, there has been much support to suggest that a narrow banking system leads to systematically stable banking sector by eliminating the threat of bank runs and offers greater macro-financial stability (see e.g. Chiarella et al., 2012). The culture difference between investment banking (risk-taking) and commercial banking (risk-averse) also makes the argument for separation. Mixing the two cultures has clearly not been successful as the 2007–08 financial crisis illustrated (Abdul-Rahman, 2014). A survey of the extensive literature which evaluates the merits of separation and particularly narrow banking is beyond the scope of this thesis. It is interesting to note however, that these suggestions are neither new concepts nor proposals aimed specifically at Islamic banking.

There is a long history of narrow banking reform proposals in the conventional economics literature, with notable contributions made in the 1930s. The ‘Chicago Plan’ (1933) advanced by a group of leading US economists87, proposed separation of the credit and monetary function of the banking system, requiring 100% reserves for deposits. Irving Fisher, a supporter of the plan, is widely known for his work on the concept of ‘100% Money’ (see e.g. Fisher, 1935). Furthermore, commercial and investment banking operations were separated by the 1933 Glass Steagall Act. These emerged as a response to the 1929 Great Depression in the US and unsurprisingly regained interest in the post 2007–08 financial crisis debate on banking reform. As with

87 The Chicago Plan is a collection of banking reforms which were proposed in the aftermath of the 1929 Great Depression in the USA. The idea underpinning the Chicago plan was first formulated by Frederick Soddy in 1926. It was picked up by Frank Knight, professor at the University of Chicago, who authored the first version of the Plan in March 1933. The Plan received considerable support from his colleagues including Paul Douglas and especially Henry Simons, who authored the second version in November 1933. As it was proposed and supported by University of Chicago professors, the reform proposals became known as the ‘Chicago Plan’. Although many different versions of the Chicago plan were circulated during the 1930s, all were unanimous on 100% deposit reserves (for detailed discussion see, Benes and Kumhof, 2012).
the 1930s experience however, the proposals for narrow banking although acknowledged, did not materialise.

The Turner Review (2009) undertaken by the FSA in the aftermath of the 2007–08 financial crisis in the UK, for example, acknowledged the debate on narrow vs. investment banking and concluded that a complete and formal legal distinction is not feasible. It supported greater constraint on banks’ risk-taking activities rather than a complete disintegration. The central recommendation made by the Vickers Commission (2011), which has been translated into law through the 2013 Financial Services (Banking Reform) Act, also calls for changes within the existing system by introducing a ring-fence to protect UK banks deposit-taking and retail businesses in separate, financially independent legal entities from the riskier investment banking activities (ICB, 2011). Similarly, the Volcker Rule, part of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act in the US, has called for restrictions on banks’ investment activities by limiting speculative trading, eliminating short-term proprietary trading, and banks’ involvement in private equity and hedge funds. Inspired by the Glass Steagall Act, the Volcker Rule is the modern attempt to effectively separate the commercial and investment functions of the bank without a full disintegration. The delay in implementation of the Volcker Rule which has already been criticised for being watered down from its original tougher stance with added exemptions, possible loopholes, further proposed changes and continued pressure from industry lobbyists pushing to roll back the Rule itself, however speaks volume about attitudes to stricter regulation in the banking industry (BBC News, 2014; Reuters, 2016, 2017). The conventional banking industry has illustrated clearly, that despite facing one of the greatest financial crisis since the Great Depression, the ‘too big to fail’ banks are also too strong to impose greater regulation on. The banking industry is extremely

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88 Ring-fencing was the core recommendation made by the Independent Commission on Banking (ICB), also known as the Vickers Commission (named after the commission chair Sir John Vickers) in the post financial crisis review in the UK. It requires UK banks to separate their deposit and lending functions from their investment banking functions. The final Vickers report was published in September 2011 and its ring-fencing recommendation has been introduced in law through the 2013 Financial Services (Banking Reform) Act. This will become effective from 1 January 2019. For details, see ICB (2011) and http://www.legislation.gov.uk/ukpga/2013/33/contents/enacted.

89 The Volcker Rule was initially proposed to take effect in 2012. The Rule however was only approved in 2013, went into effect in April 2014 with compliance required by July 2015 until the Federal Reserve extended the compliance deadline to July 2017 for some parts, only to receive a further five-year extension application by major banks, extending the potential compliance period to 2022 (BBC News, 2014; Reuters, 2016).
resistant to reforms and thus a move towards complete separation and particularly narrow banking is unrealistic.

Are the proposed reforms likely to happen in Islamic banking? The simple answer is, No. Structural changes of this significance require not only strong political will but also cooperation from the industry, neither of which are likely. For Muslim governments, supporting Islamic banking has been a low-risk, low-cost, publically popular policy to pacify the resurgence of religious sentiment in their societies. Any attempt to halt the industry’s progress is likely to be politically unpopular. The Islamic banking industry, similar to its conventional counterpart, is also highly resistant to reforms as the case for greater SSB regulation discussed earlier shows. The industry has from the outset given preference to secular goals over religious values. Therefore, support for such major changes, which can possibly cause reputational damage by exposing to the masses the industry’s lack of religious legitimacy, is highly improbable. The industry has also made significant efforts in recent years to converge with conventional finance and integrate in global markets and therefore is likely to follow the regulatory precedents set. There are also huge costs involved in the proposed reforms. Amongst others, one of the most obvious in a narrow banking system is the loss of current account deposits as a source of cheap funding. Current accounts in Islamic banks earn no return and therefore all profits earned from their use currently accrue to Islamic banks. Losing this privilege under a narrow banking system is hardly appealing. Finally, given the interconnected nature of financial markets, Muslim countries are unlikely to follow narrow banking principles in a global fractional reserve banking system. Therefore, while the proposal to fully separate investment and commercial banking operations is rather idealistic and unlikely to happen anytime soon, the adoption of narrow banking principles is out of the question.

Compliance with the sharia principle of safekeeping for deposits is unachievable in the current banking environment, therefore the only tenable option for Islamic banks to improve religious adherence is to focus on the PLS principle. By following the ring-fencing regime and setting up a pure-PLS window within the existing Islamic bank’s structure, PLS financing can be made a viable option. Through this, the two-tier mudarabah model can materialise without the issue of mismatched risk and maturity profiles currently faced under the commercial bank’s asset/liability structure. To be
strengthened, this policy proposal requires empirical support and therefore further investigation into PLS financing behaviour of current Islamic banks needs to be undertaken.

3.7 Conclusion

Contemporary Islamic banking emerged as the outcome of post-colonial socio-political and economic developments which took place in Muslims countries during the mid-twentieth century. After the initial conceptual struggles, the two tier-mudarabah structure, which propagated intermediation on PLS basis, emerged as the theoretical model for Islamic banking. Pan-Islamism and the 1970s oil boom provided the political and financial impetus transforming Islamic banking from a conceptual idea to reality.

Development of the industry however took a path considerably different from that envisioned by Islamic economists. As soon as the first Islamic banks were established, modifications were made to the theoretical model and non-PLS instruments were introduced. The development and sharia certification of murabahah was a defining moment for the industry. It not only allowed Islamic banks to compete with conventional counterparts by mimicking the interest-bearing loan contract, but also started the culture of developing Islamic banking products on the basis of compliance with the letter rather than the spirit of sharia law. The instant popularity of murabahah led to development of other non-PLS financial instruments which have ever since dominated the industry.

Non-PLS instruments are however severely criticised as legal ruses i.e. structuring strategies which are designed specifically to circumvent rather than comply, in any meaningful way, with the sharia injunctions. In addition to murabahah, the highly popular but equally controversial Islamic banking instruments including ijarah, commodity murabahah, tawarruq and sukuk have all been analysed and shown to be no more than de facto interest-bearing instruments, which rely on differences in contractual forms and Arabic labels to establish an Islamic identity (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal, 2006; Zaman, 2008; El-Diwany, 2010; Khan, 2010; Khan, 2010a). Despite the criticism, the form-over-substance approach to defining and designing sharia-compliant products has become the accepted norm of the industry (El-Gamal, 2006; Iqbal and Lewis, 2009).
Why did the industry take such a developmental path? As this chapter explained, the divergence between PLS-oriented theory and non-PLS-oriented practices of Islamic banking has both practical and more fundamental roots. From a practical perspective, the lack of PLS financing is understandably a rational response to the higher transaction costs associated with this mode of financing relative to the non-PLS (debt) alternative. Furthermore, the institutional environment in which Islamic banks emerged and continue to operate, was from the outset, designed for conventional commercial banking and thus is geared towards supporting debt over PLS (equity) financing. As discussed earlier, PLS financing requires the existence of supportive institutions which reduce transactions costs associated with adverse selection, contract creation, monitoring and enforcement of PLS arrangements. In the absence of such a supportive institutional framework, by adopting PLS financing, Islamic banks stand to incur additional expenses and therefore naturally prefer the non-PLS alternative.

At a more fundamental level, however, the divergence between theory and practice of Islamic banking was inevitable, quite simply because the two-tier mudarabah is not a model of commercial banking. Contrary to the debt-assets/debt-liabilities structure of a commercial bank, the two-tier mudarabah propagates PLS-assets/PLS-liabilities. It therefore depicts the structure of venture capital, private equity and mutual funds; institutions which exist alongside, but not in competition with commercial banks.

Even more crucial is the inherent inconsistency between the principles of commercial banking and those of Islamic finance. As shown in this chapter, the foundation on which commercial banking operates, fractional reserve and intermediation by converting risk-free deposits into credit, are the polar opposites of the principles underpinning Islamic finance, which requires 100% reserve for risk-free deposits and intermediation on PLS basis. Thus, no Islamic bank operating on a commercial banking basis can simultaneously comply fully with the sharia. Indeed as argued above, sharia principles, specifically risk-sharing and safekeeping, call for the separation between investment (intermediation) and commercial (transactional) banking operations.

Historical evidence supports this view, as financial institutions which developed in medieval Islamic societies operated with a clear disconnection between the deposit and credit function. Even the famous precursors to Islamic banking which were known to have embodied the spirit of sharia were non-banking financial institutions. Mit Ghamr
operated as a mutual credit union and Tabung Haji as an investment and savings vehicle, neither operated as commercial banks. Nevertheless, the case for separation, although can be proven on principle-basis, is unlikely to materialise. Adoption of narrow banking principles is highly unrealistic to even be considered any time soon and given the precedent set by the conventional banking industry, a full separation of investment and commercial banking operations is also rather unlikely.

As suggested earlier, the only policy proposal which can be realistically offered to the industry is the establishment of pure-PLS windows within the existing Islamic banks’ structure. Using the ring-fencing regime, this window operation can be legally and financially separate from the rest of the bank’s operations. As the two-tier mudarabah model materialises in this shape, without the issue of mismatched risk and maturity profiles currently faced under the commercial bank’s asset/liability structure, the provision of PLS financing can increase, bringing Islamic banking activities somewhat closer to the sharia principles. Future research should therefore consider investigating whether this proposal is empirically supported.

Finally, this chapter’s conclusion, that no present-day Islamic commercial bank can be fully compliant with the sharia, leads to an interesting question. If no Islamic bank can be fully Islamic, can some be considered more Islamic than others? As mentioned above, by operating as commercial banks, all Islamic banks work on a fractional reserve basis and therefore fail to comply with the 100% deposit (safekeeping) principle. The case of the PLS principle however is different. Although low, PLS is not completely absent in the Islamic banking industry. Differences in PLS levels may therefore enable differentiation between banks which are operating closer to the sharia principles, than those relying solely or predominantly on non-PLS alternatives. If such a difference exists within the industry, it will invalidate a key assumption made in the current literature. Due to the overwhelming dominance of non-PLS instruments, critics have dismissed the entire Islamic banking industry as nothing more than a branding exercise, an industry that is simply “indistinguishable” from its conventional counterpart (Kuran, 2004; El-Gamal, 2006; Khan, 2010, p.817). Such a conclusion however implicitly assumes that the Islamic banking industry comprises a homogenous group of banks, all with negligibly low levels of PLS, making them equally un-Islamic. This may not hold true. The next chapter investigates this interesting prospect.
Chapter 4

Distinguishing between the Indistinguishable: Are All Islamic Banks Equally Islamic?

4.1 Introduction
Profit-and-Loss-Sharing (PLS) is the *raison d’être* of Islamic banking (Chapra, 2007). The lack of PLS financing has therefore understandably raised serious cause for concern and criticism of the industry. Due to the overwhelming dominance of non-PLS instruments, critics have dismissed the entire Islamic banking industry as nothing more than a branding exercise, an industry that is simply “indistinguishable” from its conventional counterpart (see e.g. Kuran, 1993, 2004; El-Gamal, 2006; Khan, 2010). Such a conclusion however implicitly assumes that all Islamic banks have negligible levels of PLS and thus are equally un-Islamic. The extent of variation in PLS levels across different Islamic banks and the potential reasons for such differences however have not been investigated in the literature thus far. Are some Islamic banks operating closer to the PLS principle than others? If so, what factors enable some banks to undertake greater levels of PLS financing despite the higher transaction costs involved? The purpose of this chapter is to answer these questions.

To achieve this aim, this chapter uses two measures of PLS to assess and compare PLS levels between Islamic banks, conventional banks with and without Islamic windows. The first one measures the percentage of PLS financing in a bank’s financing portfolio and thus focuses on the types of financing contracts (PLS or debt) employed by banks. The second measure examines the percentage of PLS assets in banks’ total financing and investment portfolio and thus examines the types of major earning assets (i.e. PLS or debt) that banks predominantly employ. Although the use of two PLS measures has eluded prior literature, as this chapter will explain, this approach provides a holistic comparison of Islamic and conventional banks. The first measure allows one to investigate if Islamic banks provide a genuine PLS alternative to the interest-bearing loan and thus evaluate if the criticism that Islamic banks are indistinguishable from their conventional counterparts validly applies to all Islamic banks. The second measure
takes into account a banks’ involvement in both PLS financing and investment assets and therefore offers an all-encompassing approach to investigating if some banks are operating closer to the PLS principle than others.

By using these two measures, this chapter examines if Islamic banking industry does indeed comprise a homogeneous group of banks that are indistinguishable from their conventional counterparts. First a cross-sectional comparison is undertaken between banks, using PLS levels for the latest year in the sample (2012). Cluster analysis is then applied to the pooled PLS dataset, covering the 2009-2012 period to validate results from the cross-sectional analysis. Finally, the random effects estimator, using Mundlak (1978)’s approach is used to investigate factors explaining why some banks undertake greater levels of PLS financing than others.

Previous studies on Islamic banking have considered several reasons for the lack of PLS financing by Islamic banks. Informational asymmetry problems are most often cited as the key reasons (Dar et al., 1999; Aggarwal and Yousef, 2000; Kuran, 1995, 2004; El-Gamal, 2007; Visser, 2009; Khan, 2010). In the presence of informational asymmetry and costly state verification, debt is superior to equity financing (Townsend, 1979; Williamson, 1987); with preference for the former increasing as agency problems become more severe (Aggarwal and Yousef, 2000). Opportunistic behaviour i.e. “self-interest seeking with guile” (Williamson, 1975, 1979, 1985) and bounded rationality (Simon, 1957, 1972) however, are innate characteristics of human nature that affect all complex financial transactions especially those conducted over time. If considerable variation in PLS financing levels does exist across banks, what factors can explain it? This question is examined in the final part of this chapter.

The remainder of this chapter is structured as follows. Section 4.2 presents an in-depth analysis of a generalised Islamic bank’s balance sheet which demonstrates the single asset type that differentiates Islamic banks from their conventional counterparts in practice. Section 4.3 presents the data and method, discussing the two PLS measures used in this study followed by results of cross-sectional comparison between Islamic and conventional banks’ PLS levels presented in section 4.4. This section concludes by identifying a typology of Islamic banks, suggesting that three distinct groups of Islamic banks exist. Section 4.5 expands this analysis by applying cluster analysis to pooled PLS data for 2009-2012 period to validate the typology identified in section 4.4 and
investigate if group membership is stable over time. Section 4.6 then examines the potential determinants of PLS financing and finally section 4.7 concludes the chapter, with a discussion of its limitations and implications for further research.

4.2 What Distinguishes Islamic from Conventional Banks in Practice? A Balance Sheet Analysis

4.2.1 Assets

Line 1: Cash and Balances with Central Banks: This includes statutory reserves, current accounts and deposits placed on commodity murabahah and/or tawarruq basis. Funds placed as statutory reserves and in current accounts earn no return and form only a small part of this asset category. Deposits placed on commodity murabahah or tawarruq earn a return. Commodity murabahah involves short-term notional commodity exchanges which replicate the returns on short-term treasury bills. Tawarruq involves a multiple party spot-purchase and credit-then-spot-sale arrangement which is designed to meet short-term cash financing needs and therefore is used for liquidity management. In both cases, fictitious sales conceal interest-bearing transactions (Obaidullah, 2005; El Gamal, 2006; Shanmugam and Zahari, 2009; Khan, 2010a; Rehman, 2010).

Line 2: Due from Banks & Financial Institutions: This includes short-term deposits placed with other banks and/or financial institutions that are invested on commodity murabahah and/or tawarruq basis. These replicate interest-bearing conventional counterparts (ibid). Some banks also hold current accounts in other banks. Funds placed in current accounts earn no return and form only a small part of this asset category.
## Figure 4.1: Generalised Balance Sheet of Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>Islamic Bank</th>
<th>Conventional Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>1 Cash and Balances with Central Banks</td>
<td>Cash and Balances with Central Banks</td>
</tr>
<tr>
<td>2 Due from Banks &amp; Financial Institutions</td>
<td>Due from Banks &amp; Financial Institutions</td>
</tr>
<tr>
<td>3 Islamic Financing: (includes)</td>
<td></td>
</tr>
<tr>
<td>3a - Non-PLS (Debt) Financing</td>
<td>Loans and advances</td>
</tr>
<tr>
<td>3b - PLS Financing</td>
<td></td>
</tr>
<tr>
<td>4 Investments in:</td>
<td></td>
</tr>
<tr>
<td>4a - Debt Securities (including sukuk)</td>
<td>- Debt Securities</td>
</tr>
<tr>
<td>4b - Equity Securities</td>
<td>- Equity Securities</td>
</tr>
<tr>
<td>4c - Associates and Joint Ventures</td>
<td>- Associates and Joint Ventures</td>
</tr>
<tr>
<td>4d - Properties</td>
<td>- Properties</td>
</tr>
<tr>
<td>5 Property and Equipment</td>
<td>Property and Equipment</td>
</tr>
<tr>
<td>6 Other assets</td>
<td>Other assets</td>
</tr>
<tr>
<td><strong>Liabilities and Equity</strong></td>
<td></td>
</tr>
<tr>
<td>7 Due to Banks &amp; Financial Institutions</td>
<td>Due to Banks &amp; Financial Institutions</td>
</tr>
<tr>
<td>8 Customer Deposits: (includes)</td>
<td>Customer Deposits</td>
</tr>
<tr>
<td>8a - Current Accounts</td>
<td></td>
</tr>
<tr>
<td>8b - Investment Accounts</td>
<td></td>
</tr>
<tr>
<td>9 Borrowings (sukuk financing)</td>
<td>Borrowings</td>
</tr>
<tr>
<td>10 Other liabilities</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>11 Equity: (includes)</td>
<td>Equity: (includes)</td>
</tr>
<tr>
<td>- Share capital</td>
<td>- Share capital</td>
</tr>
<tr>
<td>- Reserves</td>
<td>- Reserves</td>
</tr>
<tr>
<td>- Retained Earnings</td>
<td>- Retained Earnings</td>
</tr>
</tbody>
</table>

**Colour Key:**

- Controversial Islamic banking assets and liabilities: fail to comply with PLS, ownership risk or full reserve requirement.
- Ideal Islamic financing and investment assets: comply with PLS or ownership risk requirement.
Line 3: **Islamic Financing**: This includes the non-PLS (debt) and PLS (equity) financing contracts. These are defined below.

Line 3a: **Non-PLS (Debt) Financing**: The primary non-PLS financing modes used by Islamic banks are murabahah and ijarah. Murabahah is a cost-plus-credit-sale contract where an asset is sold at a cost-plus-mark-up price with deferred payment, usually scheduled as regular instalments, made over a specified period of time. Ijarah is a lease contract where Islamic banks purchase and lease assets to receive a regular rental income for a specified term, at the end of which the asset’s legal title transfers to the lessee. Other less frequently used contracts include salam (prepayment sale) and istisna (sale order for manufactured asset). Extremely similar to murabahah, but less commonly used arrangements also include musawamah (sale with no mark-up disclosed), and bai-al-muajjal (credit sale). Although structured as sale/lease contracts, these financing modes replicate the conventional interest-bearing loan (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal 2006; Zaman 2008; El-Diwany, 2010; Khan 2010).

Line 3b: **PLS financing**: This comprises of musharakah (equity partnership) and mudarabah (silent partnership) contracts. These are considered the “ideal instruments of Islamic financing” as they are based on PLS terms and thus meet not only the letter but also the spirit of sharia (Usmani, 2004, p.12). Under these contracts, Islamic banks finance an enterprise or a particular project as an equity partner. Profits arising from these arrangements are shared according to a predetermined ratio whilst losses under musharakah are shared according to the capital contribution ratio and under mudarabah fall solely on the capital provider (i.e. Islamic bank) unless caused by the financed firm’s negligence (Warde, 2000; Usmani, 2004; Ayub, 2007; Shanmugam and Zahari, 2009; Visser, 2009; El-Diwany, 2010). A counterpart of this does not exist in conventional commercial banks.\(^{90}\)

Line 4: **Investments**: These include debt and equity investments as detailed below. The investment portfolio of Islamic and conventional banks comprises of similar assets and is materially indistinguishable.

\(^{90}\) An equivalent can be identified in conventional universal banks which also hold an equity stake in firms they finance. The exact nature of their contractual terms however differs from Islamic PLS financing contracts e.g. a counterpart to the mudarabah arrangement, where losses fall solely on the bank (capital provider), does not exist even in universal banks (Warde, 2000; Iqbal and Lewis, 2009).
Line 4a: **Debt securities:** This comprises of sukuk (Islamic bonds) and other fixed-return debt securities which are not explicitly declared as sharia-compliant. The latter are essentially interest-bearing conventional debt securities that Islamic banks hold to achieve a diversified investment portfolio. Sukuk, designed as asset-backed securities, are structurally different but in substance the same as conventional interest-bearing bonds. These have a similar risk/return characteristic as their conventional counterparts, to the extent that even the rate of return on sukuk is benchmarked to the interest rate paid on conventional bonds with similar credit ratings (Iqbal and Tsubota, 2006; El-Gamal, 2006; Ayub, 2007; Zaman, 2008; El-Diwany, 2010; Khan, 2010). The debt securities portfolio of Islamic and conventional banks is materially the same, especially as many conventional banks in the GCC also hold sukuk issued by governments.

Line 4b, c, and d: **Investments in: equity securities, associates, joint ventures and properties:** The first three financial assets listed in this category operate on a PLS basis, as the bank shares the risk of the businesses invested in and faces the possibility of making a real profit or loss. The final one, properties, refers to investments in real estate which forms a relatively small part of this asset category. Banks invest in properties for capital gain purposes. These investment properties are therefore held for a considerable amount of time exposing banks to the risks associated with ownership, including the risk of property prices appreciating and depreciating. Recall from chapter 3, when banks bear the ownership risk of the tradeable asset, the return earned through its trade is valid under the sharia (Usmani, 2004). This part of the banks’ overall investment portfolio is therefore in line with the sharia principles as the first three assets operate on a PLS basis and the final one meets the ownership risk requirement. Conventional banks also hold these types of investment assets, as figure 4.1 highlights.

Line 5: **Property and Equipment:** These are the premises and equipment used by banks to provide banking services to their customers. These are not a distinguishing feature of Islamic banks.

Line 6: **Other assets:** These include miscellaneous assets which differ by bank. These are not a distinguishing feature of Islamic banks.
4.2.2 Liabilities and Equity

In addition to equity capital, the liability side of an Islamic bank’s balance sheet is materially indistinguishable from that of a conventional commercial bank.

Line 7: **Due to Banks & Financial Institutions:** These short-term deposits, placed by other banks and/or financial institutions, are invested on commodity murabahah and/or tawarruq basis, and replicate their interest-bearing conventional counterparts. Some banks also place funds in current accounts, which earn no return and form only a small part of this liability category. These are analogous to the deposits discussed in line 2.

Line 8: **Customer Deposits:** This includes current accounts and investment accounts. Details are provided below.

Line 8a: **Current accounts:** Qard hasan (interest-free-loan) or wadiah-wad-dhamanah (safekeeping with guarantee) contracts are used to provide current account services which operate as in conventional banks, on a fractional reserve basis with no return paid to the depositors and are under an explicit deposit guarantee (Visser, 2009).

Line 8b: **Investment accounts:** These deposits earn a return, which theoretically is on a PLS basis. In practice, the PLS principle is never strictly followed. There is an implicit deposit guarantee as the capital sum in these accounts is never written down even when the banks make a loss (Warde, 2000; Zaher and Hassan, 2001; El-Hawary et al., 2007; Visser, 2009; Khan 2010). Banks also use discretionary reserves such as Profit Equalisation Reserves (PER) and/or Investment Risk Reserve (IRR) to generate a smooth and stable return for the investment account holders (IAH). The expected rate of return on these deposits is therefore implicitly guaranteed and delinked from the banks’ actual profits (Zaher and Hassan, 2001; Farook et al., 2012). Moreover, the return paid mimics the interest rate paid on conventional banks’ deposits. With no real PLS arrangement, investment accounts are similar to the interest-receiving saving accounts offered by conventional banks91 (Kuran 1995; Chong and Liu, 2009).

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91 Two types of investment accounts exist in Islamic banks: restricted investment accounts where depositors can place restrictions on the range of assets the bank can invest their funds in (these may be tied to specific projects), and unrestricted investment accounts where the bank manages funds with full discretion. Accounting treatments differ with regards to reporting of investment accounts, with some banks reporting restricted investment accounts as off-balance-sheet activity. The rationale behind this treatment is that the bank does not own these funds; it acts as the depositors’ agent in managing the funds
Line 9: **Borrowings:** Some banks raise funds through issuing sukuk, which as discussed earlier on the asset side (line 4a), replicate conventional interest-bearing bonds.

Line 10: **Other liabilities:** These include miscellaneous liabilities which differ by bank. These are not a distinguishing feature of Islamic banks.

Line 11: **Equity:** This comprises of share capital, reserves and retained earnings of the bank. Equity capital comprises of similar components in both Islamic and conventional banks, albeit in different proportions. These are not a distinguishing feature of Islamic banks.

### 4.3.3 The Distinguishing ‘Islamic’ Feature

Three important points emerge from the balance sheet analysis above. First, note that in practice, PLS exists only on the asset side of an Islamic bank’s balance sheet. With no genuine PLS-based deposits, the liability side of an Islamic bank’s balance sheet is materially indistinguishable from that of its conventional counterpart. Second, PLS assets exist in both the financing and investment portfolio of an Islamic bank. Thus, PLS arrangements are not limited to musharakah and mudarabah contracts; rather they also exist in several investment assets, which as highlighted in figure 4.1 are also present in conventional banks. Finally, given the above points, it is clear that PLS financing is the only asset type which meaningfully distinguishes the balance sheet structure of an Islamic bank from its conventional counterpart. In practical terms then, PLS financing signifies the unique ‘Islamic’ attribute of a bank.

Following from this analysis, the next section will describe the data and how the measures of PLS used in this study are defined.

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in predetermined investment activities where the losses are accrued solely to the investment account holders. However, banks reporting in accordance with the International Financial Reporting Standards (IFRS) treat investment accounts as deposits and report these under liabilities (Schoon, 2010). While it cannot be confirmed due to insufficient details in banks’ annual report if off-balance-sheet investment account operate on actual PLS basis, differences in accounting treatments do confirm that on-balance-sheet investment accounts operate on a fixed return basis.
4.3 Method: Measuring Profit-and-Loss-Sharing (PLS)

4.3.1 Data

The sample studied here comprises of 61 banks from the Gulf Co-operation Council (GCC). It includes 23 full-fledged Islamic and 38 conventional banks, of which 18 own Islamic windows. To begin the sample selection process, the complete list of all institutions licensed to operate as a bank was collected from each of the six GCC country’s central bank website at the start of January 2014. Any investment-only or special-purpose banks were then excluded. The sample therefore is limited to commercial banks.

Data is collected from consolidated annual reports which include the parent bank and all its subsidiaries. All Islamic windows are therefore treated as part of the parent conventional bank rather than as separate Islamic banks. This confines the Islamic bank category to full-fledged Islamic banks only. Banks which are owned by a non-banking parent/holding company have been included in the sample and are analysed at the bank (not the holding company) level, as these are expected to have greater control over their banking activity and strategic decision making compared to an existing bank’s subsidiary. The final sample also does not include any foreign banks. This is primarily because of data limitations as separate financial statements reporting on these banks’ GCC operations are not available. Most foreign banks produce consolidated financial reports (i.e. at the parent bank level) which do not explicitly provide enough information to permit the calculation of PLS levels as required for this work.

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92 Of the 38 conventional banks in the sample, 24 have Islamic windows. However, as data on PLS financing (musharakah and mudarabah) is not explicitly available in the annual reports of 6 banks, these have been included in the conventional bank category as their Islamic windows could not be included in the sample analysed.

93 Starting from the Central Bank’s list ensures that all banks operating in the GCC are considered for inclusion in the study and that the final sample is representative of the bank population in each country.

94 Treating Islamic windows as separate Islamic banks is not always possible especially as some Islamic window operations can simply be a branch rather than a stand-alone subsidiary. Given this, it is reasonable to assume that the decision-making authority regarding policies on sharia compliance including the provision of PLS financing is likely to be determined at the bank’s parent level rather than the window level, which further justifies limiting the Islamic bank category to full-fledged Islamic banks.

95 Exclusion of foreign banks has led to a substantial reduction in the number of analysable banks. However, without sufficient data on the Islamic banking operations (in particular, the share of PLS financing) financial ratios required for this study could not be calculated.
Finally, data is collected for the four-year period following the financial crisis, namely 2009 – 2012. A breakdown of the sample banks per country and type is provided in Table 4.1.

<table>
<thead>
<tr>
<th>Country</th>
<th>Islamic</th>
<th>Conventional</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>5</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Kuwait</td>
<td>4</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Oman</td>
<td>0</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Qatar</td>
<td>4</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>4</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>UAE</td>
<td>6</td>
<td>13</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>23</strong></td>
<td><strong>38</strong></td>
<td><strong>61</strong></td>
</tr>
</tbody>
</table>

*In total there are 24 conventional banks with Islamic windows however, as data on PLS financing (musharakah and mudarabah) is not explicitly available in the annual reports for 6 banks, those Islamic windows could not be included in the sample analysed*

General descriptive statistics for the sample banks and results of the univariate comparisons between Islamic and conventional banks are provided in Table 4.2. As indicated by the total assets value, which is commonly taken as a proxy for bank size, conventional banks, on average, are twice as large as Islamic banks with a mean total asset value of $23.09 billion compared to $11.72 billion for Islamic banks. This difference in size is highly statistically significant as the p-value for the two-sided t-test reported at the bottom of the table illustrates. Further breakdown of conventional banks illustrates that this result is driven by the difference in size between Islamic banks and conventional banks with Islamic windows, as the latter have a mean total assets value which is almost three times as large as Islamic banks. Conventional banks without Islamic windows however are, on average, similar size to Islamic counterparts. The largest bank in the entire sample is also from the conventional banks with Islamic windows category, as the maximum value shows. Together, this suggests that the larger conventional banks tend to offer Islamic banking services through window operations.

For all categories of banks, i.e. Islamic, conventional with and without Islamic windows, the mean total assets value is higher than the median indicating that the

*2012 was the latest year available at the time of data collection*
distribution is skewed to the right. This is due to the size of the largest banks in the sample which are almost 3-15 times larger than the median banks in their respective category. The variation in bank size is notable as the total assets value for the full sample ranges from less than $0.5 billion to over $95 billion. Variation in size is nevertheless smaller in the Islamic banking industry which has a standard deviation of 14 compared to 22.85 in the conventional banking industry.

Further details provided by the financing and investment ratios show that on average almost 60% of banks’ total assets are in the financing (i.e. loans) portfolio with a further 15% in the investments portfolio. Interestingly, the average investment ratios are identical in Islamic and conventional banks, and while there is some variation between conventional banks with and without Islamic windows, this difference is not statistically significant. In contrast, there is a highly significant difference in the average financing ratio for Islamic and conventional banks, both with and without Islamic windows, as the average financing ratio in Islamic banks is lower, 55.7% compared to 61.7% in conventional banks. This finding is consistent with prior literature, see e.g. Beck et al. (2013), which finds that Islamic banks on average tend to be less involved in the traditional banking activities which are highly reliant on intermediation through interest-generating loans and instead tend to have a higher share of fee-income than their conventional counterparts.

Similar to the financing ratio, standard deviation for the financing-to-deposit ratio is greater amongst Islamic banks (21.2%) compared to conventional banks (16.3%), revealing that there is greater variability in the Islamic banking industry relative to its conventional counterpart. The financing-to-deposit ratio is also lower in Islamic banks, with an average of 88.3% compared to 92.8% in conventional banks, although this difference is only marginally significant at the 10% level of significance and is insignificant when Islamic and conventional banks without Islamic windows are compared. Nevertheless, this comparison does indicate that the average Islamic bank intermediates less of the deposits it receives than its conventional counterpart.

97 For Islamic banks this includes sharia-compliant alternatives i.e. the non-PLS financing modes
Table 4.2: Descriptive Statistics and Univariate Test of Difference between Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>Balance Sheet Structure: Selected Indicators</th>
<th>Mean</th>
<th>Median</th>
<th>Min</th>
<th>Max</th>
<th>St. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Assets ($ billion)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Banks</td>
<td>18.89</td>
<td>10.29</td>
<td>0.43</td>
<td>96.96</td>
<td>20.75</td>
</tr>
<tr>
<td>Islamic Banks</td>
<td>11.72</td>
<td>6.68</td>
<td>0.43</td>
<td>68.60</td>
<td>14.00</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>23.09</td>
<td>14.53</td>
<td>1.39</td>
<td>96.96</td>
<td>22.85</td>
</tr>
<tr>
<td>with Islamic Windows</td>
<td>34.93</td>
<td>29.77</td>
<td>1.93</td>
<td>96.96</td>
<td>21.84</td>
</tr>
<tr>
<td>without Islamic Windows</td>
<td>12.71</td>
<td>5.82</td>
<td>1.39</td>
<td>88.57</td>
<td>18.28</td>
</tr>
<tr>
<td>Financing Ratio</td>
<td>0.595</td>
<td>0.619</td>
<td>0.064</td>
<td>0.827</td>
<td>0.128</td>
</tr>
<tr>
<td>All Banks</td>
<td>0.557</td>
<td>0.589</td>
<td>0.064</td>
<td>0.827</td>
<td>0.142</td>
</tr>
<tr>
<td>Islamic Banks</td>
<td>0.617</td>
<td>0.650</td>
<td>0.206</td>
<td>0.791</td>
<td>0.114</td>
</tr>
<tr>
<td>with Islamic Windows</td>
<td>0.616</td>
<td>0.625</td>
<td>0.422</td>
<td>0.771</td>
<td>0.084</td>
</tr>
<tr>
<td>without Islamic Windows</td>
<td>0.618</td>
<td>0.668</td>
<td>0.206</td>
<td>0.791</td>
<td>0.136</td>
</tr>
</tbody>
</table>

Investments Ratio

| All Banks                                  | 0.153  | 0.145  | 0.017 | 0.431 | 0.091   |
| Islamic Banks                              | 0.153  | 0.145  | 0.017 | 0.307 | 0.079   |
| Conventional Banks                         | 0.153  | 0.145  | 0.023 | 0.431 | 0.096   |
| with Islamic Windows                       | 0.166  | 0.163  | 0.049 | 0.378 | 0.076   |
| without Islamic Windows                    | 0.142  | 0.097  | 0.023 | 0.431 | 0.110   |

Financing-to-Deposits Ratio

| All Banks                                  | 0.912  | 0.918  | 0.387 | 1.875 | 0.182   |
| Islamic Banks                              | 0.883  | 0.873  | 0.387 | 1.875 | 0.212   |
| Conventional Banks                         | 0.928  | 0.957  | 0.405 | 1.402 | 0.163   |
| with Islamic Windows                       | 0.932  | 0.926  | 0.572 | 1.402 | 0.144   |
| without Islamic Windows                    | 0.924  | 0.983  | 0.405 | 1.251 | 0.179   |

Deposit Ratio

| All Banks                                  | 0.659  | 0.697  | 0.018 | 0.833 | 0.144   |
| Islamic Banks                              | 0.630  | 0.678  | 0.018 | 0.833 | 0.189   |
| Conventional Banks                         | 0.674  | 0.699  | 0.199 | 0.818 | 0.110   |
| with Islamic Windows                       | 0.668  | 0.694  | 0.382 | 0.793 | 0.088   |
| without Islamic Windows                    | 0.680  | 0.702  | 0.199 | 0.818 | 0.126   |

Capital Ratio

| All Banks                                  | 0.163  | 0.143  | 0.076 | 0.902 | 0.092   |
| Islamic Banks                              | 0.203  | 0.159  | 0.076 | 0.902 | 0.138   |
| Conventional Banks                         | 0.140  | 0.137  | 0.081 | 0.238 | 0.031   |
| with Islamic Windows                       | 0.141  | 0.137  | 0.095 | 0.238 | 0.029   |
| without Islamic Windows                    | 0.140  | 0.136  | 0.081 | 0.227 | 0.034   |

cont.
Looking now at the liability side of the balance sheet, as the deposit ratio indicates, customer deposits are the main source of funding for both Islamic and conventional banks, although the latter rely on this funding source to a greater extent than Islamic banks (67.4% versus 63% respectively). Breakdown of conventional banks further shows that conventional banks without Islamic windows have a slightly higher reliance on this funding source on average than conventional banks with Islamic windows, although the difference between the two is not statistically significant. The difference in the average deposit ratio between Islamic and conventional banks is also only significant at the 10% level of significance. In contrast, the difference in the capital ratios between Islamic and conventional banks, both with and without Islamic windows, is highly statistically significant. Islamic banks have a higher capital ratio, averaging 20.3% compared to conventional banks with an average of 14%. This finding is consistent with prior studies which find that Islamic banks tend to be better capitalised than their conventional counterparts and that this has been an important factor in Islamic banks’ resilience during the financial crisis period (see e.g. Hasan and Dridi, 2010; Beck et al., 2013).

Overall, the comparison between Islamic and conventional banks’ balance sheet structures suggests that Islamic banks tend to be smaller than conventional banks, have

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**Table 4.2: Descriptive Statistics and Univariate Test of Difference between Islamic and Conventional Banks**

<table>
<thead>
<tr>
<th>Difference in Means (p-values)</th>
<th>IB v ACB</th>
<th>IB v CBIW</th>
<th>IB v CB</th>
<th>CB v CBIW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>0.000</td>
<td>0.000</td>
<td>0.694</td>
<td>0.000</td>
</tr>
<tr>
<td>Financing Ratio(^a)</td>
<td>0.001</td>
<td>0.001</td>
<td>0.005</td>
<td>0.903</td>
</tr>
<tr>
<td>Investments Ratio</td>
<td>0.992</td>
<td>0.300</td>
<td>0.461</td>
<td>0.113</td>
</tr>
<tr>
<td>Financing-to-Deposits Ratio(^a)</td>
<td>0.096</td>
<td>0.088</td>
<td>0.182</td>
<td>0.742</td>
</tr>
<tr>
<td>Deposit Ratio</td>
<td>0.052</td>
<td>0.102</td>
<td>0.049</td>
<td>0.520</td>
</tr>
<tr>
<td>Capital Ratio</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.768</td>
</tr>
</tbody>
</table>

\(^a\)These are commonly referred to as 'loans ratio' and 'loan-to-deposit ratio' in conventional banking literature. In keeping with Islamic banking literature and industry analyst reports (e.g. the IFSB IFSI Stability report), the terms 'financing ratio' and 'financing-to-deposit ratio' are used here.

Total Assets are in US $ billion, deflated using 2010 as the base year. Financing Ratio is calculated as Total Financing / Total Assets. Investments Ratio is calculated as Total Investments / Total Assets. Financing-to-Deposits Ratio is calculated as Total Financing / Total Customer Deposits. Deposit Ratio is calculated as Total Customer Deposits / Total Assets. Capital Ratio is calculated as Total Equity Capital / Total Assets. Values stated in the rows entitled 'Conventional Banks' are descriptive statistics for all conventional banks in the sample which include banks with and without Islamic windows. Further sub-sample breakdown, differentiating between banks with and without Islamic windows are presented in rows below. The acronyms IB refers to Islamic banks; ACB refers to all conventional banks; CBIW refers to conventional banks with Islamic windows and CB refers to conventional banks without Islamic windows. T-test for equality of means is calculated assuming unequal sample variances, two-sided p values are reported.
lower financing, deposit and financing-to-deposit ratios and therefore are less involved in the traditional banking intermediation activities, which relies on generating income through loans and funding via customer deposits. They do however, on average, hold almost identical proportion of their total assets in the form of investments. Finally, there is a significant difference in the capital ratios between the two industries as Islamic banks tend to be better capitalised than their conventional counterparts. The next subsection will now discuss the PLS measures that will be used in this chapter to evaluate and compare Islamic and conventional banks.

4.3.2 Why Use Two Measures of Profit-and-Loss-Sharing (PLS)?

Profit-and-Loss-Sharing (PLS) has been long recognised as the core principle of Islamic banking. Banks offering more PLS contracts are “considered more ‘Islamic’” than those relying on non-PLS (debt-based) alternatives (Azmat et al., 2015, p.269). Yet to the best of my knowledge, no study has focused on comparing PLS levels between individual banks thus far to identify if some are operating closer to the PLS principle than others and whether the criticism that Islamic banks are indistinguishable from conventional counterparts is validly applicable to all Islamic banks. To overcome this gap, PLS levels between banks need to be compared. To achieve this, a measure of PLS is required.

As the prior Islamic banking literature illustrates, two alternative approaches can be used to measure the extent to which a bank operates on the principle of PLS. These approaches differ on the basis of how one defines what constitutes a PLS asset. According to the first approach, PLS assets comprise only the contracts of musharakah and mudarabah which, as noted in chapter 3, have a long history in Islamic legal text going back to the time of early Islamic societies and have traditionally been the focal point of theoretical literature on Islamic banking. In evaluating the extent to which a bank operates on the PLS principle, studies following this approach focus solely on the financing contracts offered by an Islamic bank and measure what percentage of a bank’s financing portfolio comprises of these PLS financing contracts. The PLS level of a bank is therefore measured as: the ratio of musharakah and mudarabah to total financing (see e.g. Aggarwal and Yousef, 2000; Chong and Liu, 2009). Prior Islamic...

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98 As the balance sheet analysis above illustrated, there are no genuine PLS-based arrangements on the liability side of Islamic banks’ balance sheet. Prior literature has therefore focused solely on the asset side of the balance sheet in evaluating how far Islamic banks adopt the PLS principle.
banking literature has almost exclusively adopted this approach in measuring banks’ PLS levels. A notable exception is Khan (2010), which has adopted a second alternative approach to measuring banks’ PLS levels by defining the category of PLS assets more broadly. In its definition of PLS assets, Khan (2010) includes not only the traditional PLS financing contracts of musharakah and mudarabah but also other ‘equity-based’ investment assets e.g. equity securities and investment in associates which, although do not have a direct reference in historical Islamic legal text but do nevertheless, operate on a risk and reward sharing basis. Khan (2010) therefore follows a broader remit in evaluating the extent to which an Islamic bank follows the PLS principle as he examines both the financing and investment portfolios of a bank to measure what percentage of these combined portfolios comprise of PLS assets. The PLS level of a bank is thus measured as: the ratio of musharakah, mudarabah and other equity-based investments to total financing and investment assets99 (see Khan, 2010).

While the literature presents two possible approaches to measuring PLS, both have their strengths offering useful but notably different insights. By focusing solely on the financing portfolio, the first approach allows one to examine whether Islamic banks provide a genuine PLS alternative to the interest-bearing loan. More importantly, for the purpose of this study, using this approach to measure and compare PLS levels between banks allows one to evaluate if the criticism stated in the current literature, that the Islamic banking industry is simply “indistinguishable” from its conventional counterpart (Kuran, 2004; El-Gamal, 2006; Khan, 2010, p.817), is validly applicable to all Islamic banks. This is because, as the balance sheet analysis in section 4.2 illustrated, it is only the PLS financing contracts of musharakah and mudarabah which meaningfully differentiate Islamic from conventional banks in practice. Therefore, for an Islamic bank to provide no musharakah or mudarabah financing implies that it is operating solely on the basis of non-PLS financing modes which are equivalent to the standard interest-bearing loan contract (Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal 2006; Zaman 2008; El-Diwany, 2010; Khan 2010), making the bank

99 As noted in the main text, Khan (2010) defines PLS assets more broadly than other Islamic banking studies to include in addition to musharakah and mudarabah, ‘other (equity-based) investment assets’ that also present the possibility of making a real profit or loss for the bank. Thus assets such as “investments in associates” and equity-based “available for sale investments” are included in the PLS level calculated for each bank. The definition of PLS measure used in Khan (2010) is not explicitly given in the paper but has been confirmed through personal correspondence with the author. I am extremely grateful to Professor Feisal Khan for providing this very useful insight.
practically indistinguishable from its conventional counterpart. By adopting the first approach to define a measure of PLS, one can therefore identify which Islamic banks have zero PLS financing, and are indistinguishable from their conventional counterparts, and which are genuinely different. Moreover, this approach also allows one to make a further distinction between individual banks as it shows if some banks have higher PLS financing levels than others and thus opens up the avenue for further research into why differences across banks in adopting the PLS financing contracts may exist, despite the higher transaction costs associated with this mode of financing.

The alternative, second approach adopted by Khan (2010) however offers two different benefits. Firstly, it appreciates banks’ participation in any form of PLS financial arrangement, acknowledging that to be consistent with the PLS principle Islamic banks are not limited to musharakah and mudarabah contracts. It therefore offers a broader definition of PLS assets which importantly includes certain financial assets that are widely used in conventional finance e.g. investments in equity securities. By adopting such a broader definition of PLS assets, Khan’s approach enables one to measure what percentage of a bank’s combined financing and investment portfolio i.e. its major earning assets are in PLS form and therefore investigate if some Islamic banks are operating closer to the PLS principle more broadly (specifically in generating majority of their income). Secondly and more importantly, by building on Khan’s approach one can construct a measure of PLS even for conventional banks without Islamic windows which, do not use musharakah and mudarabah contracts but, do have equity-based investment assets. This enables one to compare PLS levels directly between Islamic and conventional banks to identify, firstly, if Islamic banks in line with the sharia principles genuinely follow a more PLS-oriented business model than their conventional counterparts in practice and, secondly, the possibility that some conventional banks may have higher PLS levels than self-proclaimed Islamic banks. Prior literature thus far has not investigated this, as the PLS levels for conventional banks have not been measured. Khan (2010) has also not pursued this option as his analysis is limited to 7 Islamic banks.

There are of course limitations to both approaches. As the first approach focuses only on the financing portfolio, it does not take into account that banks may be involved in PLS investment arrangements. It also does not allow one to compare PLS levels between Islamic and conventional banks which do not own Islamic windows (i.e. for
which PLS financing levels are always zero). Using Khan’s approach to measure PLS
overcomes these problems. However, Khan’s approach has its own limitation as it does
not explicitly reflect whether a bank provides the ‘ideal’ PLS financing contracts of
musharakah and mudarabah\(^{100}\), which as noted in chapter 3 are widely recognised as the
raison d’être of Islamic banking (Chapra, 2007) and are the only feature which
practically distinguish Islamic banks’ balance sheet structure from their conventional
counterpart. Thus, Khan’s approach alone does not allow one to evaluate if the criticism
of Islamic banks being indistinguishable from their conventional counterparts is validly
applicable to all Islamic banks.

Given these different strengths and limitations, which of the two approaches should one
use? In making this decision, it is important to note that while both approaches attempt
to evaluate the adoption of PLS principle in banks, these do not measure the same thing.
The definition of PLS assets and the asset portfolio under review (i.e. the numerator and
denominator used in the calculations) differ between both approaches, and thus the
resultant PLS levels are not directly comparable. These two approaches in fact offer
complementary measures which are best suited to investigate two different but related
questions as indicated above. As the first approach measures the presence and level of
PLS financing in banks, it is better suited to answer the questions: do Islamic banks
provide a genuine PLS alternative to the interest-bearing loan and (thus evaluate) does
the criticism that Islamic banks are indistinguishable from their conventional
counterparts validly applies to all Islamic banks? Khans’ approach however is better
suited to answer the question: are some banks operating closer to the PLS principle than
others, as it takes an all-encompassing view to defining PLS assets by accounting for a
banks’ involvement in both PLS financing and investment assets. Both these questions
are of interest to this thesis. Moreover, there are benefits of using multiple measures of
PLS even though this practice is absent in the current literature. Firstly, the two
measures overcome each other’s limitations as discussed earlier to offer additional
insights compared to using only one. Secondly and more importantly, combining results

\(^{100}\) To appreciate this, a closer examination of Khan’s results is required. Take for example, the PLS
Superficial reading of these results may lead one to assume that KFH provides PLS financing options to
its customers. However, my own analysis of KFH’s 2004/2005 annual reports revealed that KFH neither
undertakes musharakah nor mudarabah financing; the PLS shares reported in Khan (2010) are solely
driven by the presence of ‘other equity investment’ assets.
from these two measures allows one to identify if banks adopt different strategies in following the PLS principle, e.g. do some Islamic banks follow the PLS principle by only holding PLS investment assets and avoiding PLS financing contracts, which incur additional transaction costs, while others hold both PLS financing and investment assets? By using both PLS measures, this type of question can be investigated and a holistic assessment of banks’ adoption of the PLS principle can be undertaken. This chapter therefore builds on both the approaches offered in the literature to define two separate measures of PLS, as detailed below.

**Defining the Share of PLS in Banks’ Financing Portfolio**

The first measure of PLS used in this work is defined as the ratio of musharakah and mudarabah to total financing\(^1\). This measure is denoted by PLS-F and follows the first approach to measuring PLS, which is widely used in the Islamic banking literature (see e.g. Aggarwal and Yousef, 2000; Chong and Liu, 2009).

A variant of the PLS-F is also defined in order to compare Islamic banks and conventional banks with Islamic windows. This is because as the data description presented earlier highlighted, the data used in this chapter has been collected from consolidated annual reports and thus the unit of analysis in this study is the parent bank. PLS-F calculation therefore uses the conventional parent banks’ financing portfolio as the denominator. To identify what proportion of the Islamic window’s financing comprises of PLS financing contracts, the variant PLS-IW is used which measures the ratio of PLS financing in the Islamic windows’ total financing portfolio. Both PLS-F and PLS-IW shares are presented in the following results section for the purposes of comparison with full-fledged Islamic banks. Box 4.1 summarises the PLS financing measures used in this study.

\(^1\) To collect data on PLS-F, notes to the consolidated financial statements for each bank have been read carefully. Diminishing musharakah used for home financing has not been included in the share of PLS-F, as this arrangement mimics a conventional mortgage (see Khan, 2010 and references within for further details).
<table>
<thead>
<tr>
<th>PLS ratio</th>
<th>Calculated as:</th>
</tr>
</thead>
<tbody>
<tr>
<td>% PLS Financing (PLS-F)</td>
<td>Ratio of PLS financing to total financing</td>
</tr>
<tr>
<td></td>
<td>$\frac{\text{PLS financing}}{\text{Total financing}}$ (line 3)*</td>
</tr>
<tr>
<td></td>
<td>- PLS financing consists of musharakah and mudarabah financing.</td>
</tr>
<tr>
<td>% PLS Financing IW (PLS-IW)</td>
<td>Ratio of PLS financing to Islamic Window’s (IW) total financing</td>
</tr>
<tr>
<td></td>
<td>$\frac{\text{PLS financing}}{\text{Total IW financing}}$</td>
</tr>
<tr>
<td></td>
<td>- PLS financing is defined as above.</td>
</tr>
<tr>
<td></td>
<td>- Total IW financing refers to total financing undertaken by the Islamic window, not the parent (conventional) bank.</td>
</tr>
</tbody>
</table>

* These line references relate to the generalised balance sheet (figure 4.1)

### Defining the Share of PLS in Banks’ Major Earning Assets

The second measure of PLS used in this study follows Khan (2010)’s alternative approach and extends its application to compare PLS levels between Islamic and conventional banks, a comparison which has eluded the literature thus far. This broader measure, termed PLS-MEA, as defined below in box 4.2, calculates the share of PLS assets in the financing and investment portfolio of a bank which represents its major earning assets (MEA). This measure not only accounts for the controversial non-PLS financing modes (e.g. murabahah) but also the controversial (debt-based) investment assets held by banks, such as sukuk, by excluding these from the category of PLS assets.

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102 The definition of PLS measure used in Khan (2010) is not explicitly given in the paper, therefore it cannot be established whether the measure used in this study is identical to Khan (2010). However, through personal correspondence with the author, it has been established that assets such as "investments in associates"/ "available for sale investments" are included in the PLS share.
Box 4.2: PLS-MEA: Ratio of PLS Assets in Major Earning Assets

<table>
<thead>
<tr>
<th>PLS ratio</th>
<th>Calculated as:</th>
</tr>
</thead>
<tbody>
<tr>
<td>% PLS Major Earning Assets (PLS-MEA)</td>
<td>Ratio of PLS assets to major earning assets (MEA)</td>
</tr>
<tr>
<td></td>
<td>PLS assets (lines 3b, 4b,c,d)*</td>
</tr>
<tr>
<td></td>
<td>Financing and investment portfolio (MEA) (lines 3+4)*</td>
</tr>
<tr>
<td></td>
<td>- PLS assets include PLS financing and PLS investments.</td>
</tr>
<tr>
<td></td>
<td>- PLS financing consists of musharakah and mudarabah financing</td>
</tr>
<tr>
<td></td>
<td>- PLS investments consists of equity investments(^{103}); investments in associates, joint ventures and investment properties(^{104}).</td>
</tr>
<tr>
<td></td>
<td>- Major earning assets are defined as sum of total financing and investment portfolio.</td>
</tr>
</tbody>
</table>

* These line references relate to the generalised balance sheet (figure 4.1)

4.3.3 Comparing PLS Levels between Banks: What Can We Expect?
When comparing PLS-F levels between Islamic banks, it can be expected that the share of PLS financing may not be a substantial portion of any Islamic banks’ financing portfolio, given the sub-optimality of equity relative to debt financing in the presence of costly-state verification and agency problems (Townsend, 1979; Stiglitz and Weiss 1981; Williamson, 1987; Aggarwal and Yousef, 2000) and evidence from industry practice (Iqbal and Mirakhor, 2002). Predicting an outcome from the comparison of PLS-F levels between Islamic banks and windows however is more difficult, as Islamic windows have not been explicitly scrutinised for adherence to Islamic principles in the prior literature nor compared with full-fledged Islamic banks even though recent literature calls for such comparisons to be conducted (Beck et al., 2013). Such a comparison is important particularly as some sharia scholars including Sheikh Nizam Yaqubby (a prominent contemporary sharia scholar) and academics have raised concerns about the ‘purity’ of Islamic windows, with questions over “serious sharia compliance failures” including the introduction of innovative products that do not abide strictly

\(^{103}\) Notes to the financial statements are used to calculate the share of equity investments in the total investment portfolio. Where explicit breakdown of debt/equity investments is not reported in the financial statements, additional supporting notes including the treatment of debt/equity investments required by the relevant reporting standards is used to determine the category of investment. This has affected 2 Islamic and 4 conventional banks

\(^{104}\) Investment properties are included as the risk of ownership (appreciation/depreciation of selling price) is taken by the bank.
with the sharia e.g. murabahah deposits; a weaker framework of sharia governance, and a
general lack of commitment to the Islamic banking principle in the overall charter of
the bank (Yaquby, n.d.; Farook, 2011a, p.26). By making a comparison between
Islamic banks and conventional banks with Islamic windows on the central, PLS
principle of Islamic financing, this chapter takes an initial step at addressing such
concerns.

Should one expect PLS financing levels to be higher or lower in Islamic windows?
According to Kuran (2004, p.19), the Islamic banking “anti-interest campaign” has
created an “exploitable opportunity” for conventional banks to enter a growing market
with a somewhat captive customer base (given the requirement to abide by sharia for
Muslims). If Islamic window operations are purely profit-motivated, Islamic windows
may avoid PLS financing in favour of low-risk non-PLS alternatives which are
equivalent to the conventional financial products, provide the benefit of requiring credit
risk analysis as opposed to project appraisals and stringent monitoring. On the other
hand, Islamic windows benefit from the resource pool, capital base, technical
infrastructure, reputation, credibility and functional including legal support of the much
larger parent conventional banks, which offers competitive advantage and the ability to
reduce overall costs associated with PLS financing, compared to full-fledged Islamic
banks (Rehman, 2010). Moreover, as argued by El Gamal (1997, 1998), an initial
critical mass of debt financing ensures efficiency of PLS. Diversification across a
variety of sharia-compliant, and/or conventional debt and PLS-financing contracts
allows the parent conventional bank to reduce the risk of its overall financing portfolio
(Markowitz, 1952, 1959). Thus, Islamic windows can benefit from the higher returns
associated with equity financing (see, Aghion and Bolton, 1992; Boyd et al., 1998) at
comp comparatively lower risk than full-fledged Islamic banks. Given the unique position of
Islamic windows, these may have higher PLS financing levels than Islamic banks. It is a
priori ambiguous which of the two possibilities is more likely.

When comparing PLS-MEA levels between banks, prior Islamic banking literature
suggests that PLS-MEA should be higher in Islamic banks than their conventional
counterparts. This is because early Islamic banking models and advocates envisioned
Islamic banks as a “cross-breed of commercial and investment banks”, inclined
towards long-term projects financed on risk-sharing (equity) basis (Mohsin, 1982;
Chapra, 1985, p.154; Ahmed, 2002). In line with such models, Islamic banks’
investment portfolio should ideally comprise of equity investments especially as conventional debt securities including bonds which offer a fixed coupon rate are banned for failing to meet the riba prohibition (Usmani, 2004; Ayub, 2007; Visser 2009). Accordingly, one can expect Islamic banks to have higher PLS-MEA than conventional counterparts, especially as conventional banks without Islamic windows do not provide PLS financing. However, given the possibility of variation in PLS-F levels between Islamic banks, which may also hold debt securities including sukuk, it cannot be determined a priori if PLS-MEA will certainly be higher in Islamic banks than their conventional counterparts.

4.4 Results
To keep the focus on differences in PLS levels which exist between banks as opposed to reflecting any changes over time, this section compares PLS levels using a single year’s data, choosing 2012 which is the latest year in the sample. PLS levels for the entire sample period (2009 – 2012) are presented in section 4.5.

4.4.1 Comparing PLS Levels in Islamic Banks and Windows
Table 4.3 presents the PLS Financing (PLS-F) levels for the 23 (full-fledged) Islamic banks in column 1 and 18 conventional banks with Islamic windows in column 2 and 3. As the results show, Islamic banks on average hold only about 6% of their financing portfolio in PLS contracts with over 90% in non-PLS (debt) financing. This finding is in line with prior literature confirming that on average PLS financing constitutes only a small proportion of Islamic banks’ financing portfolio (Aggarwal and Yousef, 2000; Iqbal and Mirakhor, 2002; Warde, 2010).

A focus on the average PLS-F level however misses the key point, as it ignores the amount of variation which exists in the Islamic banking industry. Within a single year, PLS-F ranges from a minimum of 0% to a maximum of over 35%, with a standard deviation of over 10%. Noticeably, PLS-F is zero in almost half, 11 of the 23 Islamic banks (henceforth written as 11/23). The financing portfolio of these banks comprise only of the non-PLS modes and for 7 Islamic banks consists only of murabahah and ijarah contracts. Based on the balance sheet analysis presented earlier, these Islamic banks are essentially ‘quasi-conventional’ banks, as there is no element distinguishing these in substance from their conventional counterparts. At the other end of the
spectrum are Islamic banks which hold more than 20% of their financing portfolio in PLS contracts. These constitute one-fifth of the sample. Compared to the zero PLS-F banks, these Islamic banks are clearly operating closer to the PLS principle and therefore are more in line with the true spirit of sharia.

The significant heterogeneity in PLS-F levels clearly invalidates the implicit assumption made in current literature that the Islamic banking industry comprises a homogenous group of banks that are indistinguishable from their conventional counterparts and therefore are equally un-Islamic. As the results show, there are clear differences between individual Islamic banks, with some holding considerable percentage of their financing portfolio in PLS contracts. Empirical evidence therefore does not support the generalised criticism that Islamic banks do not provide a genuine PLS alternative to conventional financing and the conclusions drawn in previous studies which dismiss the entire industry as nothing more than conventional banking by another name (e.g. Kuran, 1995, 2004; Zaman and Movassaghi, 2002; El-Gamal, 2006; Zaman 2008; Khan 2010).

Examining PLS-F levels at the bank rather than the industry level with a focus on intra-industry comparison, as in this study, provide important insights into the Islamic banking industry. These insights have not only gone unnoticed in prior literature but also deserve attention and further investigation to determine why some banks have considerably higher levels of PLS-F despite the higher transaction costs associated with this mode of financing. This is addressed in section 4.6.
Table 4.3: PLS-F Levels in Islamic Banks and Conventional Banks with Islamic Windows

<table>
<thead>
<tr>
<th>Islamic Banks</th>
<th>Conventional Banks with Islamic Windows: Analysis at</th>
<th>Parent Bank Level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Islamic Window Level</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Banks</td>
<td>PLS-F</td>
</tr>
<tr>
<td>AB</td>
<td>0.00%</td>
<td>ANB</td>
</tr>
<tr>
<td>AHB</td>
<td>0.00%</td>
<td>AUB</td>
</tr>
<tr>
<td>ARB</td>
<td>0.00%</td>
<td>FGB</td>
</tr>
<tr>
<td>BAJa</td>
<td>0.00%</td>
<td>RB</td>
</tr>
<tr>
<td>BWB</td>
<td>0.00%</td>
<td>SHB</td>
</tr>
<tr>
<td>BYB</td>
<td>0.00%</td>
<td>SIVB</td>
</tr>
<tr>
<td>KFH</td>
<td>0.00%</td>
<td>UABa</td>
</tr>
<tr>
<td>KIB</td>
<td>0.00%</td>
<td>NBAD</td>
</tr>
<tr>
<td>NIB</td>
<td>0.00%</td>
<td>ABC</td>
</tr>
<tr>
<td>SIB</td>
<td>0.00%</td>
<td>ENBD</td>
</tr>
<tr>
<td>WB</td>
<td>0.00%</td>
<td>QNBb</td>
</tr>
<tr>
<td>MAR</td>
<td>0.29%</td>
<td>CBD</td>
</tr>
<tr>
<td>QIB</td>
<td>0.71%</td>
<td>DBa</td>
</tr>
<tr>
<td>QIIB</td>
<td>0.91%</td>
<td>BSF</td>
</tr>
<tr>
<td>ITB</td>
<td>1.94%</td>
<td>SFG</td>
</tr>
<tr>
<td>ADIB</td>
<td>3.81%</td>
<td>ADCB</td>
</tr>
<tr>
<td>ABG</td>
<td>7.86%</td>
<td>MB</td>
</tr>
<tr>
<td>BAB</td>
<td>7.96%</td>
<td>UNB</td>
</tr>
<tr>
<td>DIB</td>
<td>19.29%</td>
<td></td>
</tr>
<tr>
<td>BISB</td>
<td>20.54%</td>
<td></td>
</tr>
<tr>
<td>KCB</td>
<td>23.06%</td>
<td></td>
</tr>
<tr>
<td>AJBa</td>
<td>24.67%</td>
<td></td>
</tr>
<tr>
<td>ASB</td>
<td>35.74%</td>
<td></td>
</tr>
</tbody>
</table>

Min. 0.00% Min. 0.00% Min. 0.00%
Max. 35.74% Max. 15.61% Max. 3.22%
Mean 6.38% Mean 3.18% Mean 0.58%
St. dev 10.49% St. dev 4.25% St. dev 1.01%

Difference in means:

<table>
<thead>
<tr>
<th>IB-IW (IW level)</th>
<th>IB-IW (bank group level)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.21%</td>
<td>5.81%</td>
</tr>
</tbody>
</table>

p value 0.193 p value 0.015

PLS Financing shares are given to 4 decimal places where the share is less than 0.01% to provide a more precise value.

a 2011 data, b 2010 data, c T-test for equality of means is calculated assuming unequal sample variances, two-sided p values are reported. The test is also conducted by excluding the outliers, ASB and UNB (at IW level). Conclusions reached are unchanged as the p values are 0.194 (at IW level) and 0.023 (at bank group level).
As table 4.3 shows, PLS-F levels also vary in conventional banks with Islamic windows but this variation is not as pronounced as in full-fledged Islamic banks when analysed at the window level and is even more muted when analysed at the conventional parent bank level. PLS-IW ranges from 0% to a maximum of 16%, whilst PLS-F for Islamic windows ranges from 0% to a maximum of 3%. Comparison between PLS-IW and PLS-F levels (column 2 and 3), shows that Islamic banking constitutes only a small proportion of the conventional banks with PLS financing on average constituting less than 1% of the parent banks’ financing portfolio.

These results confirm that by having Islamic window operations, conventional banks enjoy greater ability to hold a diversified portfolio at the parent bank level whilst also providing substantial PLS financing at the window level. Thus, there is some support for diversification argument via Islamic windows. For example, in UNB, PLS financing constitute 15.61% of the Islamic window’s financing portfolio which is higher than 18 of the 23 Islamic banks, however, when calculated at the parent bank level, PLS constitutes just over 1% of UNB’s total financing portfolio. Risks associated with PLS financing are therefore substantially lower at the parent bank level, than they would be for a full-fledged Islamic bank with the same level of PLS-F.

Nevertheless, there are mixed results on whether the Islamic window model implies higher or lower PLS levels. On the one hand, the difference in average PLS-F between Islamic banks and conventional banks with Islamic windows (columns 1 and 3) is statistically significant. Results show that 40% of Islamic windows operate as quasi conventional banks by providing no PLS financing. These Islamic window operations can be considered the practical manifestation of the “exploitable opportunity” the “anti-interest campaign” has created for conventional banks (Kuran, 2004, p.19), whereby without changing their lending behaviour in any fundamental manner, conventional banks have adopted the quasi-conventional sharia-certified non-PLS-instruments as the means to enter the lucrative and growing Islamic banking market. On the other hand, there are also several cases where Islamic windows show evidence of operating closer to the spirit of Islamic banking by providing PLS financing options to their customers that several Islamic banks do not provide. In 7 Islamic windows, PLS-IW is higher than the PLS-F levels in 16 Islamic banks. Even when PLS-F levels are compared (column 1 and 3), the two highest ranking Islamic windows (BSF and SFG) hold a higher share of PLS-F than 15 Islamic banks.
This finding has important policy implications. In February 2011, Qatar Central Bank passed a directive for all conventional banks to cease their Islamic banking operations by the end of the year. Although the motive behind this decision was not disclosed in a public statement, speculation suggests that this decision was made to protect the purity of Islamic banking operations, avoid comingling of Islamic and conventionally funds and to level the playing field for much smaller Islamic banks (Reuters, 2012a; Gulf Times, 2012). Results from this study suggest this policy has been detrimental for the promotion of PLS as the share of PLS-F in Qatari Islamic windows, QNB and DB is higher than 12 Islamic banks (and higher than 15 and 16 Islamic banks respectively if PLS-IW is compared). Thus, by implementing a ban on Islamic windows, not only has financing choice been limited in the Qatar Islamic banking industry, but more importantly, the level of PLS financing i.e. the ‘real and ideal’ Islamic financing (Usmani, 2004) has also been reduced in the economy. Furthermore, competition in the Qatari banking industry has also decreased as the number of institutions offering Islamic banking has been reduced from twelve to four (Reuters, 2012a). As Aggarwal and Yousef (2000) suggest higher competition reduces the bargaining power of banks, relative to borrowers (entrepreneurs), and therefore lowers their rent-seeking ability which in turn may increase demand for PLS financing. With fewer Islamic banks in the market, the incentive of PLS financing may have been hampered further.

### 4.4.2 Comparing PLS Levels in Islamic and Conventional Banks

Table 4.4 shows the results for the share of PLS in banks major earning assets (PLS-MEA) in Islamic and conventional banks with and without Islamic windows (column 1, 2 and 3 respectively). The average PLS-MEA for Islamic banks is 14%, which is nearly four times larger than the average PLS-MEA for conventional banks and this difference is highly statistically significant. Thus, Islamic banks do on average, place a greater emphasis on PLS forms of financing and investment assets than their conventional counterparts. Nevertheless, this result cannot refute the criticism that Islamic banks rely heavily on debt instruments, since on average, less than 15% of Islamic banks’ major earning assets (MEA) are in PLS form.

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105 Industry level results refer to full-fledged Islamic banks only, as Islamic windows are included as part of the parent conventional bank.
A closer look at the results shows the significant variation between Islamic banks. PLS-MEA ranges from less than 1% to over 53% in the single year. For 8 of the 23 banks (35% of the sample), PLS-MEA is higher than the average and for 3 of these banks, PLS-MEA comprises 40% or more, representing a considerable proportion of the banks’ MEA. For the highest ranking Islamic bank, ASB, PLS assets exceed more than 50% of its financing and investment portfolio. Contrary to the criticism of Islamic banks, these results provide empirical evidence to suggest that some Islamic banks follow a different, more PLS-oriented banking model than conventional banks.

On the other hand, there are also Islamic banks for which PLS-MEA is negligible (less than 2%). These banks exhibit an overall low risk-sharing approach to their operations. Moreover, comparison with conventional banks reveals that several Islamic banks are even less PLS-oriented than their conventional counterparts. For 5 Islamic banks PLS-MEA is lower than the average PLS-MEA of conventional banks, with the highest ranking conventional bank with (without) Islamic window holding PLS-MEA share greater than 8 (15) Islamic banks.
### Table 4.4: PLS-MEA Levels in Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>With Islamic Windows</td>
</tr>
<tr>
<td>Banks</td>
<td>PLS-MEA</td>
</tr>
<tr>
<td>AHB</td>
<td>0.47%</td>
</tr>
<tr>
<td>NIB</td>
<td>0.69%</td>
</tr>
<tr>
<td>ARB</td>
<td>0.73%</td>
</tr>
<tr>
<td>AB</td>
<td>1.85%</td>
</tr>
<tr>
<td>BAI&lt;sup&gt;b&lt;/sup&gt;</td>
<td>2.06%</td>
</tr>
<tr>
<td>MAR</td>
<td>3.28%</td>
</tr>
<tr>
<td>BWB</td>
<td>4.33%</td>
</tr>
<tr>
<td>QIB</td>
<td>6.80%</td>
</tr>
<tr>
<td>ADIB</td>
<td>7.34%</td>
</tr>
<tr>
<td>BAB</td>
<td>8.80%</td>
</tr>
<tr>
<td>ABG</td>
<td>9.05%</td>
</tr>
<tr>
<td>QIIB</td>
<td>9.06%</td>
</tr>
<tr>
<td>WB</td>
<td>9.50%</td>
</tr>
<tr>
<td>KIB</td>
<td>9.50%</td>
</tr>
<tr>
<td>BYB</td>
<td>9.98%</td>
</tr>
<tr>
<td>SIB</td>
<td>15.03%</td>
</tr>
<tr>
<td>KFH</td>
<td>18.63%</td>
</tr>
<tr>
<td>AJB&lt;sup&gt;a&lt;/sup&gt;</td>
<td>23.50%</td>
</tr>
<tr>
<td>DIB</td>
<td>23.64%</td>
</tr>
<tr>
<td>ITB</td>
<td>24.71%</td>
</tr>
<tr>
<td>BISB</td>
<td>39.85%</td>
</tr>
<tr>
<td>KCB</td>
<td>44.51%</td>
</tr>
<tr>
<td>ASB</td>
<td>53.72%</td>
</tr>
<tr>
<td>Min.</td>
<td>0.47%</td>
</tr>
<tr>
<td>Max.</td>
<td>53.72%</td>
</tr>
<tr>
<td>Mean</td>
<td>14.22%</td>
</tr>
<tr>
<td>St. dev</td>
<td>14.71%</td>
</tr>
</tbody>
</table>

**Difference in means**

| IB-CBIW | 11.29% | CBIW-CB | -0.31% | IB-CB | 10.98% |
| p value | 0.001  | p value | 0.711  | p value | 0.002 |

<sup>a</sup> 2011 data, <sup>b</sup> 2010; T-test for equality of means is calculated assuming unequal sample variances, two-sided p values are reported.
Taking PLS levels as an important indicator of banks’ Islamicness as in prior literature (Khan, 2010; Azmat et al., 2015), then these results show that with a broader definition of PLS, some conventional banks appear to be more ‘Islamic’ than the self-proclaimed Islamic banks\(^{106}\), as they are operating closer to the PLS principle strongly advocated to be the cornerstone of Islamic banking (Iqbal and Molyneux, 2005). The variation in PLS-MEA levels across Islamic banks again emphasises that it is important to take a nuanced approach towards evaluation of Islamic banks, as opposed to relying on industry averages.

Looking at the results from table 4.3 and 4.4 together shows evidence to suggest that some Islamic banks substitute away from the costlier PLS financing contracts towards cheaper forms of PLS assets, such as equity securities which do not incur the sort of origination and monitoring costs of higher agency problems associated with PLS financing. Despite zero PLS-F, banks such as KFH (19%) and SIB (15%) hold above average PLS-MEA, higher than all conventional banks. PLS-MEA levels for these banks are completely driven by the non-financing forms of equity investments. High PLS-MEA levels in Islamic banks therefore are not always a result of PLS-F but similar to conventional banks can be determined only by other equity investment assets\(^{107}\).

Most importantly, these results also suggest that there is considerable heterogeneity in the Islamic banking industry regarding the strategies adopted by individual Islamic banks to follow the PLS principle. Whilst some focus entirely on non-financing PLS investments, others hold substantial portions of their financing portfolio in PLS form as shown in table 4.3.

Intra-industry variation in PLS-MEA also exists in the conventional banking industry and there is some difference in PLS-MEA levels between conventional banks with and without Islamic windows, the former’s ranging from 0% to 7% and the latter’s between 0% to over 11%. However, this difference in averages is not statistically significant.

\(^{106}\)Such a conclusion must be treated with caution, as it implicitly assumes 1) risk-sharing as the sole determinant of Islamicness and 2) debt-based financing instruments and sukuk are equivalent to conventional debt contracts in line with the view expressed by notable academics in the Islamic banking literature (see for example, Kuran, 1995, 2004; El-Gamal 2006; Khan 2010).

\(^{107}\)For five out of the eight banks with above average PLS-MEA, the level of PLS-F is also above average. However, KFH and SIB are notable exceptions which imply that high PLS-MEA is not a necessary condition for a bank to hold high PLS-F.
4.4.3 A Typology of Islamic Banks

Combining the results from PLS-F and PLS-MEA\textsuperscript{108} analysis to identify which Islamic banks operate differently from their conventional counterparts leads to an interesting insight; it is the same group of Islamic banks. In fact, a pattern emerges when both the PLS-F and PLS-MEA results are studied simultaneously. This pattern, illustrated in figure 4.2, can be best described as a typology\textsuperscript{109} of Islamic banks.

As figure 4.2 shows, there are three broad groups of banks identified. Only one bank, ITB (labelled Bank A in figure 4.2) is an exception to the generally recognised pattern with high PLS-MEA but low PLS-F. This is the implication of recent changes in the bank. ITB, previously a conventional investment bank, reorganised operations with its Islamic banking subsidiary (Shamil Bank) to operate as an Islamic retail bank in 2010. PLS financing contracts of the Islamic subsidiary bank transferred to the parent bank’s financing portfolio. The low level of PLS-F for ITB therefore reflects the difference in the scale of Islamic window and the much larger parent bank\textsuperscript{110}. Thus, at present this bank does not fit in any of the three identified groups. The main characteristics of each group are summarised in table 4.5 and detailed below.

Table 4.5: Typology of Islamic Banks (2012)

<table>
<thead>
<tr>
<th>Bank Group</th>
<th>PLS-F</th>
<th>PLS-MEA</th>
<th>Group Label</th>
<th>Share of Total Islamic Banking Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>0%</td>
<td>&lt;20%</td>
<td>Quasi-conventional</td>
<td>57.30%</td>
</tr>
<tr>
<td>Group 2</td>
<td>0.01% -10%</td>
<td>&lt;10%</td>
<td>Hybrid</td>
<td>32.30%</td>
</tr>
<tr>
<td>Group 3</td>
<td>≥20%</td>
<td>&gt;20%</td>
<td>PLS-Oriented</td>
<td>10.40%</td>
</tr>
</tbody>
</table>

\textsuperscript{108} Combining the results from both measures of PLS provides a comprehensive picture of how Islamic banks perform against each other and conventional banks with regards to the principle of PLS.

\textsuperscript{109} I am grateful to Dr Carola Wolf for suggesting the use of this term to present these results.

\textsuperscript{110} As financial statements for Shamil Bank are no longer available online, it is not possible to calculate what the PLS-F share would be if calculated at the window level (i.e. using Shamil Bank’s total financing as the denominator).
Figure 4.2: Typology of Islamic Banks (2012)
Group 1: Quasi conventional Islamic Banks: PLS-F 0%; PLS-MEA <20%

The quasi-conventional group includes Islamic banks which genuinely are indistinguishable from conventional banks and thus are validly criticised as such in prior literature. With zero PLS-F, these banks rely purely on non-PLS financing contracts, and only apply the PLS principle through holding conventionally recognised equity investment assets, which are also present in conventional banks. As noted earlier, some Islamic banks in this group hold even lower PLS-MEA than conventional counterparts. The two notable Islamic banks in this group are SIB and KFH with the highest, over 15% PLS-MEA however; these also do not provide a PLS (equity-based) alternative to conventional financing. The group contains 11 of the 23 (henceforth written as 11/23) Islamic banks, comprising of all 4 Kuwaiti banks, 3/4 Saudi, 3/6 UAE, and 1 Qatari bank and represents the majority of the GCC Islamic banking industry. As Table 4.4 illustrates, more than 50% of the Islamic banking assets from the analysed sample are placed in banks which fall under this category. Extending the analysis to include Islamic windows reveals that almost half, 7 of the 18 Islamic windows, also fall in this quasi-conventional group. Thus, these Islamic windows have only superficially changed their banking operations by adopting non-PLS financial instruments and in reality continue to operate as conventional banks and continue to rely exclusively on debt over PLS financing arrangements. This group, which consists of almost half of the full-fledged Islamic banks and Islamic windows, has therefore been labelled as quasi-conventional banks, which have practically failed to provide a genuine PLS alternative to conventional banking.

Group 2: Hybrid Islamic Banks: 0.01% <PLS-F <10%; PLS-MEA <10%

Table 4.5 illustrates that a further 32.3% of Islamic banking assets are in group 2 banks. These hybrid Islamic banks, while distinct from purely conventional banks, are far from the ideal PLS-based model promoted by Islamic economists. PLS financing is provided by these banks but constitutes only a small proportion, less than 10% of the overall financing portfolio. PLS-MEA also constitutes less than 10% of the overall financing and investment portfolio. The PLS principle is followed to some extent but these banks predominantly rely on debt instruments. This group consists of 7/23 Islamic banks; 3 Qatari, 2 Bahraini and 1 bank each from UAE and Saudi Arabia. Two banks, ABG and BAB labelled as Bank B/C in figure 4.2 have noticeably higher PLS-F than other banks in the group. However with less than 8% PLS-F, these banks essentially represent the
‘average’ Islamic bank which holds more than 90% of its financing portfolio in debt form. Again, extending the analysis to cover Islamic windows, shows that this group also includes 11/18 conventional banks with Islamic windows, which is difficult to show on the figure 4.2 diagram, as majority of the banks (8/11) have less than 1% PLS-F. To remain consistent with the unit of analysis (i.e. banks analysed at the parent bank level), PLS-F rather than PLS-IW shares are presented in figure 4.2 for conventional banks with Islamic windows. This does not change the classification of the banks.

**Group 3: PLS- Oriented Islamic Banks: PLS-F ≥20%; PLS-MEA >20%**

Group 3 comprises only 5 Islamic banks, 3 from Bahrain and 2 from the UAE, constituting approx. one fifth of the sample. These banks are unambiguously different from the others in the sample as they show evidence of actively pursuing PLS-oriented business model i.e. PLS focused strategies in terms of their financing arrangements and investment portfolio. With PLS-F and PLS-MEA greater than 20%\(^{111}\), these are operating as a “cross-breed of commercial and investment banks” as originally envisioned for the Islamic banking model (Chapra, 1985, p.154; Ahmed, 2002). ASB, labelled as Bank D in figure 4.2, may be considered an outlier with significantly higher PLS-F and PLS-MEA than the rest of the group. However, these groups are broadly defined and the inclusion or exclusion of ASB in group 3 does not change the key conclusion that there are some Islamic banks which are operating closer to the PLS principle by actively adopting PLS financial instruments over debt-based alternatives, which makes them more Islamic and undeniably distinguishable from their conventional counterparts.

4.5 Validating the Typology of Islamic Banks using Cluster Analysis

The above comparison of PLS levels between and across the Islamic and conventional banking industries has shown that the Islamic banking industry does not comprise a homogeneous group of banks, that are all indistinguishable from their conventional counterparts. Rather, three distinct groups have been identified. While banks within each group appear to follow a similar strategy, banks across the three groups seem to

\(^{111}\) This also includes DIB, with PLS-F of 19.29% as the difference between this bank and others in group 3 is smaller than banks in group 2.
follow different strategies regarding their adoption and implementation of the PLS principle e.g. relative to the other groups, quasi-conventional Islamic banks avoid PLS financing contracts altogether. This finding suggests that the typology of Islamic banks identified in the previous section may be reflecting the presence of ‘strategic groups’ within the Islamic banking industry, a possibility that has not been explored thus far (due to the assumption of homogeneity).

The concept of strategic groups has been long studied in the strategic management literature since the term was first coined by Hunt (1972). Although there is no universally accepted formal definition, the term ‘strategic group’ commonly refers to a group of firms within a single industry which use similar strategies, i.e. make similar decisions in key areas and thus are more homogeneous in their decision making and actions than firms are across the industry more generally (Porter, 1980; Reger and Huff, 1993; Fiegenbaum & Thomas 1995; Short et al., 2007; Mergaerts and Vennet 2016). Strategic group theory therefore rejects the assumption of intra-industry homogeneity and recognises that not only do differences exist between firms but crucially similarities also exist in the strategic choices made by groups of firms within an industry (Barney and Hoskisson, 1990). Firms in different strategic groups compete for the same customer base but in diverse ways as represented by the different business models they adopt\textsuperscript{112} (Harrigan, 1985). The concept of strategic groups therefore provides a useful means to categorise firms within an industry on the basis of their strategic choices/business models. Importantly, the exact composition of strategic groups differs depending on which strategic decision variables are selected as the basis for defining the groups (Hatten and Hatten, 1987).

Findings from the previous section suggest that when the PLS principle is used (assessed using the two PLS measures defined in this study), three groups of banks can be identified in the Islamic banking industry, characterised by distinct: Quasi-conventional, Hybrid and PLS-oriented business models. Although the presence of strategic groups has not been explicitly studied in the context of Islamic banking, there is a history of literature seeking to identify if strategic groups exist within the conventional banking sector. Amel and Rhoades (1988) for example, tested for the

\textsuperscript{112} As Mergaerts and Vennet (2016) highlight, the concept of business models itself stems from the literature on strategic groups as the former reflect firm strategy including for example, the choice of products a firm offers (e.g. to provide PLS financing or not).
presence of strategic groups across 16 banking markets using data on banks’ balance sheet composition for three years. As the balance sheet composition reflects a bank’s strategic choices (the nature of its assets and liabilities), the use of balance sheet data for the identification of strategic groups and bank business models has been long established in the banking literature (see e.g. Amel and Rhoades 1988) and continues to be used by recent studies (Ayadi et al., 2011; Mergaerts and Vennet, 2016). Even in the Islamic banking literature, balance sheet data has been used to compare Islamic and conventional banks’ business models (Beck et al., 2013). By using the two PLS measures, this chapter follows prior literature in making use of banks’ balance sheet data to identify if different groups exist within the Islamic banking industry.

Crucially, as the above analysis uses only a single year (2012) data, the question arises: does evidence still support the existence of different groups when data from multiple years is analysed, and, if so, does group membership change over time? These are important questions to address because finding an affirmative answer to the first question will confirm that the conclusion drawn from the 2012 analysis\(^{113}\) is not simply an artefact of a single year, rather it is reflective of the industry structure more broadly\(^{114}\). Moreover, finding stable group membership will confirm the significance of between-bank variation in the adoption and implementation of the PLS principle relative to within-bank variation. Some level of variation in PLS levels within banks is expected, since the composition of banks’ asset portfolio naturally changes over time following the course of business, however, finding that banks repeatedly fall in the same groups will indicate that a clear difference does exist in the strategic choices made by different groups of banks with respect to the PLS principle.

\(^{113}\) i.e. Islamic banking industry does not comprise a homogeneous group of banks that are all indistinguishable from conventional banks as is suggested in the literature

\(^{114}\) Recognising an industry’s structure accurately is important for an improved understanding of market competition and possible differences in performance between firms. However for the purpose of this study specifically, it is also important for identifying if the Islamic banking industry does indeed comprise heterogeneous group of banks where some choose to operate closer to the PLS principle and importantly, provide PLS financing option relative to others. It is noteworthy that a significant part of the strategic management literature has focused on investigating the impact of strategic group membership on firm performance (see e.g. Short et al., 2007; Mergaerts and Vennet, 2016 and references within), which although an interesting area of research, is beyond the focus on this thesis. This chapter will therefore not investigate the impact of group membership on bank performance, rather the focus of this section remains on confirming if different groups still exist in Islamic banking industry when PLS levels for more than a single year are analysed.
Thus, to evaluate if the Islamic banking industry does comprise of heterogeneous groups and whether group membership is stable, this section expands the analysis presented in section 4.4 by adding a further three years to the dataset. PLS-F and PLS-MEA levels are therefore calculated for an additional three years in the post financial crisis period preceding 2012, leading to a revised sample of 2009 – 2012. As some banks began operations during the sample period while for others data required to calculate PLS levels was unavailable at the time of data collection, the final sample comprises of an unbalanced panel of 225 bank-year observations (81 full-fledged Islamic, 66 conventional banks with Islamic windows and 78 without windows).

Tables 4.6 and 4.7 respectively summarize the PLS-F and PLS-MEA data over the 2009-2012 period. As the summary statistics show, both the annual average PLS levels and the variation across banks is higher in the Islamic banking industry throughout the studied period. The average PLS-F for full-fledged Islamic banks over the four-year period ranges around the 6% mark, with a minimum of 0% to maximum of 36%, compared to an average of 1% for conventional banks with Islamic windows (henceforth CBIWs) where PLS-F ranges between 0 – 10%. The standard deviation is also noticeably higher in the former (7% to 10%) than the latter (1% to 2.7%). Similarly, the annual average PLS-MEA in Islamic banks ranges from 14% – 17.5% which is four-to-five times larger than the annual average PLS-MEA for conventional banks with and without Islamic windows. The standard deviation for Islamic banks is also more than five times greater than conventional banks’ as PLS-MEA varies from a minimum of 0% to a maximum of 57% in Islamic banks, relative to conventional banks (with Islamic windows) where it ranges from 0% to less than 12% (10%). Therefore, the four-year data shows that while on average Islamic banks show higher levels of PLS, there is also greater variability in the industry (i.e. between banks).

Tables 4.6 and 4.7 also show that PLS levels change within individual banks, although the magnitude and direction of these changes differs across banks. In banks such as KCB, both PLS-F and PLS-MEA have consistently increased over the four years whereas in banks such as ADIB, PLS levels have decreased. In other banks such as ABG, PLS levels show both positive and negative year-on-year changes over the

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115 The preceding three years are used as 2012 was the latest year at the time of data collection.
116 To ensure that the unit of analysis remains consistent with the typology discussed earlier in section 4.4.3, the PLS-F values for conventional banks with Islamic windows are provided in table 4.6.
sample period. As noted above, it is expected that PLS levels will change within banks as the composition of their asset portfolios changes over time, therefore the observed variation is not entirely surprising.

Nevertheless, the magnitude of change in certain banks is more notable than others. In MAR for example, PLS-F has reduced from almost 15% to less than 0.5% over the four-year period whereas in ASB, PLS-F has increased from 3.8% to almost 36%. In depth study of MAR’s financial statements indicate that the fall in PLS-F level is a result of a decrease in both the amount of musharakah and mudarabah (PLS) financing and an increase in non-PLS financing contracts particularly murabahah as well as the introduction of other non-PLS alternatives such as istisna during 2011 (MAR, 2011, p.20117). The reduction in PLS financing could be due to a change in bank’s strategy (possibly due to a change in leadership/management)118, or simply because the musharakah and mudrabah partnership contracts completed their term as these are time bound. Alternatively, the ban on Islamic windows imposed by the Qatar Central bank may have had an impact on PLS-F levels. With the ban imposed, the number of institutions offering Islamic banking in Qatar reduced from twelve to four (Reuters, 2012a). According to Aggarwal and Yousef (2000), higher competition reduces banks’ bargaining power relative to borrowers and therefore lowers their rent-seeking ability which in turn may increase demand for PLS financing. With fewer Islamic banks in the market, the incentive of PLS financing may have been hampered. QIB, another Qatari Islamic bank, also shows reduction in its PLS-F to almost 0% after 2011. Whether these banks substituted PLS for non-PLS financing due to reduced competition or simply increased non-PLS financing to capture customers no longer served by conventional banks’ Islamic windows needs further investigation to be answered. Therefore, to fully understand the impact of the ban on Islamic windows on PLS financing, a more indepth study focusing on the Qatar banking industry is required which is beyond the scope of this thesis.

ASB’s annual reports on the other hand are more suggestive of the potential reason for the sharp increase in the banks’ PLS-F level. As indicated in the bank’s 2009 annual

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117 Refers to the banks’ financial statements
118 During data collection, only the financial statements for MAR were available. Without the full annual report which provides information on bank’s management (e.g. names of directors), any change in management could not be confirmed.
report, ASB acquired Bahrain Saudi Bank (BSB), a conventional commercial bank, in 2009. As of December 31st 2009, ASB’s consolidated financial statements therefore comprise the financial statements of ASB and its subsidiary BSB, resulting in a significant increase in the bank’s total assets. Since BSB is a conventional bank, its assets are not PLS-based. This inevitably increased the proportion of non-PLS assets in ASB’ balance sheet. Over the sample period, as explained in its annual reports, ASB has been converting BSB’ non-sharia compliant assets including its financing contracts to sharia-compliant alternatives. In its 2010 report for example, ASB states the bank has “been successful in converting a significant portion of conventional assets and liabilities of BSB to Shari’a compliant products” (ASB, 2010, p.22). Error! Bookmark not defined. This conversion process has continued into 2011 and 2012. While the acquisition of BSB has certainly had an impact on the balance sheet structure of ASB, it cannot be completely ruled out that the potential reason for the sharp increase in PLS-F may be due to a shift in bank’s strategy as well e.g. to operate as a more PLS-oriented bank. To reach a definitive conclusion, interviews with the bank’s management may help shed light on the reason for the observed changes in PLS level however such a mode of investigation is beyond the scope of this thesis.

Finally, it is notable that for both Islamic banks and CBIWs that have chosen to operate as quasi-conventional banks by offering no PLS financing, this position appears to be a stable (and potentially long-term) strategy. As table 4.6 shows, all Islamic banks with 0% PLS-F consistently remain at this level throughout the four-year period with the exception of only one (BWB, which has reduced its PLS-F from 0.01% to 0% over the 2011-12 period). Similarly, all CBIWs that have 0% PLS-F have remained at this level, with the exception of only two banks (CBD and ENBD, which have increased from 0% to 0.3% and 0.13% over the 2011-12 and 2010-11 period respectively). Therefore while PLS-F levels have changed in banks which provide PLS financing, there has been almost no change in the majority of the banks that offer no PLS financing. This is an important finding as it illustrates that remaining a quasi-conventional bank seems to be the dominant position for banks that have chosen this strategy. Nevertheless, given the exceptions, it is clear that banks can and do move in and out of the identified groups e.g. BWB has joined the quasi-conventional group while CBD and ENBD have exited from it by offering PLS financing. This suggests that group membership may not be completely fixed. Whether stable group membership is the dominant position for most
banks therefore needs to be further investigated. Moreover, given that PLS levels have changed in several banks, how many distinct groups of banks does the data support? To answer these questions, cluster analysis is used. Similar to previous banking studies (e.g. Ayadi et al., 2011 and Mergaerts and Vennet, 2016), cluster analysis was applied to the pooled (2009-2012) dataset to identify the presence and number of different groups and whether group membership changes over time. Further details on cluster analysis are given below.
Table 4.6: PLS-F Levels in Islamic Banks and Conventional Banks with Islamic Windows (2009-2012)

<table>
<thead>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AB</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>ABC</td>
<td>0.03%</td>
<td>0.01%</td>
<td>0.01%</td>
<td>0.01%</td>
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</tr>
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</tr>
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<td>19.29%</td>
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<td></td>
<td>SFG</td>
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<td>9.11%</td>
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</tr>
<tr>
<td>KCB</td>
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<td>16.88%</td>
<td>20.09%</td>
<td>23.06%</td>
<td>SHB</td>
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</tr>
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<td>SIVB</td>
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<td>UNB</td>
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</tr>
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<td></td>
<td></td>
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</tr>
<tr>
<td>QIB</td>
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<td>3.54%</td>
<td>3.10%</td>
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<td></td>
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</tr>
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<td>0.45%</td>
<td>0.91%</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
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<td>0.00%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WB</td>
<td></td>
<td></td>
<td></td>
<td>0.00%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

PLL Financing shares are given to 4 decimal places where the share is less than 0.01% to provide a more precise value.
Table 4.7: PLS-MEA Levels in Islamic and Conventional Banks with and without Islamic Windows (2009-2012)

<table>
<thead>
<tr>
<th>Islamic Banks</th>
<th>Conventional Banks With Islamic Windows</th>
<th>Conventional Banks Without Islamic Windows</th>
</tr>
</thead>
<tbody>
<tr>
<td>AB</td>
<td>0.00%</td>
<td>0.41%</td>
</tr>
<tr>
<td>ABG</td>
<td>14.85%</td>
<td>16.54%</td>
</tr>
<tr>
<td>ADIB</td>
<td>11.88%</td>
<td>10.48%</td>
</tr>
<tr>
<td>AHB</td>
<td>0.96%</td>
<td>0.70%</td>
</tr>
<tr>
<td>AJB</td>
<td></td>
<td>23.50%</td>
</tr>
<tr>
<td>ARB</td>
<td>1.57%</td>
<td>1.53%</td>
</tr>
<tr>
<td>ASB</td>
<td>56.92%</td>
<td>49.13%</td>
</tr>
<tr>
<td>BAB</td>
<td>8.68%</td>
<td>10.58%</td>
</tr>
<tr>
<td>BAJ</td>
<td>3.19%</td>
<td>3.40%</td>
</tr>
<tr>
<td>BISB</td>
<td>35.64%</td>
<td>29.75%</td>
</tr>
<tr>
<td>BWB</td>
<td>4.02%</td>
<td>4.33%</td>
</tr>
<tr>
<td>BYB</td>
<td>14.71%</td>
<td>12.87%</td>
</tr>
<tr>
<td>DIB</td>
<td>36.40%</td>
<td>29.40%</td>
</tr>
<tr>
<td>ITB</td>
<td>28.84%</td>
<td>27.53%</td>
</tr>
<tr>
<td>KCB</td>
<td>32.42%</td>
<td>40.15%</td>
</tr>
<tr>
<td>KFH</td>
<td>21.79%</td>
<td>21.08%</td>
</tr>
<tr>
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</tr>
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<td>0.69%</td>
</tr>
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<td>14.09%</td>
</tr>
<tr>
<td>QIIB</td>
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<td>7.37%</td>
</tr>
<tr>
<td>SIB</td>
<td>12.81%</td>
<td>13.23%</td>
</tr>
<tr>
<td>WB</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Min. 0.00% 0.41% 0.15% 0.47% Min. 0.12% 0.01% 0.00% 0.09% Min. 0.01% 0.00% 0.00% 0.00%
Max. 56.92% 49.13% 54.00% 53.72% Max. 7.60% 9.64% 9.61% 7.14% Max. 7.85% 7.76% 11.39% 11.54%
Mean 17.50% 16.18% 15.26% 14.24% Mean 3.89% 3.83% 3.32% 3.08% Mean 3.48% 3.25% 3.23% 3.31%
St. dev 15.08% 13.63% 15.06% 14.78% St. dev 2.47% 2.75% 2.82% 2.06% St. dev 2.53% 2.49% 3.03% 3.15%
4.5.1 Method: Cluster Analysis

Cluster analysis is a statistical technique that assigns data objects/observations into distinct groups called clusters, with the aim of grouping together observations such that they are homogeneous within clusters and heterogeneous between clusters based on a set of pre-selected characteristics. By definition then, observations within a particular cluster are more similar to each other in terms of the selected characteristics than observations across clusters (Barney and Hoskisson, 1990; Ayadi et al., 2011). When characteristics reflecting firms’ strategic choices are used as the basis of cluster analysis, the resulting clusters qualify as strategic groups (Hatten, 1974; Hatten et al., 1978). Cluster analysis has therefore been recognised as a “valuable” and “important tool” for identifying the presence of strategic groups/business models and has been widely used in the strategic management literature as well as in previous banking studies (see e.g. Hatten, 1974; Hatten et al., 1978; Amel and Rhoades, 1988; Fiegenbaum & Thomas 1995; Ketchen and Shook, 1996, p.455; Short et al., 2007; Ayadi et al., 2011; Mergaerts and Vennet, 2016).

As cluster analysis aims to group together observations on the basis of similarity (Everitt et al., 2011), the first step in generating clusters is to select the clustering variable(s) i.e. to determine which characteristic(s) will be examined to establish (dis)similarity between individual observations (Sarstedt and Mooi, 2014). Depending on the research question, prior studies have used different types and number of clustering variables, ranging from a single variable to more than half a dozen. Porter (1980) for example used firm size to group together firms while Ayadi et al., (2011) and Mergaerts and Vennet (2016) used a variety of balance sheet indicators to identify business models in European banking markets. As Ayadi et al. (2011) highlight, for the identification of strategic groups/business models, the chosen clustering variables must be those that are within the firm’s control. In this chapter, the two PLS measures are used as the clustering variables. These capture banks’ strategic orientation towards the adoption and implementation of the PLS principle and meet the above-mentioned criteria as banks have direct influence over the decision to provide PLS financing and the amount of their financing and investment portfolio they choose to hold in PLS form.

Once the clustering variables have been selected, the next step is to choose the clustering procedure (which includes the method for measuring (dis)similarity and
partitioning clusters) and finally determine the appropriate number of clusters (Ayadi et al., 2011). There are several different types of clustering procedures. The most popular are 1) hierarchical and 2) non-hierarchical (partitioning) clustering, both of which adopt different approaches to generate clusters.

In hierarchical (agglomerative) clustering, clusters are formed sequentially starting with the highest possible number of clusters. Each (bank-year) observation is therefore initially treated as a separate cluster. Similar observations are then merged to form new clusters. The most similar (of these new) clusters are then merged and the process is repeated, progressively aggregating the preceding clusters until all observations are eventually grouped, creating a tree-like structure (dendogram). (Dis)similarity is measured by calculating the distance between observations in the original variable(s) space, as similar observations have smaller distances between them. Formation of clusters is thus dependent on how distance is measured. Most commonly the (squared) Euclidean distance, illustrated in figure 4.3, is used (De Maesschalck et al., 2000; Everitt et al., 2011; Sarstedt and Mooi, 2014).

Figure 4.3: Euclidean Distance

\[
\text{Euclidean Distance (d)} = \sqrt{(x_2 - x_1)^2 + (y_2 - y_1)^2}
\]
If collinearity exists between the clustering variables however, the alternative Mahalanobis distance is recommended (De Maesschalck et al., 2000; Sambandam, 2003; Sarstedt and Mooi, 2014). The Mahalanobis distance\(^{119}\) is given by:

\[
MD_i = \sqrt{(x_i - \bar{x})C_x^{-1}(x_i - \bar{x})^T}
\]

for \(i = 1\) to \(n\), where \(X\) is \((n \times m)\) matrix, containing \(n\) observations and \(m\) variables and \(C_x\) is the variance-covariance matrix.

Once the distance measure is selected, one (or more) clustering algorithm(s) is chosen to partition the clusters. Each algorithm optimises a different criterion in partitioning clusters and thus can lead to different results. Previous research has found some procedures are better at identifying group structures in the data than others (see Milligan (1981) for an evaluation of different clustering procedures). Of the various hierarchical clustering algorithms, Ward’s (1963) minimum-variance method has been highly recommended especially in the presence of overlaps and has thus been widely applied in the strategic management literature as well as by banking-specific studies (Milligan, 1981; Barney and Hoskisson, 1990; Reger and Huff, 1993; Short et al., 2007; Ayadi et al., 2011; Sarstedt and Mooi, 2014; Mergaerts and Vennet, 2016). As with the other hierarchical methods, Ward’s method starts by treating each observation as a single cluster. However, in generating and partitioning the clusters, Ward’s method follows a slightly different approach to the other hierarchical algorithms. Instead of combining observations with the least distance, Wards’ method combines observations which increase the within-cluster variance by the least amount, to form the cluster solutions (Ayadi et al., 2011; Sarstedt and Mooi, 2014).

To determine the appropriate number of clusters, a ‘stopping rule’ is required. By evaluating various stopping rules, Milligan & Cooper (1985) recommend the Calinski and Harabasz’s (1974) pseudo-F index as the best, most consistent stopping rule as it identified group structures correctly in over 90% of the cases in simulations (Ayadi et al., 2011). Accordingly, the Calinski and Harabasz’s index has been a popular choice used by previous studies to determine the number of clusters (see Ayadi et al., 2011 and Mergaerts and Vennet, 2016 for application to banking-specific research). The Calinski and Harabasz’s index is “the sample estimate of the ratio of between-cluster variance to within-cluster variation”, therefore the number of clusters which relate to the highest

\(^{119}\) If there is no correlation between the variables, the Mahalanobis distance is the same as the Euclidean distance (Sambandam, 2003).
pseudo F index value is selected as the most appropriate and distinct clustering configuration (Ayadi et al., 2011, p.23).

In contrast to hierarchical clustering, non-hierarchical procedures adopt a different approach to generate and partition the clusters. The non-hierarchical clustering procedure begins by randomly assigning observations to a pre-specified (k) number of clusters (Sarstedt and Mooi, 2014). Observations are then reassigned successively to other clusters to minimise the within-cluster variation which is measured using the (squared) distance from each individual observation to the geometric centre, the centroid (i.e. arithmetic mean) of the associated clusters. Cluster centroids are recomputed as new observations are added. Non-hierarchical clustering is therefore an iterative process, whereby multiple passes are made through the data as observations change group affiliations depending on the distance from the recomputed cluster centroids (Ketchen and Shook 1996). If reallocating an observation to another (different) cluster reduces the within-cluster variation, the observation is reallocated to the (new) cluster and the process is repeated until all observations are assigned to a cluster and no further changes to cluster affiliations take place i.e. clustering solution reaches convergence (Anderberg, 1973; Ketchen and Shook, 1996; Sarstedt and Mooi, 2014). As with hierarchical clustering, various algorithms exist in non-hierarchal clustering as well, with k-means being the most widely applied (Sarstedt and Mooi, 2014).

Given the differences between the two clustering procedures, which one should one use? In making this decision, it is important to note the strengths and weaknesses of both procedures. One of the drawbacks of hierarchical clustering is that cluster affiliations do not change during the clustering process therefore each observation remains part of the initial cluster it has been assigned. In contrast, in non-hierarchical clustering, cluster affiliations can and do change during the clustering process as observations are reassigned to different clusters in locating the optimal clustering solution (Ketchen and Shook, 1996; Sarstedt and Mooi, 2014). This difference translates into a notable advantage offered by the non-hierarchical clustering over its hierarchical counterpart. This advantage relates to the impact of outliers. While both hierarchical and non-hierarchical clustering can be sensitive to the presence of outliers, non-hierarchical clustering is impacted less by outliers (Ketchen and Shook, 1996,
p.446). As non-hierarchical clustering is an iterative process, even if the initial clusters are distorted by the presence of outliers, this distortion is often corrected during successive iterations as observations change cluster affiliations and the cluster centroids are recomputed (Hair et al., 1992; Ketchen and Shook, 1996). Moreover, by allowing observations to change cluster affiliations as multiple passes are made through the dataset, non-hierarchical clustering optimises within-cluster homogeneity and between-cluster heterogeneity for the final clustering solution. These advantages however come at a cost. As noted earlier, non-hierarchical clustering requires that the number of clusters is prespecified i.e. established a priori (Milligan, 1980; Ketchen and Shook, 1996). This is problematic as cluster analysis is mainly a descriptive and exploratory statistical technique (Ketchen and Shook, 1996; Everitt et al., 2011). To overcome this problem, many experts have advocated for ‘two-stage clustering’, which combines the principles of both procedures by running hierarchical clustering in the first stage to identify the number of clusters and their centroids and non-hierarchical clustering in the second stage which uses results from the first stage as the starting point. Previous research has shown that the two-stage clustering procedure increases the validity of the cluster solutions and has therefore been recommended and used as a method of triangulation to help increase the validity of results drawn from cluster analysis (Milligan, 1980; Punj and Stewart, 1983; Hair et al., 1992; Ketchen and Shook, 1996; Short et al., 2007; Sarstedt and Mooi, 2014).

In line with these recommendations, this study adopts the two-stage clustering procedure, whereby Ward’s hierarchical clustering procedure is used in the first stage with the Calinski and Harabasz’s index used as the stopping rule to determine the appropriate number of clusters, followed by the k-means non-hierarchical clustering used in the second stage. Results from the first stage are used as the starting point for k-means. To further ensure robustness of the cluster solutions, k-means is also run with random starting points.

Before turning to the results, the one final consideration required for cluster analysis is to ensure that the resultant clusters offer a “meaningful strategic interpretation” i.e. that they represent important differences in the strategic choices/business models adopted by the different groups of firms (McGee and Thomas, 1986, p.148; Sarstedt and Mooi, 2014). To ensure that clusters are meaningful and interpretable, it is recommended that
any a priori expectations and knowledge which may determine the nature of a group are taken into account prior to generating data-driven clusters. Practical considerations are therefore paramount and choices regarding the nature of groups need to be made even before embarking on the cluster analysis procedure (Sarstedt and Mooi, 2014). Prior studies e.g. Short et al. (2007) have therefore relied on using both deductive (i.e. where a priori expectations regarding nature of groups exists) and inductive (data-driven) approaches to conduct cluster analysis, relying on a priori (theoretical) framework and analysis to impose group solutions. A key benefit that the inducto-deductive approach offers is that it enables the constructed groups to be informed by not only statistical but also theoretical and practical considerations. This is highly valuable especially as the latter are considered of “utmost importance when deciding on the number of clusters” (Short et al., 2007; Sarstedt and Mooi, 2014, p.298).

In this study, an important consideration which needs to be accounted for arises from the balance sheet analysis conducted in section 4.2. Using prior literature, the analysis illustrated that the balance sheet structure of an Islamic bank which does not offer PLS financing contracts is practically indistinguishable from its conventional counterpart. Such a bank essentially operates as a quasi-conventional bank, as it relies solely on debt-based financing contracts and follows the PLS principle solely through holding PLS (equity-based) investment assets which are also present in conventional banks. This decision to avoid PLS financing contracts altogether reflects the adoption of a very specific, important and fundamentally different strategic position compared to Islamic banks which offer PLS financing. Running cluster analysis without accounting for this major difference would lead to erroneous grouping as banks with 0% PLS-F and just above 0% PLS-F (e.g. 0.07%) will be included in the same cluster (since the distance between 0% and just over 0% is small). Such a clustering solution will fail to represent the fundamental difference in strategic choices made between banks that choose not to provide PLS financing and those that do (i.e. PLS-F>0%). To avoid this error, quasi-conventional banks need to be recognised a priori as a separate strategic group, where membership of this group is defined by the absence of PLS financing. Accordingly, in the following analysis, the quasi-conventional group is constructed by definition to include banks with 0% PLS-F. For the remaining banks i.e. where PLS-F > 0%, groups are generated using cluster analysis and therefore the number of groups and their
membership is purely data-driven. Results from the cluster analysis are presented below.

4.5.2 Results from Cluster Analysis

This section presents and discusses the results from the two-stage cluster analysis procedure detailed above. As the first stage of the cluster analysis involved using Ward’s hierarchical approach, the Calinski and Harabasz’s pseudo-F Index was used to determine the appropriate number of clusters. Results presented in table 4.8 show that the index attained a single maximum value, indicating the 2 cluster solution as the most appropriate and distinct cluster configuration.

<table>
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<th>Number of Clusters</th>
<th>Calinski and Harabasz Pseudo-F index</th>
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<tbody>
<tr>
<td>2</td>
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</tr>
<tr>
<td>3</td>
<td>135.32</td>
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<td>14</td>
<td>129.75</td>
</tr>
<tr>
<td>15</td>
<td>123.83</td>
</tr>
</tbody>
</table>

As these are the number of clusters present amongst banks where PLS-F > 0%, the results suggest that there are two further groups in the Islamic banking industry in addition to the quasi-conventional group which, recall from the above discussion, has been defined to include all banks where PLS-F = 0%. In total then, the inducto-deductive approach indicates the presence of three groups.

Following on from Ward’s clustering method, the second stage involved using the k-means clustering procedure. As the 2-cluster solution yielded the highest pseudo-F
index value, k-means was specified to run with 2 clusters (i.e. k=2)\textsuperscript{120}. Both the centroids determined by the Ward’s hierarchical clustering as well as randomly generated centroids were used as the starting points sequentially. Both approaches produced highly consistent results. Moreover, as both the Ward’s hierarchical and k-mean non-hierarchical clustering procedures also produced consistent results i.e. banks were assigned to the same clusters in the final solutions, These results are presented graphically in figure 4.4.

Figure 4.4: Cluster Analysis: PLS-F and PLS-MEA (2009-2012)

Group 1 has been deductively defined based on the balance sheet analysis such that all banks where PLS-F = 0% are a member of this group. Groups 2 and 3 are inductively defined using cluster analysis.

As figure 4.4 illustrates, in addition to the quasi-conventional group, there are two groups of banks identified. Group 3 banks show notably higher PLS levels however there is also greater dispersion amongst these compared to banks in group 2. The descriptive statistics for all three groups are given in table 4.9 below. For each group, the breakdown per bank type is also given to provide greater detail. For group 1, where

\textsuperscript{120} To further validate the number of clusters generated, k-means was also run with different number of predefined clusters e.g. k= 3, 4, 5 etc. Calinski and Harabasz’s Index can also be used with k-means to check the pseudo-F value produced for each number of prespecified cluster solution (Sarstedt and Mooi, 2014). The 2 cluster solution with k-means generated the highest pseudo-F value.
(by definition) PLS-F is 0%, the PLS-MEA value ranges from a minimum of 0% to a maximum of 21.79%. As the table shows, there is greater variation amongst Islamic banks than CBIWs (standard deviation of 7.29% v. 2.40%). The mean PLS-MEA for the entire group (including Islamic banks and CBIWs) is 5.46%. Islamic banks have a slightly higher mean PLS-MEA value (7.29%) compared to CBIWs (3.26%) however the difference between these is not statistically significant. For comparison, descriptive statistics for conventional banks without Islamic windows (henceforth CBs) is also provided (as these banks also do not engage in any PLS financing). Again, although the mean PLS-MEA in CBs is lower than Islamic banks and CBIWs, the difference in means is not statistically significant. In total there are 66 bank-year observations in this group, 36 Islamic and 30 conventional banks with Islamic windows. As was discussed earlier, by excluding PLS financing contracts from their financing portfolio, these banks operate as conventional banks which only provide debt-based financing options to their customers. Moreover, comparison of PLS-MEA levels shows that on average the proportion of these banks’ major earning assets which is in PLS form does not differ from conventional counterparts. This indicates that, irrespective of how the adoption of the PLS principle is measured (as PLS-F or PLS-MEA), there is a group of Islamic banks and CBIWs which is genuinely indistinguishable from their conventional counterparts.

Comparing the average PLS-F and PLS-MEA levels across groups 1 and 2 offers an interesting insight. While the difference in mean PLS-F levels between the two groups is statistically significant at the 1% level of significance, the difference in mean PLS-MEA between the groups is only statistically significant at the 10% level. Therefore, as these results indicate, the average PLS-MEA level alone cannot differentiate between these groups; rather it is the presence of PLS-F which differentiates banks in group 2 from the quasi-conventional banks in group 1. This is an important finding, for if one accepts the choice to offer PLS financing as an important strategic decision then these two groups illustrate the presence of distinct strategic groups within the Islamic banking industry, where banks in each group have adopted fundamentally different banking business models. If, however, one looks only at the level of PLS-MEA, by measuring PLS broadly as in Khan (2010), banks in group 1 and 2 cannot be differentiated as separate strategic groups. Given the balance sheet analysis presented earlier which discussed the importance of PLS financing as the sole differentiating feature of Islamic
Table 4.9: Descriptive Statistics for Bank Groups from Cluster Analysis

<table>
<thead>
<tr>
<th></th>
<th>Group 1</th>
<th>Group 2</th>
<th>Group 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PLS-F (%)</td>
<td>PLS-MEA (%)</td>
<td>PLS-F (%)</td>
</tr>
<tr>
<td>Islamic Banks</td>
<td>Min 0.00</td>
<td>0.00</td>
<td>Min 0.01</td>
</tr>
<tr>
<td></td>
<td>Max 0.00</td>
<td>21.79</td>
<td>Max 15.32</td>
</tr>
<tr>
<td></td>
<td>Mean 0.00</td>
<td>7.29</td>
<td>Mean 5.11</td>
</tr>
<tr>
<td></td>
<td>St.Dev 0.00</td>
<td>7.05</td>
<td>St.Dev 4.53</td>
</tr>
<tr>
<td></td>
<td>(N= 36)</td>
<td></td>
<td>(N= 28)</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>Min 0.00</td>
<td>0.00</td>
<td>Min 0.002</td>
</tr>
<tr>
<td>with Islamic Windows</td>
<td>Max 0.00</td>
<td>7.74</td>
<td>Max 10.11</td>
</tr>
<tr>
<td></td>
<td>Mean 0.00</td>
<td>3.26</td>
<td>Mean 2.15</td>
</tr>
<tr>
<td></td>
<td>St.Dev 0.00</td>
<td>2.40</td>
<td>St.Dev 2.71</td>
</tr>
<tr>
<td></td>
<td>(N= 30)</td>
<td></td>
<td>(N= 35)</td>
</tr>
<tr>
<td>All (Islamic and</td>
<td>Min 0.00</td>
<td>0.00</td>
<td>Min 0.002</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>Max 0.00</td>
<td>21.79</td>
<td>Max 15.32</td>
</tr>
<tr>
<td>with Islamic Windows</td>
<td>Mean 0.00</td>
<td>5.46</td>
<td>Mean 3.46</td>
</tr>
<tr>
<td></td>
<td>St.Dev 0.00</td>
<td>5.79</td>
<td>St.Dev 3.89</td>
</tr>
<tr>
<td></td>
<td>(N= 66)</td>
<td></td>
<td>(N= 63)</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>Min 0.00</td>
<td>0.00</td>
<td>Min 0.00</td>
</tr>
<tr>
<td>without Islamic</td>
<td>Max 0.00</td>
<td>11.54</td>
<td>Max 11.54</td>
</tr>
<tr>
<td>Windows</td>
<td>Mean 0.00</td>
<td>3.32</td>
<td>Mean 3.32</td>
</tr>
<tr>
<td></td>
<td>St.Dev 0.00</td>
<td>2.76</td>
<td>St.Dev 2.76</td>
</tr>
<tr>
<td></td>
<td>(N=78)</td>
<td></td>
<td>(N=78)</td>
</tr>
</tbody>
</table>

T-test results confirm that the difference in means between groups (1 and 2; 2 and 3; 1 and 3) is statistically significant at the 1% level of significance. The exception is the difference in mean PLS-MEA between groups 1 and 2, where the differences in means for the entire group is significant at the 10% level.
banks in practice and the long-standing literature supporting the importance of PLS financing as the core of Islamic banking, it is considered important in this thesis to make a distinction between banks that do and do not offer PLS financing. Thus, in addition to the reasons discussed earlier, using two PLS measures, as in this study, also proves to be informative regarding the presence of strategic groups in the Islamic banking industry.

Looking now at the composition of group 2, as table 4.9 shows, there are 63 bank-year observations in this group, 28 Islamic and 35 CBIWs. PLS-F ranges from a minimum of 0.01% (0.002%) to a maximum of 15.32% (10.11%) in Islamic banks (CBIWs). Similar to group 1, the mean PLS-F value is higher in Islamic banks (5.11%) relative to CBIWs (2.15%), however the difference is not statistically significant. Overall, this group shows a mean PLS-F value of 3.46% with a standard deviation of 3.89%. PLS-MEA ranges from 3.28% to 28.84% in Islamic banks and 0.53% to 9.64% in CBIWs. As with PLS-F, the mean PLS-MEA is higher in Islamic banks (11.81%) compared to CBIWs (3.88%), the difference between these however is statistically significant. Thus, on average, Islamic banks in group 2 have higher PLS-MEA level than CBIWs, although as the standard deviation illustrates, there is also greater variation in the former (6.48%) than the latter (2.62%). Overall, with over 90% of their financing (and major earning) assets in non-PLS form, banks in this group represents the ‘average’ Islamic bank which engages in some level of PLS while in fact predominantly relying on non-PLS alternatives.

Group 3 on the other hand depicts a distinctly different set of banks which engage in PLS considerably more than banks in the other two groups. The mean PLS-F and PLS-MEA values for this group are over five times larger than group 2’s. Expectedly, the difference in means across the groups is highly statistically significant. The range of PLS levels also highlights the difference between the groups. The maximum PLS-F value for example is almost twice the maximum for Islamic banks in group 2 while the minimum PLS-MEA value for group 3 banks is almost the same as the maximum PLS-MEA for Islamic banks in group 2. The one notable exception is the minimum value for

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121 Having defined the quasi-conventional group (deductively) enables this study to make this distinction.
PLS-F (3.87%) which belongs to Al-Salam Bank (ASB, 2009)\textsuperscript{122}. As this bank has an extremely high PLS-MEA level (56.92%), it is closer to the group 3’s centroid than group 2’s when both PLS-F and PLS-MEA are considered together and therefore it is allocated to group 3. Although this observation is an outlier (with relatively low PLS-F compared to others), the inclusion and exclusion of this bank does not lead to any significant change in results. While excluding ASB (2009) from group 3 changes the minimum PLS-F value to 12.85%, the mean (standard deviation) changes by 1% point to 21.98% (5.81%). The maximum PLS-MEA changes to 54% while the mean (standard deviation) changes to 36.78% (10.27%), which is also a change of approximately 1% point. The clustering solution, i.e. the number of clusters and group membership, also remain unchanged with/without inclusion of this observation. In relation to group membership, it is notable that this group does not comprise any CBIWs, rather there are only 18 Islamic bank-year observations in this group, making this the smallest of three group of banks. With notably high PLS levels, these banks nevertheless represent an important minority which show evidence of actively pursuing PLS-oriented strategies in formulating their financing and investment portfolios and thus are clearly operating closer to the principle of PLS than other banks in the industry.

Given the characteristics of each group discussed above, parallels can be drawn between the cluster analysis results and the groups identified from the 2012 analysis (see discussion on typology presented in section 4.4). Figure 4.5 below illustrates this as it shows that, in addition to the quasi-conventional banks, the groups generated by cluster analysis are consistent, in principle, with the groups identified from the 2012 analysis. There is a difference in the bounds defining the groups across the single and multi-year analysis. However, this is unsurprising as PLS levels vary in banks over time and the bounds (minimum/maximum) and the centroids (means) are defined such that these describe the cluster characteristics based on its constituents. As new observations are added, the recomputed centroids and bounds change to reflect the characteristics of cluster members. With additional data (e.g. further years), these are likely to change further. Nevertheless, despite the difference in the bounds and group means, the cluster analysis with three years additional data validate the main conclusions drawn from the 2012 analysis. As the results show the Islamic banking industry does not comprise a

\textsuperscript{122} As was discussed earlier in section 4.5 (in relation to table 4.6), the low PLS-F level reflects the changes in the bank which arose due to the acquisition of a conventional bank (BSB in 2009).
homogeneous group of banks that are all indistinguishable from conventional banks, contrary to the criticism presented in the literature. Furthermore, evidence from the multi-year sample still supports the presence of three distinct groups of banks in the Islamic banking industry. Group 1, as defined earlier, comprise quasi-conventional banks which are materially indistinguishable from their conventional counterparts; group 2 represents the hybrid banks which engage in PLS financing but rely predominantly on non-PLS alternatives while group 3 comprise of PLS-oriented banks which show clear evidence of pursuing PLS-oriented strategies, with almost 40% of their major earnings assets (financing and investment assets) in PLS form and over 20% of their financing portfolio comprising of the ideal PLS contracts of musharakah and mudarabah. These three groups demonstrate that important differences exist between groups of banks within the Islamic banking industry regarding the strategic position they have adopted in relation to the implementation of the PLS principle. Thus, results

123 The possibility that any further years’ data may show more or less than 3 distinct groups cannot be ruled out, however over the 2009-2012 period, cluster analysis with the inducto-deductive approach adopted in this study supports the three group solution.
from the cluster analysis with multiple years’ data validate the typology of Islamic banks identified and discussed earlier which, in light of earlier discussion, can also be interpreted to support the presence of strategic groups in the Islamic banking industry.

Finally, as figure 4.5 shows, both ITB (2010-12) and ASB (2009) stand out as outliers. For both banks, earlier discussions presented in section 4.4 and 4.5 respectively explain that the merger and acquisition undertaken by these banks during the sample period inevitably had an impact on their balance sheet structures which explain the observable pattern in their PLS levels. To ensure that the results are robust, the two-stage clustering procedures were run with the inclusion and exclusion of these outliers, results however remained unchanged i.e. banks were allocated to the same clusters. Therefore, for completeness, these bank-observations are included in the analysis and figure 4.5.

While the evidence discussed above supports the presence of three distinct groups, the question whether group membership is stable remains. To answer this, a closer look at each group’s constituent banks is required. Table 4.10 below presents the list of banks assigned to each group from the cluster analysis. Banks which remain within the same group throughout the sample period are listed by name only. For banks which move groups, the years for which they are a member of the relevant group are also presented. As table 4.10 shows, group membership is highly stable throughout the three groups. Less than 3% of the bank-year observations move groups over the studied period. These include BWB, which has moved from the hybrid to the quasi-conventional group over the 2011-12 period and CBD and ENBD which have moved in the opposite direction over the sample period. Importantly, there has been no change in the PLS-oriented group, which comprise of the same five banks that were identified as constituents of this group from the 2012 analysis. Results on group membership from cluster analysis and the 2012 analysis are therefore consistent. Moreover, while these results indicate that banks can change their strategic positioning on PLS sufficiently to move between groups, stability in group membership is the dominant feature of each group. Stable group membership therefore supports the conclusion that important differences do exist in the adoption and implementation of the PLS principle between banks.
4.6 Further Analysis: Investigating the Variation in PLS Financing between Banks

Results from the preceding sections show that the adoption of PLS financing contracts varies between banks, with some banks having notably higher PLS-F levels than others. As PLS investment assets, such as equity securities, do not incur the additional transaction costs associated with PLS financing, the fundamental question arises: why do some banks have higher levels of PLS financing than others? The current Islamic banking literature has not addressed this question as variation in PLS financing levels between banks has not been studied. This section aims to overcome this gap in the literature by investigating this question.

To achieve this, data on PLS-F for the four-year period (2009 – 2012) is used. All conventional banks without Islamic windows (i.e. which do not engage in any form of...
Islamic banking services, PLS or non-PLS) are excluded from the sample. The current sample therefore comprises of 41 banks, 23 Islamic and 18 conventional banks with Islamic windows. As some banks began operations during the sample period while others have missing data on some variables of interest, an unbalanced panel of 147 bank observations forms the final dataset.

4.6.1 Identifying the Potential Determinants of PLS Financing

Although the literature has not explicitly addressed the question why some banks may have higher PLS financing levels than others, some guidance from the literature can be found concerning factors which may influence a bank’s ability and decision to provide PLS financing. These are discussed below.

**Bank-Specific Characteristics**

The first potential determinant is the age of a bank. Controversial non-PLS financing modes, e.g. murabahah, were originally permitted by sharia scholars as ‘exceptions’ to support the transitional, introductory period of Islamic banking. Such financing modes were argued to provide Islamic banks with an essential starting point to establish themselves as viable institutions against conventional banks operating on interest-based lending. It was expected that over time, reliance on non-PLS financing would be replaced by a move towards the ideal PLS contracts (Ahmad, 1993; Khan, 1995; Usmani, 2004; Rehman, 2010; Warde, 2010). Thus, according to this ‘(controversial) means to an (Islamic) end’ argument, older Islamic banks should have higher PLS-F.

The second potential determinant is the size of a bank. PLS financing requires close monitoring of clients to reduce moral hazard. Banks may therefore need to set up in-person and on-site monitoring systems to verify declared profits from PLS-funded projects (Visser, 2009). This can be particularly expensive and difficult to standardise as the scale of the operation grows. Lack of standardisation in such monitoring systems may put large banks at a disadvantage (ibid; Čihak and Hesse 2008). Thus, there may be diseconomies of scale in the ‘ideal’, PLS mode of Islamic financing. To benefit from economies of scale, larger banks may turn towards the more standardised non-PLS alternatives. Some evidence in support of this has been found in an international sample of Islamic banks, where Aggarwal and Yousef (2000) find that the financing portfolio of larger banks is skewed more towards murabahah (non-PLS) than smaller banks. Thus, according to this ‘size matters’ argument, larger banks should have lower PLS-F.
The third potential determinant is the liability structure of the bank, particularly the reliance on depositor funds as the main source of funding. Azmat et al. (2015) put forth a theoretical proposition that a higher reliance on depositor funds will be associated with lower PLS financing because of depositors risk aversion and withdrawal risk that Islamic banks face. Venture capitalists face far less susceptibility to such withdrawal risk as they raise the required funds primarily from institutional investors and with approximately seven years commitment (Gompers and Lerner, 1999). Islamic banks however, are reliant on risk-averse depositors which have short-term liquidity needs (Ahmed, 2002). To encourage such depositors to invest in PLS investments (with uncertain returns and the potential loss of capital), Islamic banks will need to charge a higher risk premium to the firms which they engage through PLS. This increases the cost of capital for the borrowing firms and thus reduces demand for this particular arrangement, dissuading firms to enter PLS arrangement with Islamic banks (Azmat et al., 2015). According to this argument then, banks which have a higher reliance on depositor funds as their main source of funding are likely to have lower PLS-F levels.

Finally differences may also exist between full-fledged Islamic banks and conventional banks with Islamic windows, especially in light of the argument presented by Kuran (2004), suggesting that Islamic banking offers an “exploitable opportunity” for conventional banks in the GCC to enter a lucrative market in their region. If the provision of Islamic banking services is profit-motivated, conventional banks with Islamic windows may avoid PLS financing in favour of low-risk non-PLS alternatives which are equivalent to the conventional financial products. The 2012 analysis also illustrated that there is a significant difference in the average PLS-F level between Islamic and conventional banks with Islamic windows, the latter being lower than the former’s. Similarly PLS-F levels may also differ for banks which were previously conventional banks but converted to full-fledged Islamic banking. On the one hand, if conversion was motivated by religious reasons, these banks may pursue PLS financing more intensely as they have chosen to change their business model for religious compliance. On the other hand, if the choice to convert was strategically motivated, i.e. to enter the increasingly important Islamic banking market in the GCC region, then PLS-F levels are likely to be lower in converted banks, as these banks can

124 Note: local conventional banks in the GCC are also owned and run by Muslims
adopt an ‘Islamic’ identity while keeping their operations fundamentally the same through the use of less costly non-PLS modes of financing. It is therefore important to control for differences in bank type when investigating PLS-F levels between banks.

**Institutional Environment**

Another important factor is the institutional environment in which a bank operates. The New Institutional Economics (NIE) literature discusses in detail the importance of institutions, both formal (e.g. property rights) and informal (e.g. customs), in shaping economic behaviour. Institutions represent man-made constraints that structure socio, economic and political interactions. Essentially these “provide the incentive structure of an economy” and as such have a direct impact on production and transacation costs associated with economic interactions (North, 1991, p.97; Williamson, 1985, see also Abdul-Rahman et al., 2014 for a summary and discussion in the context of Islamic banking). Chapter 3 discussed at length the importance of the institutional environment and its impact on transaction costs associated with PLS financing. As was discussed earlier, the lack of a supportive institutional environment is recognised as one of the key factors for the low adoption of PLS financing contracts by Islamic banks (Iqbal et al., 1998; Chapra, 2007). It can therefore be expected that banks are likely to have higher PLS-F levels in countries which provide an institutional network supporting Islamic banking and have adopted policies which are favourable for PLS over debt-based financing. The below summarises important differences between GCC countries, noting especially the factors which are systematically different in Bahrain and UAE compared to the other GCC nations, that are likely to have an impact on PLS levels.

**The Effect of Formal Institutions on Trust and Transaction Costs**

Institutions play an important economic role in reducing transaction costs (Dahlman, 1979). In transactions where there is a principal/agent relationship, such that the agents’ actions are not costless to monitor and economic incentives do not suffice in aligning principal/agent interest, alternative relationships such as trust between parties is required to ensure that the agents do not cheat, even when it is the “rational economic behaviour” to do so (Arrow, 1968, p.538). By increasing confidence between transacting parties, trust reduces transaction costs as fewer resources are expended in monitoring the agent’s actions. It further makes drafting contracts easier and less costly

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125 Refer to section 3.6 for further details.
since not all possible contingencies need to be specified at the outset, and as imperfect contracts are more effective in trusting relationships, disputes and therefore litigation is also less likely. The “genetic predisposition to cooperate [however] is unlikely to vary across societies…variations in trust across societies must [therefore] be attributable to differences in the social, economic and legal environments” (Zak and Knack, 2001, p.299).

One of the key determinants of trust in societies is the strength of formal\textsuperscript{126} institutions, established to protect contractual rights and restrain government expropriation of funds (Knack and Keefer, 1997; Zak and Knack, 2001). A measure of formal institutions therefore includes the strength of the judicial system including protection of property rights and more generally the efficacy of the state including levels of corruption (ibid; Herreros and Criado, 2008). According to the Global Competitiveness Report (2011-2012) issued by the World Economic Forum (henceforth, GCR, 2012), Bahrain tops the GCC region for the strength of property rights. Strong property rights reduce risk associated with transactions as it guarantees that contractual rights will be upheld, and therefore has a positive impact on social trust (Zak and Knack, 2001; Herreros and Criado 2008). A strong judicial system which enforces contracts and punishes cheaters also limits the incentives for cheating (Zak and Knack, 2001). When moral hazard is low, equity contracts dominates debt (Aggarwal and Yousef, 2000). PLS financing is likely to be higher in such environments, especially as third-party enforcement agencies subsidise the costs of contract enforcement for the parties involved, including Islamic banks.

Secondly, the impact institutions have on trust levels in a society is not automatic and depends on the credibility and legitimacy of the institutions as well as the state which creates them (Herreros and Criado, 2008). The state as an enforcement agency has to be legitimate in order to enhance trust between parties that do not share personal ties such

\textsuperscript{126} As Zak and Knack (2001) note informal institutions also aid in constraining opportunism by agents through channels such as reputational effects, religious beliefs and moral norms. Anecdotal evidence confirms this, as Baele et al (2014) find default rate on Islamic banks loans to be lower than conventional banks even amongst the same borrowers. Informal institutions are also important as all economic transactions are embedded within a social context, which determines both the rewards associated with cooperation as well as punishments for deviation (Becker, 1974; Granovetter, 1985; Grief, 1989), and therefore have a bearing on the size of transaction costs associated with any financial arrangement (Williamson, 1985). This is especially evident from the success of PLS financing modes in early Islamic societies when equity (in particular the PLS arrangements) rather than debt financing was the norm (Udovitch, 1981 in Chapra 2007; Kuran 2005)
as family bonds. Confidence between parties in such cases stems from credibility of governance structures (Korczynski, 2000). For PLS financing especially, where banks enter into risk-sharing arrangements, this source of trust is extremely important to sustain a joint liability relationship. With regards to indicators of corruption, both UAE and Bahrain fare better than the other GCC countries. Bahrain ranks highest for the lack of diversion of public funds and UAE ranks highest for lack of irregular payments and bribes, whilst Kuwait is the lowest ranking GCC country for proxies of corruption and state efficacy\(^{127}\) (GCR, 2012). A high rank on indicators of low corruption is a positive sign of the government’s credibility and trust placed in the institutional environment. Where trust in governance structures is lacking, collateralised loans whether conventional or sharia-compliant alternatives e.g. murabahah are naturally preferred.

Finally, where formal institutions are underwritten by a government’s strong commitment to support development of the financial sector, government policies reflect this. Bahrain tops the GCC region for transparency of government policy (GCR, 2012), which supports long term business planning and investment evaluations including the selection of production technologies which are optimal over the long-run. Such an environment is especially conducive for PLS financing, which is better suited to long term projects due to the time diversification effect of equity (Dar et al., 1999).

**The ‘Financial Centre’ Status**

One of the key distinctions between Bahrain, the UAE and other GCC countries is that the former two are regional finance hubs. Bahrain is in fact the “global centre for Islamic finance” (Baba, 2007, p.384). In pursuit of diversifying the sources of national wealth away from oil reserves\(^ {128}\), the Bahraini government worked towards establishing its country as the centre of finance in the Middle East, starting with the offshore banking sector in 1975 and fully embracing Islamic finance in the late 1970s (Baba, 2007). The country is now the regional specialist in finance, with 406 financial institutions, 117 banking institutions (28 retail and 76 wholesale banks); 151 insurance companies and organisations; 61 investment business institutions and 2827 authorised

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\(^{127}\) These include diversion of public funds, irregular payments and bribes and transparency of government policymaking.

\(^{128}\) Bahrain is the lowest ranked country in the GCC for oil reserves. In 2011, Bahrain as a share of the GCC held only 0.5% of the value of hydrocarbon reserves. Source: BP Statistical Review of World Energy 2013 (Global Finance Magazine, 2014) and BP Review of World Energy, QNB Capital Estimates (Zawya, 2012)
funds (Central Bank of Bahrain, 2014). After Bahrain, UAE is the second most concentrated financial centre of the region, with 366 financial institutions including 51 commercial banks and 120 representative offices of foreign banks (Central Bank of UAE, 2014). In the last decade, UAE has moved towards becoming the regions’ finance hub through the establishment of an onshore capital market, the Dubai International Finance Centre (DIFC) in 2002 and has even advanced towards the establishment of Islamic-specific institutions (Baba, 2007). Bahrain nevertheless, remains the world leader in Islamic finance with Bahraini banks ranking highest for soundness in the GCC region\textsuperscript{129} (GCR, 2012).

Moreover, as was highlighted in chapter 3, Bahrain has played a critical role in modernising the regulatory environment for Islamic banking by establishing standard-setting and industry coordination bodies. As illustrated in table 4.11, more than half of the international Islamic infrastructure institutions, created to support the Islamic financial industry, are located in Bahrain.

<table>
<thead>
<tr>
<th><strong>Table 4.11: Islamic Infrastructure Institutions</strong></th>
</tr>
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<tbody>
<tr>
<td><strong>Institution and Year of Establishment</strong></td>
</tr>
<tr>
<td>Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 1991)</td>
</tr>
<tr>
<td>General Council of Islamic Banks and Financial Institutions (CIBAFI, 2001)</td>
</tr>
<tr>
<td>International Islamic Centre for Reconciliation and Commercial Arbitration for Islamic Finance Industry (IICRA, 2005)</td>
</tr>
<tr>
<td>International Islamic Financial Market (IIFM, 2002)</td>
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<tr>
<td>International Islamic Rating Agency (IIRA, 2002)</td>
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<tr>
<td>Islamic Development Bank Group (IDB, 1975)</td>
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<td>Islamic Financial Services Board (IFSB, 2002)</td>
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<tr>
<td>Liquidity Management Centre (LMC, 2002)</td>
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Sources: Iqbal and Molyneux (2005); Iqbal (2007) and Baba (2007) in Handbook of Islamic Banking (Hassan and Lewis, 2007).

The presence of such institutions aimed specifically at supporting Islamic finance is likely to have a positive impact on banks’s propensity to engage in the ideal form of

\textsuperscript{129} The Prudential Information and Regulations for Islamic Banks (PIRI) framework introduced by the Bahrain Monetary Agency in early 2002 covers liquidity management, asset quality and capital adequacy (Iqbal and Molyneux, 2005) whilst AAOIFI reporting standards work to establish greater market discipline through standardised accounting and auditing standard which increases transparency and therefore consumer and investor confidence in the banking sector.
Islamic financing i.e. PLS. Moreover, with 5 of 8 Islamic infrastructure institutions being in Bahrain, the country undoubtedly benefits from institutional complementarity\textsuperscript{130}, which is absent in the other GCC countries. For Islamic banks to undertake PLS financing, a supportive network of institutions is required which lowers costs associated with asymmetric information (Iqbal et al., 1998; Chapra, 2007). In Bahrain, a cluster of supportive legal, accounting and advisory firms specialising in Islamic finance exist, in addition to the Islamic-finance-specific infrastructure institutions mentioned in table 4.11. In UAE as well, an Islamic-finance-specific arbitration avenue, the IICRA has been established to resolve financial and commercial disputes between Islamic banks, their clients and any third parties through reconciliation and arbitration according to the sharia (IICRA, 2013). While litigation on average costs 20\% of the disputed amount, an out-of-court settlement costs approximately 17\% (Iqbal, 2007). By lowering the costs associated with any disputes in PLS arrangements e.g. mudarabah, where the negligence of the entrepreneur needs to be proven so that full financial burden does not fall on Islamic banks, institutions such as IICRA are likely to increase confidence to undertake more complex forms of Islamic financing including PLS compared to the standardised debt-financing contracts\textsuperscript{131}.

Compared to these countries, Kuwait and Qatar do not host any major Islamic finance specific institution. Saudi Arabia, however does host the IDB, however as this institution is aimed specifically at promoting trade and development in the Muslim world, its remit does not focus precisely on supporting Islamic banking institutions (Warde, 2000). Therefore the impact of IDB on banks’ propensity to engage with PLS may not be as strong especially as Saudi Arabia, which is major oil producing state, has not focused on establishing an institutional network for the finance sector which would allow the country to benefit from institutional complementarity as is present in Bahrain and UAE, which hold the ‘financial centre’ status in the GCC region.

\textsuperscript{130} Complementarity refers to the extent to which one institution “enhances the usefulness of another” (Kuran, 2009, p.601-2).

\textsuperscript{131} Although IICRA operates internationally, the uptake of its services is likely to be higher in UAE, where it is headquartered due to the local presence, which is likely to support the provision of PLS financing by local UAE banks
**Tax Policy**

Finally, one of the most influential government policies which directly impact the provision of PLS financing is the tax policy. Disadvantageous tax regimes, where profits are taxed but interest is exempted as a cost item, have been noted as an important reason for Islamic banks to avoid PLS (Baele et al., 2014). The impact of tax can be considerable, as evident from the case of mudarabah companies in Pakistan which grew considerably before the withdrawal of their tax-exempt status in 1992 (Dar et al., 1999). Such policies also intensify agency problems. Entrepreneurs have an incentive to underreport profits, not only from the desire to keep a bigger share, but also due to discriminatory tax treatment. In developing countries where tax evasion is a particularly serious problem, Islamic banks face the problem of receiving a share of profit, calculated using the entrepreneurs’ official financial accounts which are created for tax purposes (Kuran, 1995; Visser, 2009). Elimination of discriminatory tax regimes therefore reduces the competitive advantage debt holds over equity financing. It also reduces incentive to cheat by underreporting profits for tax purposes. As shown in table 4.12, the only two countries in the GCC with a 0% corporate income tax rate are Bahrain and UAE, which is certainly more favourable towards PLS financing than the rates in other GCC countries. Even in countries e.g. Kuwait and Saudi Arabia, where interest is not tax deductible, the rate at which interest is taxed is lower than equity, making debt financing more competitive.\(^{132}\)

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\(^{132}\) Note, that a favourable tax regime alone is not sufficient to induce PLS financing as evident from the experience of Turkey (Kuran, 1995). Such policies work effectively only when embedded in an environment that is supportive of PLS arrangements and overcoming the problems of asymmetric information more broadly. This again highlights the importance that institutional complementarity holds for government policies to have the intended effect.
Given these differences amongst the GCC nations, which as discussed above may be important factors affecting bank’s choice to engage in PLS, it is deemed important to control for country level differences when investigating why some banks have higher PLS-F levels than others.

### 4.6.2 Method: Econometric Modelling

To investigate the variation in PLS-F levels between banks, the random effects model is used in this study. In doing so, the approach proposed by Mundlak (1978) is applied, which extends the random effects model by including means of the individual time-varying independent variables as regressors to avoid the bias introduced by the correlation between the independent variables and the unobserved effects. Mundlak’s approach is commonly used as a “compromise between the fixed and random effects models” (Greene, 2011, p.421). The fixed effects model, which cannot accommodate the estimation of time-invariant regressors, could not be used as several variables of interest in this study (e.g. bank type) are time-invariant. Previous Islamic banking studies which seek to include time-invariant regressors have also adopted the random effects model (see. e.g. Doumpos et al., 2017) and recent conventional banking studies (e.g. Mergaerts and Vennet, 2016) have specifically used the Mundlak’s approach, as it explores both the within and the between dimensions simultaneously. An additional benefit of using the Mundlak’s specification is that it provides an alternative approach for the Hausman test. The statistical significance of the estimated coefficients for the group means, can be used to test if the assumption made by the random-effects

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133 Oil and gas companies are subject to different tax rates

134 Pooled OLS was also initially run however the Breusch and Pagan Lagrangian multiplier (LM) test results (Prob>chi2 = 0.000) supported random effects specification.
estimator (i.e. the observed variables are uncorrelated with the unobserved variables) holds for individual regressors (Greene, 2011; Perales, 2013; Bell and Jones, 2014; Mergaerts and Vennet, 2016).

In practice, the following equation is estimated in this study:

\[ y_{ict} = x'_{ict} \beta + \bar{x}'_{ic} \gamma + \theta_c + \alpha_{ic} + \varepsilon_{ict} \]

where \( y_{ict} \) is the PLS-F level (i.e. PLS financing as percentage of total financing) for bank \( i \) in country \( c \) in year \( t \). \( x'_{ict} \) contains variables capturing bank-specific characteristics, which have been identified from previous literature as potential determinants of PLS financing. These include: Age, measured as the number of years from incorporation of a bank till end of 2012 inclusive\(^{135}\); Size, proxied by the natural logarithm of banks’ total assets measured in 2010 constant US$ billion; Deposit ratio, which is measured as deposits as a percentage of total assets; Convert and CBIW which are dummy variables where Convert takes value 1 if a bank converted from conventional to Islamic banking and CBIW takes value 1 for conventional banks with Islamic window\(^{136}\). The term \( \bar{x}'_{ic} \) includes bank-specific averages of only the time-varying variables over the sample period included in \( x'_{ict} \) (i.e. size and deposit ratio). The within and between parameters for the time-varying variables, size and deposit ratio, are given by \( \hat{\beta} \) and \( (\hat{\beta} + \hat{\gamma}) \) respectively. As noted by Mergaerts and Vennet (2016), this model specification not only accounts for the unobserved heterogeneity and correlation between the explanatory variables (\( x'_{ict} \)) and the unobserved effects (\( \alpha_{ic} \)), but also exploits the cross-sectional dispersion in the data and therefore offers an intuitive interpretation: the within parameters reflect the impact of changes in banks over time while the between parameters reflect the impact of differences across banks.

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\(^{135}\) The year of incorporation is counted as a full year if the bank has been incorporated for full 6 months of that year; otherwise, the following year is taken as the first full year. For Islamic banks that have converted from conventional banking, the year when conversion began is used instead of the year of incorporation, as the latter refers to the establishment of the conventional bank and does not accurately represent the number of years the bank has been operating as an Islamic bank. For ARB, 1987 is used as the year of incorporation in accordance with the information provided in the bank’s annual report.

\(^{136}\) Additional analysis was conducted to examine: 1) the relationship between Sharia Supervisory Board (SSB) members and PLS-F, to examine the influence of certain sharia scholars; and 2) if the geographical reach of a bank’s operations i.e. whether it operates mainly in the domestic or international market (another proxy for size) has an effect on PLS-F levels. No clear relationship was found in either case.
The model also includes, $\theta_c$, which captures differences in the institutional environment across countries, the importance of which has been discussed earlier. How favourable the institutional environment of a country is for PLS is difficult to measure empirically. Although numerical scores indicating the quality of individual institutions e.g. property rights, judicial independence etc. can be gained from sources such as the annual Global Competitiveness Report issued by the World Economic Forum, these reports do not measure the presence and quality of Islamic finance specific institutions created to support the industry. Moreover, the scores for individual institutions do not capture the ‘complementarity’ effect (Kuran, 2009), which as was discussed in chapter 3 and above, has been recognised as a crucial component for promoting PLS. Furthermore, as institutions are slow to develop and change, there are unlikely to be significant changes in the institutional environment of a country within the four-year sample period considered in this study. The Global Competitiveness Reports demonstrate this as there is very little change in the scores issued to the GCC countries over the 2009 – 2012 period\textsuperscript{137}. Including country dummies in the model offers a pragmatic and parsimonious way of capturing differences in the institutional environment across countries including the effect of various (general and Islamic banking specific) institutions, their complementarity, the impact of government policies as well as other macroeconomic conditions\textsuperscript{138}.

Descriptive statistics for the variables included in the estimated model are presented in table 4.13 below.

\textsuperscript{137} See for example Global Competitiveness Report (2012) for comparison between 2012 and 2011 and preceding years’ reports for comparison between earlier years.

\textsuperscript{138} Year dummies are also included to control for any differences across the individual years.
Table 4.13: Descriptive Statistics for Selected Variables by Bank type and Country

<table>
<thead>
<tr>
<th>By Bank Type</th>
<th>PLS-F (%)</th>
<th>Age</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>St Dev</td>
</tr>
<tr>
<td>Islamic</td>
<td>6.12</td>
<td>8.98</td>
</tr>
<tr>
<td>CBIW</td>
<td>1.14</td>
<td>2.24</td>
</tr>
<tr>
<td>All</td>
<td>3.94</td>
<td>7.31</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>By Country</th>
<th>PLS-F (%)</th>
<th>Ln (Total Assets)</th>
<th>Deposit Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>St Dev</td>
<td>Min</td>
</tr>
<tr>
<td>Bahrain</td>
<td>10.34</td>
<td>10.35</td>
<td>0.00</td>
</tr>
<tr>
<td>Kuwait</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Qatar</td>
<td>2.16</td>
<td>3.81</td>
<td>0.00</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>1.94</td>
<td>3.31</td>
<td>0.00</td>
</tr>
<tr>
<td>UAE</td>
<td>3.90</td>
<td>7.80</td>
<td>0.00</td>
</tr>
<tr>
<td>All</td>
<td>3.94</td>
<td>7.31</td>
<td>0.00</td>
</tr>
</tbody>
</table>

As the figures show, Islamic banks on average have higher PLS-F than conventional banks with Islamic windows (CBIWs) however there is also greater variation in the former than the latter. Islamic banks are also younger but smaller in size and have lower deposit ratio than CBIWs. There is also a notable difference in PLS-F levels across countries. Bahrain has the highest average PLS-F (10.34%) while Kuwait’s average PLS-F is zero. Saudi banks are on average the oldest banks while Kuwaiti banks are the youngest. The average age for banks in the sample is 22 years however there is considerable variation as the youngest banks in the sample are 1 year old compared to the oldest which is 55 years. On average Bahraini and Kuwaiti banks are the smallest while Saudi banks are the largest and also have the highest average deposit ratio. The lowest variation in deposit ratio is amongst UAE banks and the greatest variation is amongst the Qatari banks. Only UAE and Saudi banks have higher than average deposit...
ratios. Finally, as none of the Kuwaiti banks engage in PLS financing (PLS-F is zero for this country), Kuwait is selected as the reference case (excluded country) during the estimation. Results are presented and discussed below.

4.6.3 Results from the Econometric Analysis

Table 4.14 presents the regression results. Firstly, as the table shows, both coefficients for the group means (mean size and mean deposit ratio) are not statistically significant. Test of joint significance also yield consistent results (p = 0.1856). Recall from the preceding section, that the significance test for the estimated coefficients on the group means is an alternative to the Hausman test for the consistency of the random effects estimation (Greene, 2011; Perales, 2013; Bell and Jones, 2014). In this case, results confirm that the assumption made by the random-effects estimator hold for the individual regressors.

As the table shows, there is no strong evidence in support of the ‘(controversial) means to an (Islamic) end’ argument, noted in prior literature (Ahmad, 1993; Khan, 1995; Usmani, 2004; Rehman, 2010; Warde, 2010). While the estimated coefficient on age is positive, suggesting that PLS-F increases with bank age, it is not statistically significant. The estimated coefficient for size however is negative and significant at the 5% level. As explained earlier, the within and between parameters for the time-varying variables are given by $\hat{\beta}$ and $(\hat{\beta} + \hat{\gamma})$ respectively. Therefore the within effect amounts to -5.61 while the between effect is smaller at -1.75. Nevertheless, as both are negative, results suggest that as the size of a bank increases, its PLS-F decreases and larger banks have lower PLS-F levels than smaller ones. This finding supports the proposition presented in earlier literature that there may be diseconomies of scale in the provision of PLS financing (see e.g. Čihak and Hesse, 2008; Visser, 2009). These results are also consistent with the findings of Aggarwal and Yousef (2000) who found in an international sample of Islamic banks, that the financing portfolio of larger banks is skewed more towards murabahah (non-PLS) than smaller banks.

Table 4.14 also shows that there is a positive relationship between PLS-F and deposit ratio. The within parameter (0.25) is highly significant, indicating that an increase in deposit ratio within a bank leads to an increase in its PLS-F level. The impact of higher deposit ratio between banks is not as large, as the between parameter amounts to 0.12. Nevertheless, the impact on PLS-F is still positive. This finding is at odds with the
Table 4.14 Determinants of PLS-F: Results from Mundlak (1978) Estimation

<table>
<thead>
<tr>
<th>Dependent Variable: PLS-F</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>P Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td>0.11</td>
<td>0.073</td>
<td>0.125</td>
</tr>
<tr>
<td>Size (Ln Total Assets)</td>
<td>-5.61**</td>
<td>2.410</td>
<td>0.020</td>
</tr>
<tr>
<td>Deposit Ratio</td>
<td>0.25***</td>
<td>0.067</td>
<td>0.000</td>
</tr>
<tr>
<td>Converted</td>
<td>-6.23*</td>
<td>3.248</td>
<td>0.055</td>
</tr>
<tr>
<td>CBIW</td>
<td>-6.33***</td>
<td>2.378</td>
<td>0.008</td>
</tr>
<tr>
<td>Bahrain</td>
<td>10.12***</td>
<td>3.382</td>
<td>0.003</td>
</tr>
<tr>
<td>Qatar</td>
<td>2.52</td>
<td>3.487</td>
<td>0.469</td>
</tr>
<tr>
<td>Saudi</td>
<td>3.24</td>
<td>3.376</td>
<td>0.337</td>
</tr>
<tr>
<td>UAE</td>
<td>5.37*</td>
<td>3.198</td>
<td>0.093</td>
</tr>
<tr>
<td>Mean Size (Ln Total Assets)</td>
<td>3.86</td>
<td>2.572</td>
<td>0.133</td>
</tr>
<tr>
<td>Mean Deposit Ratio</td>
<td>-0.13</td>
<td>0.090</td>
<td>0.152</td>
</tr>
<tr>
<td>Constant</td>
<td>-3.03</td>
<td>4.259</td>
<td>0.477</td>
</tr>
</tbody>
</table>

Observations: 147
Number of Banks: 41
Wald Chi sq.: 53.3
Prob > chi sq.: 0.000
R squared (within): 0.1352
R squared (between): 0.5343
R squared (overall): 0.4894

The model is estimated using the Mundlak (1978) estimator. Kuwait is the excluded country. Estimations use year dummies to control for any differences across the individual years. Standard errors in parentheses are clustered at the bank level. *, **, *** represent significance at the 10%, 5% and 1% respectively.

...theoretical proposition put forth by Azmat et al. (2015), who postulate that a higher reliance on depositor funds will be associated with lower PLS financing due to depositors’ risk aversion and potential withdrawal risk faced by Islamic banks. Empirical evidence from this study however shows that once bank size, age, type and country effects have been controlled, there is a positive and significant relationship between a higher deposit ratio and PLS financing. This could simply be because depositors’ funds are a cheap source of finance for banks compared to genuine PLS (equity) capital, as banks pay no return on current accounts (Visser, 2009) and do not in practice follow a PLS arrangement with investment account holders (Warde, 2000; Zaher and Hassan, 2001; El-Hawary et al., 2007; Visser, 2009; Khan 2010). Given the higher risks associated with PLS financing, Islamic banks are expected to charge a...
premium on PLS financing contracts which, would suggest that the higher returns earned through PLS arrangements, would accrue (almost) entirely to the bank, encouraging them to undertake PLS financing contracts using depositors’ fund.

Turning now to the control variables, as the results show, converted Islamic banks and conventional banks with Islamic windows, on average, have 6% lower PLS-F value than full-fledged Islamic banks. The relationship between conversion and PLS-F is therefore indicative of strategic behaviour whereby converting to Islamic banking appears to be a tactical decision on part of conventional banks in the GCC to enter the increasingly important Islamic banking market in their region. By relying on non-PLS financing, which mimic conventional loans, these converted banks have adopted an ‘Islamic’ identity while keeping their operations fundamentally the same. Similarly, as conventional banks with Islamic windows have lower PLS-F levels, results also support Kuran (2004)’s position which contends that the provision of Islamic banking services has been a profit-motivated opportunity taken up by conventional banks to enter a growing market in their region, and therefore these banks, on average, favour low-risk non-PLS alternatives to PLS financing.

Finally, as table 4.14 shows, country effects are highly significant. Relative to Kuwait (the reference country), banks in Bahrain have on average 10% higher PLS-F values while banks in UAE have 5% higher PLS-F. These are both statistically significant, the former at 1% and the latter at 10% level of significance. Although, the coefficients are positive for both Qatar and Saudi, these are not statistically significant. These findings therefore suggest that operating in Bahrain and UAE results in higher PLS-F levels than other countries. As discussed earlier, there are notable differences between these two countries especially Bahrain and the other GCC nations, in terms of their institutional environment being more favourable towards the finance sector in general and Islamic finance in particular. The significant and positive effect attached to Bahrain and UAE can therefore be attributed to the supportive institutional environment that these countries offer. In particular, Bahrain undoubtedly benefits from institutional complementarity, having created an environment conducive for Islamic financing, through hosting a cluster of Islamic infrastructure institutions geared to support the Islamic finance industry (noted earlier in table 4.11), and a nexus of legal, accounting and advisory firms specialising in Islamic finance, which are absent in the other GCC nations. Strong collective institutions create the environment for higher system trust.
(Korczynski, 2000) which reduces agency problems and associated costs, making PLS a more competitive financing option relative to debt (Iqbal et al., 1998; Chapra, 2007).

Given the well-developed financial infrastructure, supportive institutions and government policies e.g. non-discriminatory tax regimes, the transaction costs associated with PLS financing are likely to be lower in Bahrain and to some extent UAE. Of course, no single factor can explain the higher adoption of PLS financing in some countries or banks over others and variation in PLS-F is likely to be a consequence of a combination of external factors and bank-specific internal factors such as strategic choices. Nevertheless, to the extent that formal institutions including property rights and state efficacy foster trust and reduce costs associated with asymmetric information, cluster of specialised institutions generate complementarity and impartial tax policies reduce the competitive advantage debt holds over equity financing, these result suggest the institutional environment matters for PLS financing and thus helps in explaining the systematic differences in PLS-F levels across banks in the GCC countries.

Finally, in evaluating the model, the overall r-squared suggests that the model performs fairly well (r-squared 0.50). The difference in the within and between r-squared however does indicate that the model performs relatively better in explaining differences in PLS-F between banks (r-squared 0.53) as opposed to within banks (r-squared 0.16). This is somewhat expected as most of the regressors are time-invariant and the focus of this study is on identifying why PLS levels differ between banks, as opposed to a focus on within bank changes. It is also likely that differences in PLS-F levels arising within banks as well as between different banks operating within a single country are driven by strategic choices, which need further research to be studied thoroughly. Future research should therefore consider expanding the sample period to examine within-bank variation in PLS-F and consider primary sources of data e.g. interviews with bank management to gauge the impact of bank-specific strategies on the adoption of PLS financing.

4.7 Conclusion

The Islamic banking industry has been subject to serious criticism, to the extent that many academics have dismissed the entire industry as “indistinguishable” from
conventional banking (Aggarwal and Yousef, 2000; Zaman and Movassaghi, 2002; Kuran, 2004; El-Gamal, 2006; Chong and Liu, 2009; Khan, 2010, p.805; Beck et al., 2013). Lack of profit-and-loss-sharing (PLS) financing and the nature of non-PLS financial instruments which dominate the industry are at the core of this criticism. By dismissing the entire industry, the current literature implicitly implies that all Islamic banks are equally unIslamic and that the industry comprises of a homogeneous group of banks, with equally negligible levels of PLS financing.

This chapter has investigated this issue in three parts. First, two measures of PLS have been used to assess and compare Islamic banks, Islamic windows and conventional banks. Using cross-sectional data initially, this chapter showed that there is significant heterogeneity in PLS levels existing within the Islamic banking industry. This chapter summarised this in form of a typology, identifying three broad but distinct groups of Islamic banks. In the second part, cluster analysis is applied to a pooled dataset covering 2009 – 2012 period, to validate the typology identified. As the results showed, the presence of three groups is verified and group membership is found to be extremely stable. As this chapter discussed, empirical evidence shows that Islamic banks follow different business models with regards to the PLS principle and therefore the industry can be seen as comprising of different strategic groups, where each group has adopted a distinct position on the adoption and implementation of the PLS principle. While some Islamic banks operate as quasi-conventional banks, focusing entirely on non-PLS financing contracts and only follow the PLS principle through holding PLS investments, others adopt a very different position. PLS-oriented banks for example hold substantial portions of their financing portfolio in the form of ‘ideal’ musharakah and mudarabah contracts, despite the higher transaction costs associated with PLS financing, while hybrid banks operate in between these two extremes.

Thus, comparison of Islamic and conventional banks confirms that while some Islamic banks are genuinely indistinguishable from conventional counterparts and in some cases even less PLS-oriented, others are notably different. The highest ranking Islamic bank for example holds over 50% of its financing and investment assets in PLS form. As the chapter showed, the assumption that the Islamic banking industry comprises of a homogeneous group of banks that are all indistinguishable from conventional counterparts is empirically invalid. As some Islamic banks follow a more PLS oriented business model, these can indeed be considered more Islamic than others.
The final part of the chapter examined the question: why do some banks have higher levels of PLS financing than others? Mundlak (1978)’s approach was used to estimate the relationship between PLS financing and factors identified from the literature as its potential determinants. Results showed that there is some support to suggest that diseconomies of scale exist in the provision of PLS financing as the size of a bank and PLS financing levels are negatively related. Contrary to the proposition posed in prior literature, a positive relationship is found between deposit ratio and PLS financing. Most importantly, results from this study illustrate clear cross-country variation in PLS levels within the GCC region, suggesting that the institutional environment matters in enabling adherence to religious principles, by lowering transaction costs incurred in PLS financing.

Given that PLS financing is considered to be the raison d’être of Islamic banking (Chapra, 2007), it is important that the industry moves closer to this equity-based model of financial intermediation. To increase levels of PLS financing in Islamic banks, reforms in Muslim counties need to “involve clusters of institutional changes” (Kuran, 2009 p.602) in order to mitigate agency problems associated with PLS, as well as a change in attitude towards equity financing. Thus far, the partial reforms and general focus on creating markets for Islamic finance, e.g. secondary markets to trade Islamic financial instruments including and especially sukuk, as opposed to changing the underlying financial system in favour of equity rather than debt, has resulted in transaction costs associated with PLS remaining prohibitively high in most Muslim countries. This study confirms that where a supportive environment exists, PLS financing can be a viable option for at least some Islamic banks.

Major institutional reforms however can take a long period to materialise. Therefore to increase the use of PLS financing, in the short run Islamic banks can use performance-related profit-sharing ratios. A sliding scale mechanism, where the profit share is a function of the observed costs of the financed project, can help mitigate agency problems associated with PLS financing (see e.g. Burns et al., 1998). Under such a scheme, if entrepreneurs are able to choose from a published scale of cost-contingent-profit-shares accruing to the bank, then efficient entrepreneurs will be able to choose a low cost projection and a low cost-contingent-profit-share for the bank, subject to the condition that failure to keep this low cost projection results in the profit share accruing...
to the bank increasing up to 100%. By doing so, efficient entrepreneurs can signal their quality to the Islamic banks in the same way as signalling in the job market (Spence, 1973) and the use of retained equity levels by owners in initial public offerings (Leland and Pyle, 1977) reducing the adverse selection problem. Such an arrangement also increases the incentive to keep costs under control and reduces moral hazard as gains from higher productive and allocative efficiency accrue to the entrepreneur through a higher share of the profit.

Another interim solution to increasing PLS financing levels in Islamic banks is to adopt a full two-tier-mudarabah model through the Islamic window avenue. Given the incompatibility discussed earlier in Chapter 3, a pure two-tier mudarabah model cannot fulfil the roles of commercial banks; however, Islamic banks can within the existing banking model incorporate a pure PLS window which operates on the two-tier mudarabah basis, and thus benefit from the ability to hold a diversified portfolio, utilise the resource capital of the parent bank to reduce cost of PLS financing and possibly overcome the lack of a supportive environment.

Finally, a notable observation from the balance sheet analysis conducted in this study is that while PLS financing exists on the asset side in some Islamic banks, evidence of actual PLS arrangements on the liability side do not exist. Investment accounts which in theory represent the risk-sharing liability side of the two-tier model in practice operate on fixed return basis. Lack of PLS on the liability side of the balance sheet suggests that Islamic banks consider PLS with depositors’ to be an even greater challenge than PLS financing on the asset side. This can be due to the regulatory system requiring guaranteed capital sums in all deposit accounts, pressure to provide fixed and stable competitive returns or simply due to Islamic banks underestimating depositor risk appetite. While a significant proportion of the population may only seek safekeeping and transaction services and prefer low risk fixed return, depositors with varying risk-return preferences exist in all societies\(^\text{139}\). By offering the option to depositors between actual PLS-based investment accounts and fixed return accounts, Islamic banks can

\(^{139}\) As stated earlier some banks report restricted investment accounts as off-balance-sheet activity. If these funds are managed purely on PLS basis (due to insufficient details in banks’ annual reports it cannot be unequivocally said that these are operating on risk-sharing basis), then there is certainly evidence to suggest that demand for PLS-based deposits exists. Through a PLS window operation, such funds can be reported on balance sheet which would lead to greater transparency in Islamic banks operations and management of PLS funds on the liability side.
benefit from matching the PLS asset and liability risk and maturity profiles on their PLS window operations and realise the stability and efficiency gains of PLS banking model advocated by Islamic economists (Siddiqui, 1983a,b; Chapra 1985; Khan 1995; Ahmed, 2002; Iqbal and Molyneux, 2005), and operate closer to the spirit of sharia. Such hybrid banking structures which conform to both the conventional banking practices and PLS mechanisms are a requirement of the environment in which Islamic banks operate. As El-Gamal (1997, 1998) concludes in a heterogeneous environment with banks operating on PLS and interest basis, “a critical initial mass” (p.1) of banks providing debt and equity financing is necessary to ensure not only the survival of PLS institutions but also the efficiency of PLS mechanisms.

For Islamic banks to move forward towards greater use PLS arrangements on both asset and liability side, in addition to significant institutional and regulatory changes, Islamic banks need to consider more innovate ways to mitigate the agency problems associated with PLS schemes, some of which are mentioned above. If however, the international Islamic banking industry continues down its current path of growth and development through sharia arbitrage, it will remain no more than an inefficient replication of the conventional banking system (El-Gamal, 2006) gaining legitimacy through a false Islamic identity as opposed to substantial differences in financial arrangements that operate according to the spirit of sharia.

Limitations and Implications for Future Research

This study has focused on the GCC region and used data over the 2009 – 2012 period to study variation in PLS levels between Islamic banks and conventional banks with and without Islamic windows. Two useful extensions to this work would be to, firstly, extend the sample period and consider changes in PLS levels in both Islamic and conventional banks over a longer period of time and secondly to extend the sample to include non-GCC countries.

Additionally, this study focuses on the PLS principle which is a direct implication of the riba prohibition. Performance with regards to the other two prohibitions mentioned in chapter 2, i.e. gharar (excessive/avoidable risk and uncertainty) and haram (religiously prohibited) activities, such as financing of illicit industries has not been measured in this work, primarily due to the difficulty of operationalising these prohibitions and finding objective measures. Gharar for example refers to clarity in
contracts and also translates into the principle of materiality for financial transactions. Judging adherence to such principle requires access to internal documents of the banks which are not readily available. Furthermore, there exists no external audit to judge if Islamic banks comply with the ‘no haram activities’ principle (Khan 2010), therefore performance of Islamic banks on this issue is also difficult to assess. Consequently, this study only uses one, albeit a key principle of Islamic banking (PLS) which can be measured objectively through financial (quantitative) data that is widely available. However, this choice does admittedly limit the dimensions of sharia principles on which banks are assessed. Future studies may explore how to overcome the aforementioned problems in creating a multi-dimensional (quantifiable) measure to assess Islamic banks.

Furthermore, future studies can build on this work by examining additional determinants of PLS financing and considering the use of qualitative data such as interviews with Islamic bank and windows managers to better understand the reasons for variation in PLS levels between and within banks over time. Although qualitative data is more resource and time consuming, which may limit sample size, it can provide additional insights into why variation in PLS-F levels exists between banks, complementing results from this work and possibly even reveal if bank managements’ religious preferences affects choice of financial instruments.

**Contributions**

Despite the above mentioned limitations, this study makes important contributions to the Islamic banking literature. This is the first study which uses two measures of PLS to investigate variation in PLS levels between Islamic banks. It is also the first study to measure PLS levels for conventional banks with and without Islamic windows and compare these with Islamic banks. Furthermore, to the best of my knowledge this is also the first study which has applied cluster analysis to identify if distinct (strategic) groups exist in the Islamic banking industry. By doing so, this study provides empirical evidence to demonstrate that the Islamic banking industry does not comprise of a homogeneous group of banks contrary to the implicit assumption made in the current literature. Furthermore, while the previous literature has focused on identifying the reasons for lack of PLS financing in Islamic banking industry, this is the first study which investigates and identifies what factors enable the provision of PLS financing
and illustrates the importance of institutional environment as an enabling factor to promote PLS financing.

Chapter 5 will now consider the social aspect of Islamic banking and focus in particular on overcoming the challenges associated with comparing Islamic and conventional banks’ corporate social performance.
Chapter 5

On Comparing the Corporate Social Performance of Islamic and Conventional Banks: Addressing the Methodological Issues

5.1 Introduction

Islamic banks are “expected to be more socially responsible than their conventional counterparts” (Haniffa and Hudaib, 2007, p.101). This expectation stems from the industry’s claim of providing banking services in accordance with the sharia which, as explained in chapter 2, not only includes law but at its core is concerned with maintaining high ethical standards (Janin and Kahlmeyer, 2007, p.31). To be fully compliant with the sharia, Islamic banks need to not only abide by the rules regulating construction of financial arrangements (e.g. avoid riba) but also act in accordance with Islamic ethics as enshrined in the sharia\(^{140}\) (Chapra, 1985). Prior studies have discussed the implications of Islamic ethics for business (Rice, 1999); accounting and social accountability (Baydoun and Willets, 2000; Lewis, 2001); environmental reporting (Kamla et al., 2006); marketing ethics (Saeed et al., 2001) and established consensus with international standards over the idea of socially responsible business\(^{141}\) (Abu-Tapanjeh, 2009; Williams and Zinkin, 2010). Broadly, prior literature confirms that Islamic ethics and the concept of corporate social responsibility (CSR) is congruent (see Aribi and Arun, 2015 for a recent discussion).

Despite this conclusion, as yet there has been no direct comparison of Islamic and conventional banks’ social performance to assess if the abovementioned expectation has been met in reality. This gap in the literature can be appreciated in light of the

\(^{140}\) Discussion of the philosophical principles underlying the concept of Islamic business ethics is beyond the scope of this thesis. Interested readers should consult Rice (1999) and Beekun and Badawi (2005) for a discussion.

\(^{141}\) Williams and Zinkin (2010) for example have found consensus between the tenets of sharia and the Ten Principles of responsible business laid out in the UN Global Compact, whilst Abu-Tapanjeh (2009) found similar stakeholder focus between the corporate governance model based on Islamic teachings and the principles proposed by the Organisation of Economic Co-operation and Development (OECD).
challenges that such a comparison presents. Firstly, a meaningful comparison between Islamic and conventional banks requires that a single research instrument is used to assess and compare the two industries. The current Islamic banking literature, despite acknowledging similarities between Islamic and secularly defined CSR, also asserts that a category of CSR is ‘particular’ to Islamic banks, required of them to demonstrate sharia compliance and fulfilment of sharia’s moral obligations (Belal et al., 2015). The presence of such a ‘particular’, religion-specific category essentially implies that CSR for Islamic and conventional banks are incommensurable\(^{142}\) and therefore incomparable. Given this, how can Islamic and conventional banks’ social performance be compared?

Secondly, even if a valid comparison could be drawn, the challenge of measuring corporate social performance still remains. Corporate social performance (CSP) is a concept closely related to CSR (Orlitzky et al., 2011) as it refers to the ‘the outcomes and actions resulting from a firms’ socially responsible behaviour’ (Wood, 1991; van der Laan et al., 2008; Ioannou and Serafeim, 2012). In the conventional CSR literature, ethical ratings issued by rating agencies such as KLD\(^ {143}\) are often used as a measure of an organisation’s CSP. For Islamic banks however, such third-party ethical ratings do not yet exist. Instead research on CSR in Islamic banking literature is largely normative and analytical as oppose to empirical (Farook et al., 2011). Importantly, the limited number of empirical studies which exist focus on measuring and analysing the volume, presence and/or type of social disclosure (e.g. positive/negative disclosure) in Islamic banks’ annual reports, often against a predetermined benchmark disclosure index, to understand Islamic banks reporting behaviour, as opposed to examining and comparing social performance (see e.g. Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2011; Kamla and Rammal, 2013; Aribi and Arun, 2015; Belal et al., 2015). A research instrument which measures and compares Islamic and conventional banks’ CSP therefore needs to be constructed.

\(^{142}\) The term incommensurable refers to something that cannot be judged by the same standard or does not have common standard of measurement

\(^{143}\) Kinder, Lydenberg, Domini Research & Analytics (KLD) is a leading ethical rating agency. It rates companies’ social performance using a rating criteria based on the company’s strengths and concerns against seven qualitative screens, each one focusing on a particular social indicator. These seven areas include: community, corporate governance, diversity, employee relations, environment, human rights and product quality and safety.
The purpose of this chapter is to construct a CSP Index which can be used to assess and compare the CSP of Islamic and conventional banks. In constructing this index, the first issue this chapter addresses is the assumption of religion-specific CSR being particular to Islamic banking. Section 5.2 first discusses the conceptualisation of CSR to illustrate that CSR is a concept embedded within a social context. It then presents the case, refuting the universal/particular categorisation propagated in the Islamic banking literature followed by the theoretical framework underpinning CSR. This section illustrates that the idea that CSR activities derived from religious norms of a society will be applicable only to a group of institutions (i.e. Islamic banks) but not others that also operate in the same environment, is inconsistent with both the conceptual and theoretical basis of CSR. This chapter therefore proposes that the assumed incommensurability problem can be overcome by selecting an appropriate context within which Islamic and conventional banks can be compared.

Section 5.3 then looks at the issue of measuring CSP. It begins by providing an explicit definition of CSP and identifies a suitable analytical framework. It then reviews CSP measures used in prior literature and finally presents the approach adopted in this thesis to assess and measure CSP. Section 5.4 describes the data and explains how the CSP index is constructed using content analysis. This is followed by a brief description of the CSP index, which comprises of 6 dimensions and 25 social performance indicators (SPIs). Section 5.5 illustrates which SPIs are present and absent in Islamic and conventional banking industries and provides a brief explanation. This section provides further empirical evidence showing that the assumption of religion-specific CSR category being ‘particular’ to Islamic banks is invalid. It shows that it is not the entire category but a single SPI which can be considered specific to Islamic banking and draws parallel with PLS financing discussed in chapter 4. Finally, section 5.6 concludes the chapter.

5.2 Addressing the Assumed Incommensurability Problem

5.2.1 Understanding Corporate Social Responsibility (CSR)
The 4-part model proposed by Carroll (1979) is one of the most widely cited and highly influential conceptualisations of CSR. It is also specifically relevant for the Islamic banking context as will be illustrated below. According to Carroll (1979, p.500) “the
social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time”. This conceptualisation offers three important insights into CSR. Firstly, it highlights that the social responsibility of businesses extends beyond the economic and legal duties. For businesses, economic and social concerns cannot be considered separate domains, as they both form the different components of a business’ overall social responsibility. As all businesses recognise their economic duties to remain profitable as a key objective, and acknowledge the need to operate within the bounds of law, more recent definitions of CSR have built on Carroll’s 4-part model and focused on the ethical and discretionary responsibilities. Accordingly, CSR has been defined more specifically as corporate practices aimed at improving on the social and environmental standards required by law; such that a de facto adoption of these shifts the focus of corporate goals away from shareholder primacy towards satisfying a broader stakeholder base (see e.g. McWilliams and Siegel, 2006).

Secondly and more importantly, Carroll’s conceptualisation indicates that it is societal expectations which define what constitutes as CSR. These expectations are understandably driven by societal norms and values which are affected by local culture including religious beliefs; differences in which can lead to variations in how CSR is actually constructed in different societies. As cross cultural differences can be significant, it is recognised that CSR does not always mean the same thing to everyone (van Marrewijk, 2003).

Finally, Carroll’s conceptualisation also suggests that CSR is not static as it reflects the expectations society has at any given time. As societal values change so do the expectations held of businesses. There also exists the possibility that expectations may move from one category to another, e.g. over time ethical expectations can become legal expectations once codified in law (Carroll, 1979). From this conceptualisation, one can appreciate the basic notion underlying CSR is that society and business are not separate entities instead they are interwoven such that the former dictates what is considered appropriate business behaviour at any given time (Wood, 1991).

Now, consider this definition within the context of Muslim countries, where Islam is the predominant religion and has significant influence on societal norms e.g. regarding community-based religious rituals and celebration of religious festivals. In such a
5.2.2 Refuting the Universal/Particular CSR Categorisation

An important source defining the CSR expectations for present-day Islamic banks is the ‘Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions’ (IFIs)\textsuperscript{144} Standard, (henceforth the CSR standard), issued by the international standard-setting body, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The CSR standard provides guidance on the nature of disclosure that Islamic financial institutions (IFIs) should provide regarding their CSR activities. Interestingly, the definition of CSR adopted by AAOIFI builds directly on Carroll (1979) as it reads, the “Corporate Social Responsibility (CSR) for IFIs refers to all activities carried out by an IFI to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions” (Governance Standard No.7, AAOIFI, 2010, p.71).

This definition illustrates explicitly that the concept of CSR as broadly understood in the western/secular world and AAOIFI as a representative body of the Islamic finance industry is overlapping. Thus, for practical purposes of engaging in and reporting on CSR, it appears that there is consensus over the notion and categories of social responsibilities of Islamic banks and non-Islamic banking organisations, with the only difference relating to the addition of religious responsibilities applying to the former.

Such a conclusion can also be drawn from the work of Belal et al. (2015), in which an ethical reporting index, comprising of 149 items is divided into ‘universal’ and ‘particular’ categories. The former comprises of ethical reporting items related to

\textsuperscript{144} The CSR Standard on ‘Corporate Social Responsibility and Disclosure for Islamic Financial institutions’ (IFIs) was adopted by AAOIFI in April 2009 and made effective from 1\textsuperscript{st} January 2010. This standard not only specifies the CSR expectations held of Islamic banks but also provides guidance on the nature of expected and recommended CSR disclosure to be made by IFIs. The standard classifies certain categories of CSR disclosure to be mandatory for all Islamic banks regardless of size and others to be recommended i.e. applicable only to those IFIs which have the capability to carry out the additional recommended social activities (Governance Standard No.7, AAOIFI). In line with recent CSR definitions, AAOIFI standard covers only the religious, ethical and discretionary categories i.e. does not include economic and legal categories.
community, customers, employees, environment and governance issues, as recommended by international CSR and governance initiatives. The latter comprises of “items that are specifically required from IFIs due to their moral obligations and shariah compliance requirements” (p.771). This includes reporting items related to zakah, Sharia Supervisory Board, qard hasan, policy to deal with insolvent clients and amount of unlawful income145, amongst others. Building on their categorisation, other studies such as Mallin et al. (2014) also divide their CSR index into universal and particular categories, with the latter “consisting of CSR items relating purely to Shari’ah principles” (p.25). Similarly, Platonova et al. (2016) state that of the six dimensions in their CSR disclosure index, the ‘zakah, charity and benevolent funds’ “dimension is specific to Islamic banking; however, the other five dimensions of social responsibility are also applicable to the conventional banking industry” (p.8).

Although, it may appear reasonable at first, this universal/particular categorisation is based on two incorrect propositions: first, the assumption that all sharia-related issues are specifically required only of IFIs and second, that reporting items within the particular category are applicable to all IFIs. To understand this, consider Belal et al. (2015)’s particular category, which is the most diverse of the three studies cited above. This covers a variety of issues e.g. sharia laws (e.g. zakah) as well as industry-specific regulations/governance (e.g. Sharia Supervisory Boards (SSB)). Consider the issue of zakah. In Saudi Arabia, zakah reporting is mandated by state law, therefore all non-Islamic banking organisations as well as Islamic banks report on and pay zakah (Kamla, 2007). Second, note that SSBs do not exist in Iran as the central bank monitors and guarantees sharia compliance of the entire banking system (van Greuning and Iqbal, 2008). Issues related to SSB’s are therefore not applicable to Iranian IFIs. Thus, neither are all issues in the particular category specific to IFIs nor are they applicable to all IFIs. Both these issues also apply to Mallin et al. (2014)’s CSR index.

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145 Islamic banks cannot earn through engaging in haram industries or transactions that are not sharia compliant. Where in the course of business while dealing with non-Islamic banks, arrangements that are not sharia compliant are made, any income arising from such arrangements are required to be given to charity as a way of purifying the income that will be disbursed to the shareholders. Islamic banks can also not use the income generated from charges put on late repayments (as that amounts to riba). To avoid moral hazard problems, banks have been permitted by sharia scholars to charge such a fixed fee, which is then given to charity.
Consider next, Platonova et al. (2016)’s dimension ‘zakah, charity and benevolent funds’. While it can be understood that zakah and benevolent funds (referring to qard hasan) are specifically derived from Islamic principles, charity is not a uniquely Islamic concept. Conventional institutions engage in charitable donations throughout the world. Simply referring to the concept of charity using the Arabic word ‘sadaqa’ does not make it specific to Islam or Islamic banking. Thus, the claim that this dimension is specific to Islamic banking is clearly erroneous.

The primary problem with the universal/particular categorisation is that, by creating such a dichotomy, the abovementioned studies explicitly assume that all elements within the ‘particular’ categories are specific and thus applicable to all and only to IFIs, which as illustrated above is not valid in reality. Of course, certain individual items may be particular to Islamic banking. However to assert that an entire category of CSR is particular to Islamic banking presents a problem when Islamic and conventional banks are to be compared. Aribi and Gao (2010) is a case in point, that works on the premise of particular CSR category. Looking to compare the level and extent of social disclosure produced by Islamic and conventional banks in the Gulf Cooperation Council (GCC), the authors compare the two industries only on the ‘universal’ subset of CSR issues. They do not investigate if conventional banks also provide any disclosure on the ‘particular’ CSR issues such as zakah, stating that “these disclosures merely relate to the religious practice and ensure that the IFIs discharge the Islamic concept of accountability; this has nothing to do with the business of CFIs [conventional financial institutions]” (p.85). In doing so, Aribi and Gao (2010) simply assume that religion-specific CSR issues are irrelevant for conventional banks, despite the sample being limited to the GCC, which includes Saudi Arabia that has codified zakah in law.

Contrast this with the findings from Kamla (2007) and Thibos and Gillespie (2011), which examine social reporting in companies from different sectors operating in the Arab Middle East. In addition to noting the zakah law in Saudi Arabia, Kamla (2007) finds that institutions from non-Islamic banking industry provided disclosure reflecting the influence of Islam on their activities e.g. a telecommunication company released special packages to assist the Hajj146 pilgrims. Thibos and Gillespie (2011) find that

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146 Hajj is the annual pilgrimage to Makkah that all Muslims are obligated to perform at least once in their lifetime, if their health permits and they can afford it.
conventional banks in the GCC support their employees for performing the umrah (the lesser voluntary pilgrimage to Makkah), while other an oil company provided free iftar (evening meals) to the local communities and workers during the fasting month of Ramadan. In explaining its findings, Kamla (2007) explains that Islam continues to have a “major impact on life and culture in Modern Middle East”. The voluntary disclosure on abiding by Islamic teachings and rules as well as incorporating Islamic values in business activities by companies which do not explicitly market themselves as Islamic is “a company’s way of portraying themselves as ‘good citizens’ in the Arab community, where religion and the teachings of Islam have a big influence on people’s everyday lives” (p.131).

Although highly relevant, these findings have been overlooked by Belal et al. (2015) that propagate the universal/particular categorisation of CSR as well as Mallin et al. (2014) and Platonova et al. (2016) that follow Belal et al. (2015)’s classification. Furthermore, these studies have also overlooked implications drawn from the most pertinent CSR theories discussed below.

5.2.3 Theoretical Framework
Organisations may engage in CSR for a multitude of different reasons. Reflecting this, a variety of different CSR theories have been developed. The social-political theories of CSR however, in particular, legitimacy theory and stakeholder theory have been known to provide the more insightful and interesting theoretical perspectives, and therefore have informed much of the penetrating analysis of CSR in the extant literature (Gray et al., 1995a). In addition to these, institutional theory has also been increasingly applied to explain CSR behaviour in more recent studies particularly those studying cross-national variations (Jackson and Apostolakou, 2010; Brammer et al., 2012). Although separate in their own right, these three theories are interrelated as they have been developed from a similar philosophical basis and thus are considered complementary, each one providing slightly distinct insights into CSR behaviour. As Gray et al. (1995a) note, CSR is too complex a phenomenon to be explained through the lens of a single theory. Adopting a multi-theoretical approach is therefore beneficial, as compatible interpretations of evidence can be made from different theoretical perspectives, enabling a better understanding and explanation of corporate behaviour with regards to CSR (Gray et al., 1995a; Deegan, 2002; Islam and Deegan, 2008). Accordingly, all
three, legitimacy, stakeholder and institutional theory are integrated in the theoretical framework presented here. Importantly, from these theoretical perspectives business organisations are assumed to have an influence on and are influenced by the society within which they operate (Gray et al., 1996; Deegan, 2002; Islam and Deegan, 2008). This perspective can help understand why in certain societies such as the GCC, conventional banks can also be expected to undertake and report on CSR which is related specifically to the religion of Islam and therefore justify the use of a single research instrument to compare Islamic and conventional banks’ CSP as in this thesis.

Essentially, political economy is “the social, political and economic framework within which human life takes place” (Gray et al., 1996, p.47). Central to the political economy and legitimacy theory is the idea that politics, society and economics are inseparable. The economic domain cannot be meaningfully studied and therefore should not be investigated in isolation from the social, political and institutional framework within which the economic transactions take place (Gray et al., 1995a).

The legitimacy theory explains an organisation’s social responsibility by reference to the norms, values and attitudes of the wider society within which it operates (Deegan, 2002; Branco and Rodrigues, 2008). According to this theory, engaging in CSR is an organisation’s response to the various external social, political and economic pressures it faces. Organisations therefore engage in CSR to legitimise their corporate actions in order to achieve societal approval to ensure continual survival and growth. Indeed, as the legitimacy theory postulates, organisations do not have any inherent right to resources or even to exist. Organisations exist only when society considers them to be legitimate by conferring upon them the state of legitimacy (Deegan, 2002).

Legitimacy theory relies on the idea that a social contract exists between organisations and society. Essentially, the social contract paradigm and legitimacy theory suggest that organisations seek to establish and communicate congruence between the social values implied by their activities and the values and norms of the society within which they operate to achieve a positive perception of their behaviour (Dowling and Pfeffer, 1975; Deegan, 2002; Branco and Rodrigues, 2008). Organisational legitimacy is achieved when there is congruence between the two value systems and is threatened when disparity arises. Of course, societal norms and values are not fixed. As societal values change over time, organisations need to continually alter their behaviour to ensure that
they meet the changing expectations and operate within the bounds of their respective societies (Deegan, 2002).

From the perspective of legitimacy theory, the perception of an organisation’s actions is crucial since legitimacy itself has been defined as: the perception that an organisation’s actions are desirable or appropriate within some socially constructed system of beliefs, norms and values (Suchman, 1995). Thus, if an organisation’s actions are perceived as breaching the social contract, its survival will be threatened as society will revoke its contract e.g. through eliminating demand for its products, supply of labour or financial capital, or lobbying for fines or laws to prohibit the actions which do not conform to society’s expectations. Organisations therefore need to not only ensure that their actions are congruent with societal values but also to communicate this effectively (Gray et al., 1995a; Deegan, 2002).

Communication is an important part of the legitimisation strategy, the process through which an organisation can achieve the state of legitimacy. Lindblom (1994) identifies four strategies that organisations seeking legitimisation may use: first, inform the public about changes the organisation has made in response to a legitimacy gap; second, change public’s perceptions of the organisation without changing actual behaviour; third, manipulate public’s perceptions; and finally, change public’s expectations regarding their performance. In all of these cases, organisation can use voluntary CSR disclosure, with strategic disclosures being used for the second and third strategy. Since ‘legitimacy’ itself is a resource on which the survival of an organisation depends, legitimisation strategies are particularly used as a response when ‘threats’ to an organisations’ legitimacy are perceived and therefore CSR initiatives and related disclosures are likely to be higher after any such threatening events (Dowling and Pfeffer, 1975; Lindblom, 1994; Suchman, 1995; Deegan, 2002; Branco and Rodrigues, 2008).

The stakeholder management theory, while complementary to legitimacy theory, offers a different, narrower level of resolution. As Clarkson (1995) highlights, no

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147 The process of achieving legitimacy i.e. legitimisation and the state of legitimacy are not the same. Whilst legitimacy can be considered ‘status or condition’, legitimisation is the process through which organisations achieve such a state (Lindblom, 1994; Brown and Deegan, 1998, p. 23).

148 There are two major branches of stakeholder theory, the ethical and the managerial. It is the managerial branch that overlaps with legitimacy theory (Islam and Deegan, 2008) and is discussed here.
business organisation can be made or be expected to deal with all social issues. Therefore before any responsibilities can be assigned and organisations can be held accountable, it is necessary to develop “a systematic method of determining what is and what is not a social issue for a corporation” (p.103). In this regard, the pioneering work of Freeman (1984) has been extremely influential. Freeman defined the abstract notion of ‘society’ for corporations by specifying the definition of a stakeholder, as “any group or individual who can affect or is affected by the achievement of the firm's objectives" (Freeman, 1984, p.49). He pointed out that corporate management bears a fiduciary relationship to its stakeholders (Freeman, 1984).

These stakeholders can be further divided into primary and secondary groups. A high level of interdependence exists between the corporation and its primary stakeholder group as it comprises of those “without whose continuing participation the corporation cannot survive as a going concern” (Clarkson, 1995, p.106). This primary stakeholder group consists of internals stakeholders such as shareholders, employees, customers as well as the public stakeholders including the government and communities that provide the market and infrastructure within which the corporations operate and to whom taxes and other obligations are due. Secondary stakeholders consist of groups that are not essential for the corporation’s survival and not directly involved in transacting e.g. interest groups and the media (Clarkson, 1995).

Stakeholders which have the greatest control over resources required by the organisation are considered most powerful. To survive, organisations require support and approval of such stakeholders groups, and therefore seek to effectively manage their relationship with them in order to ensure access to resources to continue their operations. Communication is a key mechanism through which organisations can strategically manage such relationships. Organisations are therefore likely to produce voluntary disclosure on issues which concern its most powerful stakeholders, to gain and maintain their support (Ullman, 1985; Gray et al., 1995a; Islam and Deegan, 2008).

The institutional theory is especially useful for understanding how and why different forms of CSR exist in different countries. According to this theory, to understand CSR holistically, requires an understanding of the institutional framework within which business is situated. This relates not only to formal institutions such as the legal framework but, more importantly to informal institutions which includes religious
norms. Since the ‘social’ in CSR relates to societal expectation, to the extent these differ across societies, so will the definition and nature of CSR produced (Brammer et al., 2012). Similar to the legitimacy theory, institutional theory views organisations as operating within a particular social framework of values and norms which define what constitutes as acceptable and appropriate behaviour. Organisations respond to pressures that arise from the institutional environment and in response adopt practices that are considered socially acceptable (Carpenter and Feroz, 2001). Therefore from this theoretical perspective as well, organisations operating in societies with certain religious norms are likely to honour them.

Institutional theory also provides an additional analytical insight in explaining why organisations that operate within the same ‘organisational field’ (e.g. banking sector) may develop homogenous characteristics. The process of homogenisation is referred to as isomorphism. As DiMaggio & Powell (1983, p.149) explain isomorphism is "a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions". Institutional isomorphism can be split into three processes i.e. coercive, mimetic and normative. Coercive isomorphism arises from external sources such as pressure from powerful stakeholders. It therefore relates to stakeholder management theory. In terms of CSR practices, it implies that powerful stakeholders can coerce organisations to adopt certain practices leading to uniformity within the sector (Deegan, 2009). Mimetic isomorphism involves organisations mimicking each other’s practices to gain competitive advantage. The motivation for this comes from a threat to their legitimacy. As Unerman and Bennett (2004) explain, organisations that fail to implement innovative practices adopted by other organisations within the same sector risk hurting and even losing their legitimacy. Finally, normative isomorphism relates to pressures that arise from common values that are a part of the accepted institutional practice within a sector. These can arise from formal or informal sources including culture (Deegan, 2009). Essentially, all of these three isomorphic processes lead to organisations adopting similar management practices (DiMaggio & Powell, 1983; Carpenter & Feroz, 2001).

149 ‘Organisational field’ refers to organisations that, in aggregate, form a distinctly recognisable area by producing similar products and services e.g. the banking sector (DiMaggio and Powell, 1983).
Finally, decoupling is another dimension of the institutional theory, which relates to the separation between the actual practices and external image of an organisation. This separation may be due to unintentional or intentional actions. When related to the latter, decoupling links directly with the second and third legitimisation strategies mentioned above, whereby an organisation may use CSR disclosures to construct a socially responsible image which may be very different to the organisation’s actual social performance (Deegan, 2009).

Overall, given this theoretical framework, it can be expected that conventional banks operating in the GCC, a predominantly Muslim region, will also face and therefore respond to societal expectations that are derived from Islamic values. As such, conventional banks can be expected to undertake religion-specific CSR initiatives.

5.2.4 Proposed Approach: Select an Appropriate Context

In light of the above, the approach proposed in this study is to compare Islamic and conventional banks within a socio-political context where the religion of Islam and social expectations related to it are applicable and relevant for both Islamic and conventional banks. In this work, it is argued that the Gulf Cooperation Council (GCC) is an ideal example of such a context. The six GCC countries are not only similar in terms of their macroeconomic environment but also their socio-political structure (Haniffa and Hudaib, 2007). More importantly, Islam is the dominant religion in the GCC and has been for more than a millennium. It has therefore shaped the cultural context within which societal norms, values and expectations have been established. By limiting the scope of this study to the GCC, where certain expectations related to the teachings of Islam are engraved in societal norms, a case can be made for the use of a single research instrument to compare Islamic and conventional banks’ CSP including an assessment on religion-specific CSR.

5.3 Addressing the Measurement Problem

This section examines the concept of CSP, provides an explicit definition, identifies a suitable analytical framework for assessing CSP and examines how it can be measured by reviewing the measures used in prior literature. The final part of this section makes the case for how and why analysis of social reporting can provide the means for comparing Islamic and conventional banks’ CSP.
5.3.1 Defining Corporate Social Performance (CSP) and Identifying a Suitable Analytical Framework

Defining the concept of CSP has a long history. In fact the definition of CSR offered by Carroll (1979) is a part of his conceptual model of CSP which comprised of three parts; defining CSR, identifying the social issues faced by organisations and the mode of organisations’ social responsiveness. Building on this work, a revised framework of CSP was proposed by Wartich and Cochran (1985), who defined CSP as "the underlying interaction among the principles of social responsibility, the process of social responsiveness, and the policies developed to address social issues" (1985, p.758). Both Carroll’s (1979) and Wartich and Cochran’s (1985) CSP models fundamentally consist of three parts; CSR (the principles), social responsiveness (processes) and management of social issues (performance) (Erden and Bodur, 2012). Wood (1991) however criticised the definition proposed by Wartich and Cochran (1985) arguing that “the term performance speaks of actions and outcomes, not of interaction or integration” (1991, p.692). She further argued that the presence of a formal policy does not imply social performance as these policies may not be reflected in actual corporate behaviour, whilst behaviour that rates highly on social performance may exist even without any formal policy. Relying on the presence of policies to infer social performance is therefore risky. Consequently, Wood (1991) built on Wartich and Cochran (1985) and redefined CSP as “a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships” (p.693). To assess a company’s CSP, researchers need to examine each of these three domains, however, as Wood explains “social outcomes, is the only portion [of the CSP model] that is actually observable and open to assessment … [and] the only place in the CSP model where any real performance exist”150 (p.711). Thus, in line with prior studies (Wood, 1991; van der Laan et al., 2008; Ioannou and Serafeim 2012), for the

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150 The three domains to be examined consist of “the degree to which principles of social responsibility motivate actions taken on behalf of the company, the degree to which the firm makes use of socially responsive processes, the existence and nature of policies and programs designed to manage the firm’s societal relationships, and the social impacts (i.e., observable outcomes) of the firm’s actions, programs, and policies” (Wood, 1991, p. 693). However as Wood explained, “Motivations are not observable, and processes are observable only by inference” therefore overall CSP of a company can and will be judged by its stakeholders on the basis of the visible outcomes (Wood 1991, p.711)
purposes of this thesis, CSP is defined more specifically as ‘the outcomes and actions resulting from a firm’s socially responsible behaviour’.

An important aspect of this definition, derived from Wood (1991), is that it allows CSP to be seen as “a construct for evaluating business output” rather than something that is inherently good (p.693). It allows one to acknowledge that the level and nature of CSP may differ across organisations based on their individual capabilities, including business strategies, competitive advantages as well as the expectations and pressures faced, which ultimately dictates the nature of social outputs produced. Indeed from the social contract, legitimacy and stakeholder theory perspectives, corporations invest resources in social programs, either one-time ventures or longer-term institutionalised projects considered to be socially desirable, to meet their stakeholder’s expectations and achieve legitimacy (Wood, 1991; Erden and Bodur, 2012). Therefore the actual outcomes and actions undertaken by corporations that form their CSP will reflect the nature of responsibilities expected of them by society.

As Clarkson (1995) emphasises defining the appropriate level of analysis is vital. Wood (1991) presents three levels of analysis of the principles of CSR (institutional, organisational and the individual level). Using the same levels of analysis, Clarkson (1995) offers a different framework which is grounded in the data of corporate case studies. He illustrates using several examples how confusion arises when terms from one level of analysis are applied to another. Clarkson argues that discussions of corporate social responsibility and responsiveness relate to the business and society relationship and are appropriately analysed at the institutional level. Corporate social performance on the other hand relates to the corporation and its stakeholder groups and therefore is appropriately analysed and evaluated at the organisational level. Finally at individual level, manager’s performance can be evaluated with regards to their management of stakeholder issues and relationships. As this thesis aims to analyse and compare the CSP of Islamic and conventional banks, the organisational level is the appropriate level of analysis (which relates to the corporations and their stakeholder groups).
5.3.2 Measures of Corporate Social Performance (CSP) in Prior Literature

The aim of this chapter is to develop a CSP index, a research instrument which can be used to assess and compare the CSP of Islamic and conventional banks. The difficulty of assessing CSP is well documented in the current literature. Assessing levels of CSP for a company is a complex exercise as it requires an objective and standard measure (Aupperle et al., 1985). Despite extensive research, consensus is yet to be reached over the optimal measure for CSP (van Beurden and Gößling, 2008; Soana, 2011). Essentially, the problem lies with the multidimensionality of this construct, comprising of corporate practices across a range of: 1) inputs e.g. sourcing renewable energy, 2) processes e.g. labour practices and 3) outputs e.g. community initiatives (Waddock and Graves, 1997). Despite the challenge, a variety of CSP proxies have been proposed in the extant literature. These include questionnaires, forced-choice surveys (Aupperle et al., 1985); reputational indices e.g. Moskowitz, 1972 (Cochran and Wood, 1984) or Corporate Reputational Index by Fortune magazine (Brown and Perry, 1994; Preston and O’Bannon, 1997); one-dimensional indicators such as pollution indices (Spicer, 1978; Chen and Metcalf, 1980) or corporate philanthropy (Seifert et al., 2004); ethical ratings based on a multidimensional indices constructed by specialised agencies (Soana, 2011) including EIRIS (Cuesta-González et al., 2006) or MSCI KLD which has been widely used in academic literature (Waddock and Graves, 1997; Ruf et al., 1998; van der Laan et al., 2008; El Ghoul et al., 2011; Mahoney et al., 2012); inclusion in ethical/social market indices (Baird et al., 2011) and content analysis of social disclosures made in corporate reports (Bowman and Haire, 1975; Ingram 1978; Anderson and Frankle, 1980; Wiseman, 1982; Patten, 1990; Tsang, 1998; Ameer and Othman, 2011). Industry-specific measures have also been used in banking studies, such as the Community Reinvestment Act ratings for US banks (Simpson and Kohers, 2002).

Each approach has its benefits but also presents certain limitations. For example, the one-dimensional indicators fail to account for the multidimensionality of CSP, with the

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151 See Orlitzky et al. (2003) and Soana (2011) for overview of the literature on CSP proxies and relation between CSP and corporate financial performance (CFP)
chosen indicator not necessarily reflecting overall social performance\textsuperscript{152} (Waddock and Graves, 1997; Chen et al., 2008). Questionnaires reflect managers’ and directors’ own perception of CSR (Soana, 2011). Ethical ratings, although increasingly popular, are found to be subjective measures as the procedures and components for ratings differ between agencies, with little transparency on such issues\textsuperscript{153} (Scholtens, 2009; see Soana, 2011 for inconsistency of ethical ratings awarded to the same banks from different rating agencies). Additionally, reputational measures e.g. by Fortune magazine have been found to be affected by the previous financial performance of firms (Brown and Perry, 1994); whilst analysis of social disclosure assumes that self-reporting is a good proxy for actual performance which may not be always the case (Wiseman, 1982; Cochran and Wood, 1984; Cho and Patten, 2007).

Unlike the long tradition existing in the conventional literature, CSR analysis of Islamic banks is still relatively new. Additionally, identifying a CSP proxy for Islamic banks presents somewhat greater challenges since a number of the abovementioned approaches cannot be used for Islamic banks. For example, ethical ratings such as KLD and the Fortune magazine reputational index do not cover the scope of Islamic banks. Third party independent CSP ratings for Islamic banks do not yet exist. A pragmatic approach to examine the CSP of Islamic banks is to analyse the social disclosure produced by the banks in their annual reports. Indeed, banks’ annual reports are widely available for both Islamic and conventional banks allowing for the possibility of comparison; however there is an important challenge which needs to be overcome.

5.3.3 The Challenge of Using Social Reporting to Assess CSP: The Issue of Corporate Identity Management

Social reporting, i.e. voluntary disclosure of a corporation’s social and environmental impact is considered a key mechanism through which companies may discharge their accountability duties and communicate their social performance (Gray et al., 1996; Unerman, 2000; Bouten et al., 2011; Belal et al., 2015).

\textsuperscript{152} For example, taking philanthropic giving as the sole measure of CSP has been found to be inappropriate. Empirical evidence supports the existence of a negative relationship between corporate giving and performance in other social areas such as environmental care and product safety. Firms performing poorly in other social aspects are more likely to make charitable donations and their extent of giving is higher than better performing firms (Chen et al., 2008).

\textsuperscript{153} For this reason, some authors, such as Scholtens (2009) propose their own indices that are similar to the ethical rating agencies, but more transparent.
Previous Islamic banking studies have focused on assessing the level of social disclosures made by Islamic banks in their annual reports against a disclosure index using content analysis (e.g. Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011; Farook et al., 2011; Aribi and Arun, 2015; Belal et al., 2015). A disclosure index is an extensive list of pre-selected items deemed important by researchers (or a reporting standard, if followed to design the index), to be disclosed by the entity under review. The use of this method allows researchers to measure the extent of information disclosed by a particular entity through a particular disclosure vehicle e.g. the annual report relative to the benchmark index (Marston and Shrives, 1991; Hassan and Marston, 2010).

Disclosure indexes have been extensively used in the general social reporting literature, popularised since Cerf (1961) and are considered a valid research tool given the selection of items is based on prior literature or international benchmarks and standards (Hooks and van Staden, 2011) such as the Global Reporting Initiative (GRI) or AAOIFI for Islamic financial institutions. However, as evident from prior literature, construction of such benchmark disclosure indexes varies greatly across studies with no consensus over the size or individual items to be included. In Islamic banking studies for example, some have considered broad theme-based categories (between 5 and 8) (Aribi and Gao, 2010; 2011) whilst others have included disclosure items ranging from 26-149 (Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Arun, 2015; Belal et al., 2015). Nevertheless, similar conclusions are drawn across the studies; Islamic banks disclose on far fewer CSR issues than expected and avoid controversial matters that may affect their Islamic image negatively (Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Arun, 2015). Evidence indicates that a strong element of identity

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154 In the case of Aribi and Arun (2015) and Belal et al. (2015), interviews with bank management have also been conducted to understand the perception of CSR held in Islamic banking industry.
155 The Global Reporting Initiative (GRI) produces sustainability reporting standards which provide guidance to corporations on how to disclose on their economic, social and environmental performance. These guidelines are designed for universal use, regardless of company size, location, or sector, although industry-specific guidelines exist. Through these guidelines, GRI aims to provide a credible and trusted framework, increasing the use and comparability of sustainability reporting worldwide. Since its formation in 1997, GRI has constantly reviewed, and refined its guidelines using a consensus-seeking consultation process with experts from all stakeholders groups e.g. business, NGOs, investors etc. More information available at https://www.globalreporting.org/Pages/default.aspx
156 The use of AAOIFI reporting standards have been considered in designing the index in almost all Islamic banking studies, with some specifically including compliance with AAOIFI standards as an item of disclosure (Hassan and Harahap, 2010).
management exists in Islamic banks as “social disclosures are used by the banks to construct a positive Islamic image” (Maali et al., 2006 p.286).

Islamic banks however are not the only institutions which use social disclosure for corporate identity management. Corporate identity is widely acknowledged as a strategic instrument. Effective management of this enables organisations to achieve differentiation, an important source of competitive advantage (Downey, 1987; Schmidt, 1995; van Riel and Balmer, 1997; Melewar and Karaosmanoglu 2006; Balmer 2008; Bolton et al., 2011) especially in the services industry such as banking where the intangible nature of products and services offered, makes differentiation ex ante difficult to communicate (Wilkinson and Balmer, 1996; Haniffa and Hudaib 2007; Sánchez and Sotorrio, 2007; Bravo et al., 2012).

CSR is recognised as one of the direct routes to establishing an ethical corporate identity (Balmer et al., 2007; Bravo et al., 2012), building reputational capital which reduces risk of regulation and legal action from stakeholders (Freeman, 1984; Robertson and Nicholson, 1996; Waddock and Graves, 1997; Halme and Laurila, 2009; Brønn and Vidaver-Cohen 2009; Spiller, 2009; Mahoney et al., 2012), whilst increasing customer and staff loyalty (Spiller, 2009). Effective communication is essential for materialising potential CSR benefits157 (Spiller, 2000; Branco and Rodrigues, 2006; Parguel et al., 2011; Bolton et al., 2011; Schreck, 2011; Bravo et al., 2012) since the organisation must be perceived by its stakeholder as socially responsible (Arvidsson, 2010; Bravo et al., 2012). In managing stakeholder perceptions, generating a positive corporate image, and in legitimising corporate behaviour, communication (including voluntary CSR reporting) plays an important strategic role (Ullmann, 1985; Guthrie & Parker, 1989; Neimark, 1992; Gray et al., 1995a; Waddock and Graves, 1997; Neu et al., 1998; Spiller, 2000; Cornelissen and Harris, 2001; Deegan, 2002; Branco and Rodrigues, 2006; Coupland, 2006; Melewar and Karaosmanoglu, 2006; Cho and Patten, 2007; Chen et al., 2008; Jamali, 2008; Brønn and Vidaver-Cohen, 2009; Reverte, 2009; Arvidsson, 2010; Bolton et al., 2011; Boujen et al., 2011; Parguel et al., 2011; Bravo et al., 2012; Pérez and d el Bosque, 2012). For external stakeholders especially, corporate communication is a key proxy to gauge an organisations’ social performance. However,

157 Voluntary disclosure reduces informational asymmetry between the firm and its stakeholders lowering perceived risk and thereby the cost of capital (El Ghoul et al., 2011)
informational asymmetry, arising from un-observability of actual corporate actions, creates scope for greenwashing and symbolic CSR (Neu et al., 1998; Parguel et al., 2011; Perez-batres et al., 2012). Through communication and corporate identity management, organisations can achieve legitimacy even without changing actual behaviour (Neu et al., 1998). It has been long established that "it is often easier to manage one's image through communication than through changing one's output, goals and methods of operations" (Dowling & Pfeffer, 1975, p. 127). Thus, companies are able to materialise the economic benefits of CSR through mere communication (Berrone et al., 2007). Evidence shows that applied ethics i.e. “firm’s behaviour – actions and policies” improve stakeholder satisfaction, while revealed ethics i.e. “communication of a firm’s ethical attitudes” are sufficient to enhance shareholder value (p.36). Thus, there exists an incentive to disclose information on CSR even if it is symbolic which can lead to potential dissonance between the communicated (what the organisation says about its self) and the actual corporate identity (what the organisation actually does) (Balmer and Soenen, 1999).

In light of this, prior studies measuring CSR disclosure in Islamic banks annual reports although make valid conclusions regarding volume and extent of disclosure against benchmark indexes and identify disclosure patterns, do not provide sufficient information to enable readers to determine the extent to which Islamic banks undertake actual CSR activities. Recent studies have stated explicitly that their aim is to “understand the extent to which IFIs follow in practice the ethical and social objectives implied by Shari’ah” (Aribi and Arun, 2015, p.2 emphasis added) and to undertake an “examination of ethical and developmental performance” of Islamic banks (Belal et al., 2015, p.1, emphasis added). However, in light of the strategic nature of CSR reporting, results from these studies cannot be deemed a measure of CSP since any type of disclosure even declarative statements which reveal the bank’s ethical attitude as opposed to communicate the result of actual CSR initiatives suffices for a score against the disclosure index. By looking at the overall index score from such studies, one cannot determine which banks have provided evidence of actually putting CSR initiatives into practice and which simply provide greater amount of qualitative narrative comprising of social and ethical claims. Thus, social performance of Islamic banks in terms of outcomes and actions remains to be measured.
5.3.4 Can CSP be Assessed Using Social Reporting? The Case for Evidence-Based Disclosure

Social reporting faces an important challenge in light of the legitimising role of CSR disclosure and the potential dissonance between declared and actual social performance. However, an important consideration in the disclosure-performance nexus is the type of disclosure. The doubt over reliability of CSR disclosure largely pertains to the narrative and qualitative nature of CSR information produced (Wiseman, 1982; Al-Tuwaijri et al., 2004; Beck et al., 2010; Hooks and van Staden, 2011). Corporate rhetoric without evidence of actual actions and outcomes is relatively uninformative of a firm’s actual CSP (Robertson and Nicholson, 1996; Scholtens, 2009).

For social reporting to be a useful proxy for CSP, disclosure and actual performance need to be congruent (Ingram and Frazier, 1980). To close the gap between disclosure and performance, comprehensive reporting has been advocated in the social reporting literature (Hooks and van Staden, 2011, Bouten et al., 2011) where comprehensiveness relates to full disclosure, i.e. disclosure on 1) corporate vision/aims, 2) management’s approach/specific actions, and 3) performance indicators i.e. reporting on outcomes and results from CSR initiatives (Robertson and Nicholson, 1996; Vuontisjärvi, 2006; Bouten et al., 2011). It is argued that such comprehensive reporting enables stakeholders to gain a better understanding of a firm’s actual social performance (Hooks and van Staden, 2011). Since it is easier to produce declarative statements than the results from actual implementation (Spiller, 2009), it is argued that organisations with poor CSP will produce greater amount of narrative comprising of qualitative disclosure (Ingram and Frazier, 1980) to symbolise their CSR commitment (de Villiers and van Staden, 2006). On the other hand, organisations with superior CSP would find it easier and less costly to produce evidence-laden and quantifiable CSR information (Mahoney et al., 2012), and therefore would voluntarily produce the type of disclosure which is difficult to mimic for poor performing organisations (Clarkson et al., 2008). Only organisations with actual commitment to fulfilling their CSR would proactively measure and therefore report on current and future impact of their decisions. Thus, a distinction between companies can be made based on the basis of the quality of reporting. Empirical evidence supports this such that comprehensiveness of reporting including quantifiable disclosure is higher in companies which actively embed CSR in their operations (Al-Tuwaijri et al., 2004; Scholtens, 2009; Mahoney et al., 2012).
5.3.5 Proposed Approach: Evidence-based Disclosure as a proxy for CSP

The above discussion indicates that if social disclosure is scrutinised to seek evidence of actions as oppose to mere declarative statements, a better view of CSP can be achieved. The importance of examining the type of disclosure has been long recognised in the CSR literature. For example Guthrie and Mathews (1985) review of the literature suggested that the type of ‘evidence’ disclosed by companies needs to be assessed, since one can gauge the quality of ‘evidence’ from whether the statement made are declarative or quantitative (Gray et al., 1995a).

To warranty the use of social reporting to assess CSP in this thesis, the established link between comprehensive reporting and performance is used (see e.g. Robertson and Nicholson, 1996; Al-Tuwajri et al., 2004; Vuontisjärvi, 2006; Cuesta-González et al., 2006; Clarkson et al., 2008; Scholtens, 2009; Hooks and van Staden, 2011, Bouten et al., 2011; Mahoney et al., 2012). Distinction is made between declarative and evidence-based disclosure as recommended (Wiseman, 1982; Guthrie and Mathews, 1985; Gray et al., 1995b; Neu et al., 1998) to better gauge actual performance. Below, the terms ‘declarative’ and ‘evidence-based disclosure’ are explicitly defined in light of previous literature and GRI guidelines.

Defining Declarative and Evidence-based Disclosure

Declarative disclosure is defined as corporate rhetoric that is not backed by any evidence of actual action, but instead expresses awareness or commitment to the CSR causes. This category covers the first two types of information disclosure required by the GRI guidelines (2011, 2011a); Robertson and Nicholson, (1996); Vuontisjärvi, (2006); Beck et al. (2010) and Bouten et al. (2011). Therefore disclosure on aims, vision and goals of the company as well as statements on how the bank is addressing CSR concerns, i.e. simple description of any actions taken, are considered part of this disclosure type. Therefore if a bank discloses it has a policy on any CSR issue, it will be considered a declarative statement, since the assertion that a policy exists does not

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158 The GRI guidelines requires reporting on firm strategy and profile; management approach and performance indicators. The categories defined in Bouten et al. (2011) are congruent with GRI; Robertson and Nicholson (1996) and Vuontisjärvi (2006).

159 The latter is included on the basis that description of an action is not as informative or easy to verify unless results from that action are mentioned (Clarkson et al., 2008; Bouten et al., 2011).
necessarily mean it is implemented (Wood, 1991; Robertson and Nicholson, 1996; Bouten et al., 2011). This approach is in line with the previous literature (Wiseman, 1982; Gray et al., 1995b; Al-Tuwaijri et al., 2004; Bouten et al., 2011).

Evidence based disclosure is defined as disclosure of objective measures, performance indicators and specific outcomes from CSR initiatives. This corresponds with the third type of information disclosure required by GRI; Robertson and Nicholson, (1996); Vuontisjärvi, (2006); Beck et al. (2010) and Bouten et al. (2011). Only disclosure that meets the following criteria is considered evidence-based: 1) Quantitative disclosure (monetary or non-monetary quantitative – for example, amount donated in charity); 2) specific qualitative disclosure (for matters where quantitative disclosure is not applicable for example, adoption of voluntary CSR-related international initiatives such as the Equator Principles; to be counted as evidence-based, specific mention of the initiative/standard is required) and 3) outcome/result from a CSR initiative (for example, reporting on amount of paper recycled, through adopting a recycling policy).

5.4 Method: Constructing the CSP Index to Assess and Compare Islamic and Conventional Banks

5.4.1 Data
This study analyses Islamic and conventional banks located in the Gulf Cooperation Council (GCC). The scope of this study is limited to the GCC region as these countries are considered relatively homogenous in terms of their culture and socio-political structures (Haniffa and Hudaib, 2007). Culture plays a major role in accounting especially social reporting practices across different countries (Lopes and Rodrigues, 2007). Limiting the scope of analysis to a homogenous region assists in reducing the impact of external influences and makes comparative analysis more appropriate (Haniffa and Hudaib, 2007; Aribi and Gao, 2010; 2011).

Only commercial banks are analysed in this study. Consolidated annual reports were collected from banks’ websites. As these reports include the performance of the banking group’s subsidiaries, any subsidiaries of local Islamic or conventional banks

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160 The evidence based disclosure category captures disclosure types 3,4 and 5 specified in in Beck et al. (2010)
were also excluded from the sample. Consequently, Islamic windows have been considered as part of the parent conventional banks as opposed to separate Islamic banks. As it is reasonable to assume that decision-making authority regarding policies on CSR exist at the bank’s parent-level rather than the subsidiary or branch level, it is deemed fairer to confine the Islamic category to full-fledged Islamic banks only.

Banks are analysed for three consecutive years, in line with Haniffa and Hudaib (2007) and Aribi and Arun (2015) to examine both the level and change in CSP within individual banks and the complete sample over time. The three years post the onset of the financial crisis i.e. 2009-2011 were selected. To ensure that every bank is represented for each year of analysis, any bank for which 2009-2011 annual reports could not be collected were excluded. The sample is also limited to banks which produced annual reports in English therefore banks with reports in Arabic were excluded. Finally, any bank which produced only the mandatory financial statements as opposed to a complete annual report (with voluntary CSR disclosure) could not be included in the study. The final sample consists of 47 banks; 12 full-fledged Islamic and 35 conventional banks. A balanced panel over the 2009-2011 period results in 141 bank-year observations. Table 5.1 presents breakdown of sample banks per country.

Table 5.1: Number of Banks per country and type

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Banks</th>
<th>Number of Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Islamic</td>
<td>Conventional</td>
</tr>
<tr>
<td>Bahrain</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Oman</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Qatar</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>UAE</td>
<td>1</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>12</td>
<td>35</td>
</tr>
</tbody>
</table>

Observations per Type of Bank 36 105

Disclosure medium: Annual Report

In keeping with prior literature, this study analyses social disclosure provided in banks’ annual reports. Annual reports have been acknowledged as an appropriate and useful medium to assess social disclosure and have been extensively used in social reporting literature (Guthrie and Parker, 1989; Neimark, 1992; Gray et al., 1995b; Neu et al.,
1998; Tsang, 1998; Maali et al., 2006; Branco and Rodrigues, 2006; de Villiers and van Staden, 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011; Beck et al., 2010; Bouten et al., 2011; Kamla and Rammal, 2013; Belal et al., 2015). The popularity of these reports lies in their practicality for research purposes as they are widely available in the public domain (Deegan and Rankin, 1997; Branco and Rodrigues, 2006; Haniffa and Hudaib, 2007; Bouten et al., 2011). More importantly, annual reports provide valuable insight into a company at a particular point in time as they are not only produced regularly but also at uniform intervals. These reports also present one of the key channels used by companies to communicate their operations to a wide variety of stakeholders and have been recognised as central to the construction of an organisation’s external social image (Neimark, 1992; Gray et al., 1995b).

It is recognised that annual reports are not the sole medium of corporate communication on CSR (Maali et al., 2006), with advertising, PR publications and specially company websites and separate CSR reports becoming increasingly popular mediums (Bravo et al., 2012). Evidence of examining such alternative mediums exists in prior literature (see e.g. Zeghal and Ahmed, 1990; Coupland, 2006; Bravo et al., 2012; Kamla and Rammal, 2013). However, as Gray et al., (1995b) note, to capture the entirety of an organisation’s CSP using social disclosure requires identification and examination of all communication mediums used by the organization to disseminate information on CSR. Such an ambitious task, however, proves practically impossible to undertake. Thus for pragmatic reasons, prior CSR literature has primarily focused on annual reports as the sole medium of communication to examine (Gray et al., 1995b).

For the purpose of this study, annual reports are considered the most appropriate information source based on five important factors. Firstly, relative to the sample period analysed, use of stand-alone CSR reports has only begun very recently in the GCC banks with some publishing their first reports in 2011, resulting in insufficient observations for analysis and comparison. Secondly, there is evidence that the most important information found in stand-alone CSR reports is often repeated, either literally or somewhat concisely, in annual reports (Beck et al., 2010; Hooks and van Staden, 2011). Thirdly, in line with the CSP definition adopted here, the exercise of CSR will result in either production of CSR outputs or use of CSR resources (McWilliams and Siegel, 2001). Since annual reports provide an overview of a firm’s operations including resource usage during the year to a large stakeholder base
(Neimark, 1992), it is argued that in cases where banks undertake actual CSR, the related resource use/output will be reported in annual reports. Fourthly, it has also been argued that social reporting in annual reports, “possess a degree of credibility not associated with other forms of advertisement” (Neu et al., 1998, p. 269) and is “not subject to the risk of journalistic interpretations and distortions possible through press reporting” as management has complete editorial control over its content (Guthrie and Parker, 1989, p. 344), thus annual reports represent a relatively reliable source of information on banks’ CSR activities. Finally, despite rising popularity, studies which examine CSR disclosure on company websites acknowledge problems with this communication medium. Most notably, the ever-changing nature of websites means that there is potential for the content on webpages to be altered, moved or even removed during the data collection period and whilst this problem exists in cross-sectional studies, it is even more acute in longitudinal studies, where the constant updating and relocation of content makes returning to the same position on the website extremely problematic over time (Coupland, 2006). As this study examines social reporting over 3 years, and based on the reasons stated above, limiting the scope of analysis to annual reports is considered appropriate.

5.4.2 Content Analysis: Choosing the Appropriate Approach

To analyse the narrative in annual reports, content analysis is used. Content analysis has been defined as “a research technique for making replicable and valid inferences from texts (or other meaningful matter) to the context of their use” (Krippendorff, 2003 p. 18). This technique enables a body of text to be analysed in a systematic, objective, reliable and replicable manner (Krippendorf, 2003; Guthrie and Parker, 1990; Gray et al., 1995b). Content analysis has been extensively used in the social reporting literature (Ingram and Frazier, 1980; Guthrie and Mathews, 1985; Guthrie and Parker, 1989; Zeghal and Ahmed, 1990; Gray et al., 1995b; Tsang, 1998; Unerman, 2000; Al Tuwaijri et al., 2004; Maali et al., 2006; Branco and Rodrigues, 2006; Vuontisjärvi, 2006; de Villiers and van Staden, 2006; Cho and Patten, 2007; Haniffa and Hudaib, 2007; Branco and Rodrigues, 2008; Clarkson et al., 2008; Aribi and Gao, 2010, 2011; Beck et al., 2010; Bouten et al., 2011; Hooks and van Staden, 2011; Bravo et al., 2012; Pérez and del Bosque, 2012, Kamla and Rammal, 2013), giving it “validity as an empirical research tool” in this field (Hooks and van Staden, 2011, p.201). Nevertheless, an important criticism of the extant content analysis studies is that many do not provide
sufficient detail to assist others in understanding how the content analysis is conducted (Bouten et al., 2011). Therefore this section explains in detail the choices made and the content analysis process undertaken in this work.

There are broadly two approaches adopted in content analysis studies. Quantitative content analysis (mechanistic approach) captures frequency/volume of disclosure e.g. word/sentence count, whereas qualitative content analysis (interpretative approach) focuses on capturing meanings in information disclosed (Beck et al., 2010). The aim of qualitative content analysis (QCA) is to identify the presence of themes/categories within a body of content which illustrate “the range of the meanings of the phenomenon” under study as understood by the producers of that text (Zhang and Wildemuth, 2009, p.2).

As stated earlier, it is well-established in the CSR literature that corporate rhetoric without evidence of actions and outcomes is often symbolic, used as a legitimising tool and therefore reliance on measuring volume of disclosure produces misleading results with regards to actual CSP (Ingram and Frazier, 1980; Robertson and Nicholson, 1996; de Villiers and van Staden 2006; Cho and Patten, 2007; Scholtens, 2009; Hooks and van Staden, 2011). Therefore in this study, qualitative content analysis (QCA) method is used, which allows detailed examination of social narrative, allowing differentiation between declarative and evidence-based disclosure. Under QCA, the unit of analysis i.e. the “unit of text to be classified during content analysis” is the individual theme which can be conveyed in a word, sentence or paragraph, therefore one looks for the expression of an idea during the coding process (Zhang and Wildemuth, 2009, p.3). Consequently, texts of varying lengths were coded as long as they represented themes associated with CSR and met the criteria of evidence-based disclosure. Consistent with prior studies (e.g. Haniffa and Hudaib, 2007), the full annual reports were read.

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161 Annual reports were loaded into the NVivo software and narrative in annual reports was coded into different nodes representing the CSP categories and subcategories, allowing for a copy of the text (evidence-based disclosure) to be kept for future reference. Using these extracts, subcategory definitions were amended to reflect the nature of initiatives communicated under evidence-based disclosure in banks’ annual reports.
5.4.3 Development of the CSP Index: Confirming Instrument Validity

The first step in content analysis is to define a classification system for the different elements of social narrative found in the annual reports. Although QCA is primarily inductive in nature as it involves designing a process to “condense raw data into categories or themes based on valid inference and interpretation”, it need not be purely inductive (Zhang and Wildemuth, 2009, p.2). Deductive reasoning is especially useful in generating concepts from prior literature at the inception of the data collection and analysis process providing a suitable and helpful starting point. In terms of the three approaches to QCA summarised by Hsieh and Shannon (2005), this study adopts the ‘directed content analysis’ approach in which coding of text starts with relevant research findings i.e. CSR categories derived from prior literature, followed by several rounds of iterations to reflect the themes emerging from the data. Developing categories in the initial stage from extant literature ensures that the research instrument is validated i.e. the categories of analysis are derived by reference to ‘shared meanings’ which recreate the same referents in all associated researchers as is required for appropriate content analysis (Krippendorf, 2003, Gray et al., 1995a, p.85; Hammond and Miles, 2004; Bouten et al., 2011) ensuring that the eventual CSP Index consists of transferrable, dependable and credible categories making this study’s findings generalizable (Kamla and Rammal, 2013, p.922).

Employing shared meaning has two important implications for the process of content analysis. First it requires that the categories of CSR are defined in a way which is compatible with prior CSR literature and secondly it requires that different coders/researchers agree in identifying what constitutes as a particular type of disclosure (Hammond and Miles, 2004). The first results in achieving instrument validity (discussed here) whilst the latter results in coder reliability (discussed later).

To achieve instrument validity key CSR themes applicable to both Islamic and conventional banks needed to be identified. For this, it was important to identify sources which define CSR in the global context and acknowledge the peculiarities of Islamic banking industry including the influence of religion. For Islamic banks, the AAOIFI CSR Standard (2010) is a natural starting point. The AAOIFI Standard is a credible source to identify the relevant CSR issues and expectations held of Islamic
banks, as it is published by the internationally acknowledged institution, AAOIFI\textsuperscript{162}, which represents the views/expectations of Islamic banking’s major stakeholders including sharia scholars, Islamic banks and academics, and has been a reference source in prior Islamic banking literature (see e.g. Maali et al., 2006; Mallin et al., 2014). To further ensure that all relevant CSR issues for conventional banking have also been identified, the internationally recognised and widely cited KLD criteria, used by numerous conventional CSR studies as a measure of CSP was also consulted (see e.g. Waddock and Graves, 1997; Ruf et al., 1998; Van der Laan et al 2008; El Ghoul et al., 2011; Mahoney et al., 2012). Keeping in mind the industry-specific nature of CSR (Simpson and Kohers, 2002; Reverte, 2009; Baird et al., 2011), prior CSR studies with a focus on Islamic and conventional banking were also examined. Given that each industry has a different stakeholder portfolio, expectations of social responsibility vary across industries impacting the type of CSP produced (Baird et al., 2011). For example, firms in manufacturing industries face greater pressure for health and safety related issues than the banking sector. Additionally environmental issues are found to be less relevant to banking given the industry’s low impact on environment while social aspects are found to be more relevant (Branco and Rodrigues, 2006; Reverte, 2009). Thus, it was deemed important to consult banking-specific CSR studies. These studies included: Branco and Rodrigues (2006); Coupland, (2006); Cuesta-González et al. (2006); Maali et al. (2006); Haniffa and Hudaib (2007); McDonald and Rundle-Thiele (2008); Scholtens (2009); Aribi and Gao (2010, 2011); Bravo et al. (2012) and Kamla and Rammal (2013).

The most common CSR categories identified from the aforementioned sources and which have been widely acknowledged in mainstream CSR literature are Community, Customers, Employees, and the Environment (Gray et al., 1995b). Robertson and Nicholsan (1996) point out that these represent the four stakeholders which account for

\textsuperscript{162} It is recognised that recommendations of the AAOIFI CSR standard target disclosure practices by Islamic financial institutions (IFIs) and are aimed at enhancing transparency and improving reporting practices in IFIs. However since the objective of this study is to gauge social performance (CSP) rather than compliance with a particular reporting standard, AAOIFI recommendations are used only as a source to identify the broad areas of CSR deemed relevant to Islamic banks and not to construct a list of disclosure items expected from Islamic banks. This approach is particularly useful since that there is no uniform method for an organisation to fulfil its social responsibility therefore banks may undertake different CSR initiatives focusing on areas congruent with their business capabilities, which are not necessarily included in the AAOIFI recommendation.
the majority of the focus\(^\text{163}\) in the broad CSR literature. However, as correctly pointed out by Gray et al., (1995b), these four categories are not exhaustive, suggesting the need for an ‘other’ CSR category to capture ‘new’ meanings of CSR emerging from the data. Close study of the Islamic banking literature and the AAOIFI CSR Standard indicated what this ‘other’ category could be at an early stage of the CSP index development, suggesting the addition of two further CSR categories. The first refers to ‘Socio-economic Development’ (SED); and the second to ‘Religion-specific Initiatives’ (RSI). Issues related to the SED are also applicable to conventional banks and have been included in several conventional studies (e.g. Coupland, 2006; Branco and Rodrigues, 2006; Cuesta-González et al., 2006; McDonald and Rundle-Thiele, 2008; Scholtens, 2009; Bravo et al., 2012) although not always under this label. Nevertheless, given the importance attached to the role of Islamic banks in promoting socioeconomic development of their respective countries as advocated by Islamic economists and sharia scholars (Maali et al., 2006; Haniffa and Hudaib, 2007; Kamla and Rammal, 2013), a separate category for SED was included in the CSP index, to determine if Islamic banks have met such expectations and how they compare with conventional banks on this particular category. The final category, RSI includes CSR issues such as payment of zakah, and provision of qard hasan which are rooted in Islamic values, and considered particular to Islamic banks in the current literature (Belal et al., 2015).

Under these six categories, a comprehensive but not exhaustive list of CSR issues was identified to construct the initial CSP index.

5.4.4 The Process of Content Analysis: Ensuring Coding Reliability

Following the initial compilation of the 6 CSR categories and their constituent subcategories, a pilot study was undertaken. Coding a sample text provides the best way to establish clarity in category definitions and test coding consistency (Zhang and Wildemuth, 2009). To ensure reliability of results from content analysis it is essential that the coding process is objective (i.e. different coders code the text in the same way) (Weber, 1990; Krippendorff, 2003). Unlike, the quantitative content analysis (mechanistic approach), the scope for subjectivity is greater in QCA, as the researcher is required to make judgement on the meaning of the text analysed in order to codify it.

\(^{163}\)Robertson and Nicholsan (1996) acknowledge that whilst the environment is not strictly a stakeholder, its inclusion in CSR categories is warranted since all corporations including banks have an impact on the environment e.g. through their lending/investment decisions (Branco and Rodrigues, 2006).
This highlights the importance of a well-written and clear coding scheme i.e. guidelines that specify how the text should be coded. In addition to producing specific definitions on what constitutes as evidence-based disclosure prior to data collection a detailed coding manual was also created at this stage, following the recommendations of Weber (1990), which included the category and subcategory names, definitions \(^{164}\) and summary of evidence-based disclosures indicating the type of text to be coded per subcategory. As the aim of QCA is to develop categories to represent as close as possible the material under study (Mayring, 2000), the coding manual was iteratively improved during and after the pilot study stage, with the subcategory definitions amended until they accurately represented the evidence-based disclosure found in banks annual reports \(^{165}\). Where banks provided evidence-based disclosure for a CSR activity not found in prior literature or AAOIFI/KLD, the description of the activity was noted and added to the relevant subcategory. Therefore, as required new subcategories \(^{166}\) were added and existing ones rephrased or merged. Any subcategories on which no bank provided evidence-based disclosure were deleted.

A further important step in the process of conducting a QCA study is to reassess coding consistency (Zhang and Wildemuth, 2009). This requires rechecking the coding consistency after the full dataset has been analysed because as newer material is coded, new themes emerging from the data are added to the coding manual and with greater exposure to similar material, the coders’ understanding of the underlying phenomenon, the categories and coding rules can change leading to inconsistency in coding over a period of time (Weber, 1990). Thus, as recommended in Weber (1990), after the initial coding of the complete dataset, all 141 annual reports were recoded using the finalised coding manual (see Appendix 5.A). This ensured that any additional coding rules established using newer material (reports coded later in the data collection process) were also applied to narrative from reports coded at the earlier stage when the coding

---

\(^{164}\) Thus, the subcategory definitions in CSP index reflect the nature of activities indicated by evidence-based disclosures in banks annual reports and are unique to this study.

\(^{165}\) As Weber (1990) states, the process of gradually coding the complete dataset, revising the coding rules and checking for coding consistency is an iterative process, which needs to be continued until sufficient coding consistency has been achieved.

\(^{166}\) E.g. it was identified that new subcategories e.g. ‘avenue for donations’ and ‘healthcare campaign’ were required under the Community category in addition to charitable donations to highlight that banks not only established avenues for customers to make donations but also undertook a variety of initiatives to raise awareness of health issues in their respective countries, in addition to donating money to healthcare causes.
manual was still in its developmental stage. Additionally, it guaranteed that all narrative was allocated to the relevant subcategories and that the finalised coding rules represented the nature of evidence-based disclosure found in the full body of data. Furthermore, as the entire data collection (from compilation of initial CSR categories from literature, to conducting pilot studies and coding the entire dataset whilst iteratively improving the coding manual) took approximately 6 months, the full sample was recoded at the end of the six-month period, which added an intra-coder reliability check to the process i.e. ensuring that the same coder codes the data in a similar manner over time, which addressed the potential for inconsistency over time highlighted above.

5.4.5 CSP Index
The CSP Index constructed from content analysis of banks’ annual reports is presented in table 5.2. It comprises of six CSP dimensions and 25 social performance indicators (SPIs). For details on each of the SPI including the definition and coding criteria, refer to appendix 5.A. References mapping each of the SPIs to AAOIFI, KLD and prior literature are presented in appendix 5.B (this confirms instrument validity). A brief description of each dimension is presented here.

The Community dimension comprises of 4 SPIs: Charitable Donations, Avenue for Donations, Healthcare Campaigns and Culture. The Customers dimension is one of the smallest, such that it comprises of only 3 SPIs: Quality of Service, Customer Service Skills and Customer Engagement. The Employees dimension is the largest, comprising
Table 5.2: CSP Dimensions and Indicators

<table>
<thead>
<tr>
<th>CSP Dimensions and Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Community</strong></td>
</tr>
<tr>
<td>1. Charitable Donations</td>
</tr>
<tr>
<td>2. Avenue for Donations</td>
</tr>
<tr>
<td>3. Healthcare Campaign</td>
</tr>
<tr>
<td>4. Culture</td>
</tr>
<tr>
<td><strong>Customers</strong></td>
</tr>
<tr>
<td>5. Quality of Service</td>
</tr>
<tr>
<td>6. Customer Service Skills</td>
</tr>
<tr>
<td>7. Customer Engagement</td>
</tr>
<tr>
<td><strong>Employees</strong></td>
</tr>
<tr>
<td>8. Diversity and Inclusion</td>
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<tr>
<td>9. Training and Education</td>
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<tr>
<td>10. Career Progression</td>
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<tr>
<td>11. Incentive Schemes</td>
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<tr>
<td>12. Healthcare Benefits</td>
</tr>
<tr>
<td>13. Occupational Health and Safety</td>
</tr>
<tr>
<td><strong>Environment</strong></td>
</tr>
<tr>
<td>14. Environmental Impact</td>
</tr>
<tr>
<td>15. Green Products and services</td>
</tr>
<tr>
<td>16. Energy Conservation</td>
</tr>
<tr>
<td>17. Raising Environmental Awareness</td>
</tr>
<tr>
<td>18. Environmental Funding Conditions</td>
</tr>
<tr>
<td><strong>Socio-Economic Development (SED)</strong></td>
</tr>
<tr>
<td>19. Support for Small and Medium Enterprises (SMEs)</td>
</tr>
<tr>
<td>20. Infrastructure Development</td>
</tr>
<tr>
<td>21. Development of Human Capital</td>
</tr>
<tr>
<td>22. Financial Inclusion</td>
</tr>
<tr>
<td><strong>Religion-Specific Initiatives (RSI)</strong></td>
</tr>
<tr>
<td>23. Zakah</td>
</tr>
<tr>
<td>24. Facilitating Religious Duties</td>
</tr>
<tr>
<td>25. Qard Hasan</td>
</tr>
</tbody>
</table>
6 SPIs: Diversity and Inclusion, Training and Education, Career Progression, Incentive Schemes, Healthcare Benefits and Occupational Health and Safety. Environment is the second largest dimension comprising of 5 SPIs: Environmental Impact, Green Products and services, Energy Conservation, Raising Environmental Awareness and Environmental Funding Conditions. The Socio-Economic Development (SED) dimension comprises of 4 SPIs: Support for Small and Medium Enterprises (SMEs), Infrastructure Development, Development of Human Capital and Financial Inclusion. Finally, the Religion-Specific Initiatives (RSI) dimension, also one of the smallest, comprises of 3 SPIs: Zakah, Facilitating Religious Duties and Qard Hasan. The next section discusses the issue of religion specific CSR initiatives being particular to Islamic banks, in light of the content analysis conducted in this work.

5.5 Is Religion-Specific CSR Unique to Islamic Banks?
Table 5.3 illustrates which social performance indicators (SPIs) are present and absent in Islamic and conventional banking industries. As table 5.3 shows, conventional banks provide evidence-based disclosure on 2 of the 3 religion-specific initiatives. Thus, empirical evidence invalidates the assumption that religion-specific CSR is an entire category that is particular to Islamic banks. As this study shows, it is not the entire category, but rather a single SPI which is unique to Islamic banks.

Results from content analysis revealed that conventional banks provided evidence-based disclosure on engaging with zakah and facilitation of religious duties. On the latter SPI, prominent initiatives were related to the month of Ramadan. These findings are in line with Kamla, (2007) and Thibos and Gillespie (2011). The month of Ramadan is one of the most prestigious months in the Islamic calendar, where not only are forms of worship including fasting and prayers but also acts of kindness and especially charity are highly promoted in Islamic societies. Many individuals arrange the payment of their zakah during Ramadan as the rewards for good deeds are considered higher during this month. Within the broader cultural context of the GCC, it is therefore unsurprising that conventional banks also undertake specific CSR initiatives aimed at Islamic festivals and facilitate the fulfilment of religious duties through their CSR programmes, despite only Islamic banks portraying a religious identity. To sustain continued operations, banks not only need to manage stakeholder expectations but also the perception held of them more broadly by operating within the accepted norms of society.
Table 5.3: Social Performance Indicators in Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>CSP Dimensions and Indicators</th>
<th>Islamic</th>
<th>Conventional</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Community</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Charitable Donations</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>2. Avenue for Donations</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>3. Healthcare Campaign</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>4. Culture</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Customers</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Quality of Service</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>6. Customer Service Skills</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>7. Customer Engagement</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Employees</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Diversity and Inclusion</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>9. Training and Education</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>10. Career Progression</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>11. Incentive Schemes</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>12. Healthcare Benefits</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>13. Occupational Health and Safety</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Environment</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Environmental Impact</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>15. Green Products and services</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>16. Energy Conservation</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>17. Raising Environmental Awareness</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>18. Environmental Funding Conditions</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Socio-Economic Development (SED)</strong></td>
<td></td>
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<tr>
<td>19. Support for Small and Medium Enterprises (SMEs)</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>20. Infrastructure Development</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>21. Development of Human Capital</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>22. Financial Inclusion</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>Religion-Specific Initiatives (RSI)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23. Zakah</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>24. Facilitating Religious Duties</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>25. Qard Hasan</td>
<td>✓</td>
<td>✕</td>
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</table>

These results are based on Islamic/conventional banks providing evidence-based disclosure for each social performance indicator at least once during the 3 year period (2009 to 2011).
In this regard, the legitimacy, stakeholder and institutional theory help understand the behaviour of conventional banks. These theories are nevertheless, limited insofar as they do not explain why conventional banks engage in only 2 of the 3 SPIs. To understand this, insights into the religion of Islam are required. What is different about the 2 SPIs conventional banks engage in i.e. ‘zakah’, ‘facilitating religious duties’ and ‘qard hasan’?

The difference lies in their status within the religion of Islam. Payment of zakah and initiatives undertaken for ‘facilitating religious duties’ relate to obligatory forms of worship. These relate directly with the five pillars of Islam, which are an essential matter of belief for all Muslims. In contrast qard hasan is a voluntary act that is recommended in Islam and is not a religious obligation. Thus, it appears that conventional banks which are also owned and run by Muslims in the GCC, engage in religious CSR that relates directly to obligatory but not voluntary acts of worship.

The payment and reporting on zakah is a case in point in this regards. A thorough examination of the conventional banks annual reports on all CSR issues considered in this study revealed that conventional banks not only report on due zakah and deduct it from dividends prior to distribution in Saudi Arabia where payment of zakah is mandated by state law, but also that several conventional banks willingly do the same or pay zakah by charging it to the income statement in other GCC counties. Even in cases, where banks are not permitted by their Articles of Association to pay on behalf of their shareholders, several banks choose to use their resources to calculate the amount of the zakah due per share and communicate this in their annual reports thereby easing the fulfilment of this religious obligation for their shareholders, assisting them in paying the correct amount of zakah owed. Thus, contrary to the particularity suggested by Belal et al. (2015), zakah is not an Islamic banking specific but rather a culture-specific-issue, applicable to all organisations operating in the GCC including Islamic and conventional banks. The assumption that religion-specific CSR is particular to Islamic banks, as in Mallin et al. (2014), Belal et al (2015) and Platonova et al., (2016), neglects this reality.

By assuming that all religion specific CSR initiatives are particular to Islamic banking, the current Islamic banking literature fails to capture the ‘religious’ aspect of CSR in the GCC. This is primarily due to a failure to appreciate the operating environment, a
narrow focus i.e. analysing Islamic banking reports only and more broadly a
decontextualized approach towards CSR. Future studies should therefore consider a
contextualised view of CSR and examine empirical evidence for new possibilities prior
to making broad-brush generalisations.

A final interesting insight from this chapter’s analysis worth noting is that qard hasan is
identified as the single differentiating feature of Islamic banks’ CSP. A parallel can be
drawn between qard hasan and PLS financing which, recall from chapter 4, is the only
feature that meaningfully differentiates Islamic banks’ balance sheet from that of its
conventional counterpart. What is interestingly common between PLS financing and
qard hasan, as was highlighted in chapter 2, is that these are both alternatives to riba-
based lending, the former is the ‘for profit’ alternative, whilst the latter is the ‘not for
profit’ alternative and as such these are considered to be “the most ‘Islamic’” forms of
financing by many Islamic scholars (Pollard and Samers, 2007, p.315). Thus it appears
that for both its financial and social aspects, it is riba which drives the practical
distinguishing features of Islamic banking relative to its conventional counterpart.

5.6 Conclusion

This chapter details how the CSP index designed to assess and compare the corporate
social performance (CSP) of Islamic and conventional banks is developed. In
constructing this index, this chapter first addressed the issue of incommensurability
between Islamic and conventional banks CSR by challenging the assumption that
religion-specific CSR initiatives are a category particular to Islamic banks, as
propagated in the current literature. By explaining the concept of CSR using Carroll
(1979)’s widely-cited definition and delineating perspectives from legitimacy,
stakeholder, and institutional theory, this chapter explained why this assumption is
inconsistent with the conceptual and theoretical basis of CSR, which by definition is a
concept embedded within a social context.

The chapter then looked at the challenge of measuring CSP. From its review of the
extant literature, this chapter has adopted a specific definition of CSP derived from
Wood (1991) and analytical framework to assess CSP based on Clarkson (1995)’s
recommendation. As there are no third-party independent ratings for Islamic banks’
CSP, and content analysis of banks’ annual reports is widely used in the current
literature, this chapter offers an improvement on the current methodology, by making a case for evidence-based disclosure to be used as a more objective means to assess CSP from social reporting. In doing so, this chapter builds on the established link between comprehensive reporting and performance and explicitly defined the terms ‘declarative’ and ‘evidence-based disclosure’ using GRI guidelines and prior literature.

By applying the evidence-based disclosure criteria, in-depth content analysis of 47 banks’ annual reports for the years 2009-2011 is conducted. From this, the CSP index is constructed which comprises of 25 social performance indicators that fall under 6 dimensions namely: Community, Customers, Employees, Environment, Socio-economic Development and Religious-specific Initiatives. As this index is grounded in actual corporate data as opposed to representing a theoretical benchmark, it arguably provides better insight into the nature of CSP in Islamic and conventional banks allowing for a better comparison, which can aid in identifying areas of improvement and thus policy making for both industries. Application of this index to conduct a thorough comparison between Islamic and conventional banks’ CSP should therefore be the next step forward, especially as a limited comparison in this chapter, seeking the presence of SPIs in both industries, has already provided important insights.

By comparing which social performance indicators are absent in Islamic/conventional banks, this chapter has identified that conventional banks provide evidence of engaging in 2 of the 3 religion-specific CSR initiatives, namely zakah and facilitating religious duties, both of which are related to the obligatory forms of worship in Islam. This chapter therefore, in addition to providing a conceptual and theoretical argument, also provides empirical evidence which invalidates the assumption that religion-specific CSR is a category particular to Islamic banking. The only religiously inspired initiative identified as unique to Islamic banking is qard hasan. This work therefore finds that it is not an entire category of religious CSR but rather a specific social performance indicator that differentiates the composition of CSP between Islamic and conventional banks.

Drawing a parallel with PLS financing, the only financial asset that differentiates Islamic from conventional banks’ balance sheet, leads to a profound insight. The only features which differentiate both the financial and social aspects of Islamic banking from its conventional counterpart in practice are the Islamic alternatives to riba-based
lending. Thus, riba which has received considerable attention in theoretical literature holds practical significance to this date.

**Limitations and Avenues for Future Research**

As with any research, this study also has its limitations. In constructing the CSP index, this study looks only at GCC banks over a three-year period. A useful extension to this work would be to increase the sample size, both in terms of the number of banks and number of years analysed. It would also be interesting to examine what CSP comprises of in other Muslim regions for example Southeast Asia and how this differs from the GCC. Additional sources of data, beyond annual reports, can also be helpful. Researchers should therefore consider analysing stand-alone CSR reports where available. Primary data analysis, for example interviews with bank management can also complement this work in gaining insights into the nature of CSP in Islamic and conventional banks.

**Contributions**

Despite its limitations, this chapter has made important contributions to the Islamic banking literature. To the best of my knowledge, this is the first study to construct a corporate social performance (CSP) index, which is based on the criteria of evidence-based disclosure and grounded in actual corporate data to assess and compare the CSP of Islamic and conventional banks. Furthermore, this is the first study to challenge and invalidate an important assumption in Islamic banking literature, i.e. the assumption of religion-specific CSR being ‘particular’ to Islamic banking, on conceptual, theoretical and empirical basis. In doing so, this study has opened up new avenues of research by showing that a meaningful comparison between Islamic and conventional banks’ CSP can be possible in an appropriate context.

It is hoped that future researchers will be able to benefit from the detailed methodology presented in this chapter to either construct their own indices using the evidence-based disclosure criteria for a better assessment of corporate social performance or adapt and modify the CSP index offered in this work for an improved evaluation of Islamic banks’ CSP and comparison with conventional banks. As this index is constructed using content analysis of banks’ annual reports, which are widely available, both the methodology and the application of this index can be generalised to contexts beyond the GCC Islamic banking industry.
Chapter 6 will now use the index developed in this chapter to conduct a thorough comparison of Islamic and conventional banks’ CSP.
### Appendix 5.A

| CSP Dimensions and Indicators | Definitions of Social Performance Indicators (SPIs) | Coding Rule: Evidence-based disclosures provided for each social performance indicator (SPI)  
**Scoring Rule:** Score 1 if at least one of the disclosure items listed is present for each social performance indicator (SPI); 0 otherwise |
<table>
<thead>
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<tbody>
<tr>
<td><strong>Community</strong></td>
<td></td>
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</tr>
</tbody>
</table>
| Charitable Donations         | Donations made to charitable organisations or causes. | - Amount of donation  
- Names of charities and/or causes supported locally and/or internationally  
- Name / details of specific CSR program / charitable trust set up by the bank |
| Avenue for Donations         | Avenues created for depositors, shareholders, clients, employees and/or general public to make donations for charitable purposes | - Initiatives such as ‘donations through ATMs’  
- Donating a percentage of amount used by customers on bank cards  
- Participating or organising fund-raising events (details of initiatives provided e.g. cause, collaborators or amount raised)  
- Internal initiatives e.g. donation opt-in for employees to contribute towards the bank’s total charity amount |
| Healthcare Campaign          | Initiatives aimed at supporting and raising awareness of health issues | - Campaigning and/or volunteering programs arranged to support / raise awareness of health issues in general public (details of initiatives given) |
| Culture                      | Promoting national culture including arts, literature and sports events | - Sponsoring cultural events including arts, literature, traditions, national days and/or sports (details of event supported given e.g. name and actions taken) |
## Customers

<table>
<thead>
<tr>
<th>Quality of Service</th>
<th>Evidence of quality customer service through proficient handling of complaints and third party awards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Service Skills</td>
<td>Measures taken to develop and enhance customer service skills including training and audit of service skills</td>
</tr>
<tr>
<td>Customer Engagement</td>
<td>Managing relations through customer engagement initiatives and/or measures undertaken to gain insight into customer satisfaction</td>
</tr>
</tbody>
</table>

- Resolution to customer complaints – percentage satisfied or time within which complaints resolved mentioned
- Evidence of high quality customer service e.g. award received for customer service by independent third party (which must be named).
- Initiatives / training programs specifically designed to improve customer service skills – evidence of training program required e.g. number of employees trained through the program
- Audit of customer service skills undertaken for employees – specific details of method of assessing customer service skills must be given e.g. through mystery shopping exercises
- Details of any customer engagement initiatives and/or
- Results from customer satisfaction surveys undertaken by bank itself
- Certification of ISO9001

ISO9001 is an international standard related to quality management systems by the International Organization for Standardization (ISO). One of its eight management principles focuses on customers’ satisfaction by ensuring that customers’ needs are identified and met. ISO 9001 certification therefore implies that customer engagement and feedback mechanisms will be in place and actions will be undertaken to improve performance accordingly. More information on: [http://www.iso.org/iso/home/standards/management-standards/iso_9000.htm](http://www.iso.org/iso/home/standards/management-standards/iso_9000.htm)
<table>
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<tr>
<th><strong>Employees</strong></th>
<th><strong>Diversity and Inclusion</strong></th>
<th><strong>Training and Education</strong></th>
<th><strong>Career Progression</strong></th>
</tr>
</thead>
</table>
|                                   | Employment/ leadership opportunities for women, disabled, minority ethnic and/or individuals from other disadvantaged groups | - Women present on board of directors and/or in senior management positions\(^{168}\)  
- Employment opportunities provided for the disabled, special needs, ethnic minorities and/or other disadvantaged members of society (evidence provided e.g. number of recruits from such groups). | - Leadership/ career development/ management programs in place (details given e.g. number of employees enrolled on such programs)  
- Sponsorship of higher education/ training and professional certifications for employees to enable career advancement (details given) |
|                                   | Continual training, skills development and education of employees                  | - Number/percentage of employees attending training programs in the year  
- Number of training days/ hours provided / training events held (internal and external to the bank, details of training programs given e.g. the topics of training covered)  
- Specific training units/departments or academies established within the bank to support staff training requirements  
- Budget allocated /costs incurred related to training needs specified |                                                                                       |

\(^{168}\) This does not include female members of the Royal families on board of directors.
| Incentive Schemes | Performance related incentive schemes for employees e.g. bonus/share plans, award schemes or other incentives | - Bonus plan in place (details of bonus plans and/or amount of bonuses paid given)\(^{169}\)  
- Share plan available for employees (details of share plans specified)  
-Award schemes for employees to recognise good performance  
- Provision of loans for employees with favourable terms |
| Healthcare Benefits | Healthcare benefits for employees including medical/health insurance and/or initiatives taken by bank aimed at improving employees physical well-being | - Medical / health insurance in place for employees  
- Initiatives undertaken by bank specifically aimed at improving employees physical well-being (details, including aim and scope of initiatives / number of employees affected mentioned) |
| Occupational Health and Safety | Initiatives taken to ensure health and safety at work | - Health and safety certification e.g. premises meeting national health and safety requirements  
- Specific training on health & safety for employees (scope of training e.g. first aid / fire safety training mentioned)  
- Reports on health and safety inspections including fire drills  
- Number of incidents/accidents on premises and details of response taken |

\(^{169}\) This does not include bonus/ shares/incentives for board of directors
<table>
<thead>
<tr>
<th><strong>Environment</strong></th>
</tr>
</thead>
</table>
| **Environmental Impact** | Initiatives taken to neutralise banks environmental impact | - Details of environmentally friendly initiatives taken e.g.  
- Recycling  
- Planting trees  
- Environmentally friendly waste management programs in place |
| **Green Products and Services** | Environmentally friendly products and services provided | - Banking products and/or services linked with environmental concerns e.g.  
- E-statements  
- Donating percentage of amount spent on credit cards to green causes |
| **Energy Conservation** | Reducing use of non-renewable sources of energy and/or minimising energy consumption | - Energy saving initiatives e.g. switch off equipment at end of day/ energy saving lights / bulbs in use  
- Use of renewable sources of energy  
- Eco-friendly building specification  
- Reporting on reduction of energy/utility usage |
| **Raising Environmental Awareness** | Organising / participating at events or sponsoring organisations that raise awareness of environmental issues | - Sponsoring organisations / participating at or organising events aimed at raising awareness of environmental issues (for external events, details such as cause supported and/or amount donated given; for internal events, details such as number of employees attending and/or frequency of events held mentioned) |
| **Environmental Funding Conditions** | Environmental considerations in lending and/or investment portfolios. | - Membership of Equator Principles  
- Evidence of environmentally friendly projects financed  
- Preferential rates or terms offered to environmentally friendly companies |
<table>
<thead>
<tr>
<th><strong>Socio-Economic Development (SED)</strong></th>
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</thead>
<tbody>
<tr>
<td><strong>Support for Small and Medium Enterprises (SMEs)</strong></td>
<td><strong>Support for small and medium sized enterprises (SMEs)</strong></td>
</tr>
<tr>
<td>- Financial products/services tailored to the needs of SMEs</td>
<td></td>
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<tr>
<td>- Amount financed specifically to SMEs and/or the number of SMEs helped</td>
<td></td>
</tr>
<tr>
<td>- Specific SME programs in place offering support to SMEs and local, small scale entrepreneurs, either initiated or in partnership with government schemes</td>
<td></td>
</tr>
<tr>
<td>- Evidence of favourable financing terms offered to SMEs</td>
<td></td>
</tr>
<tr>
<td><strong>Infrastructure Development</strong></td>
<td><strong>Investment in development of country’s infrastructure.</strong></td>
</tr>
<tr>
<td>- Investment/ funding of infrastructure project e.g. utilities (electricity, water, gas) / transport / education (public schools/universities) / hospitals / affordable housing projects and/or government buildings</td>
<td></td>
</tr>
<tr>
<td>- Support for trade infrastructure between countries</td>
<td></td>
</tr>
<tr>
<td>(for all of the above, details of projects financed given e.g. name/ cause/ amount spent; includes private and public joint ventures)</td>
<td></td>
</tr>
<tr>
<td><strong>Development of Human Capital</strong></td>
<td><strong>Contributing to the development of human capital through training and opportunities provided to youth in order to assist them in finding and securing employment</strong></td>
</tr>
<tr>
<td>- Training and recruitment opportunities for graduates including:</td>
<td></td>
</tr>
<tr>
<td>- Internships offered at the bank to students (details of internship program given, including number of interns)</td>
<td></td>
</tr>
<tr>
<td>- Collaboration with universities / government initiatives to guide/train graduates in securing jobs in banking sector</td>
<td></td>
</tr>
<tr>
<td>- Participation at and selection of graduates from career fairs (number recruited given)</td>
<td></td>
</tr>
<tr>
<td>- Sponsoring higher education for graduates /courses to help youth get jobs</td>
<td></td>
</tr>
</tbody>
</table>
| Financial Inclusion | Provision of finance for the socially and economically disadvantaged members of society and/or women empowerment schemes | - Specific financial products aimed at women and/or special needs customers  
- Extension of branches to rural communities  
- Microfinance schemes offered by the bank  
- Women empowerment schemes (e.g. sponsoring skills training courses) |
|---------------------|--------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|

**Religion-Specific Initiatives (RSI)**

| Zakah | Paying zakah on behalf of shareholders where permitted or specifying the amount of zakah due where not permitted | - For banks permitted to pay zakah on behalf of shareholders: amount of zakah paid / Zakah deducted from dividends before being paid to shareholders  
- For banks not permitted to pay zakah on behalf of shareholders: amount of zakah due per share given (to ease the calculation of zakah for the individual) |
|--------|-------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|
| Facilitating Religious Duties | Providing facilities to ease fulfilment of religious duties (does not include payment of zakah by the bank) | - Making fulfilment of religious duties easier e.g.  
- Providing savings account for Hajj and/or umrah (pilgrimage)  
- Funding hajj/umrah for employees/customers or members of general public  
- Providing payment avenue for customers to pay zakah  
- Taking special initiatives for Ramadan e.g. providing free iftars[^170]  
- Taking special initiatives and/or donations made on the Eid festivals (nature of initiatives / beneficiaries mentioned) |
| Qard Hasan | Provision of qard hasan | - Amount of qard hasan given during the year  
- Specific qard hasan fund in place |

[^170]: Iftar is the meal eaten at sunset for breaking one’s fast during Ramadan
## Appendix 5.B

### Corporate Social Performance (CSP) Index

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<th>CSP Dimensions &amp; Indicators</th>
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<th>Islamic Studies References</th>
<th>Conventional Studies References</th>
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<td>KLD; Branco and Rodrigues, 2006; Coupland, 2006; Cuesta-González et al., 2006; Scholtens, 2009</td>
</tr>
<tr>
<td>Avenue for Donations</td>
<td>5/3/6b,c (para 32)</td>
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<tr>
<td>Culture</td>
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<td>Haniffa and Hudaib, 2007</td>
<td>Branco and Rodrigues, 2006; Cuesta-González et al., 2006; Bravo et al., 2012</td>
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<td><strong>Customers</strong></td>
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<td>and 6/2/2b (para 46)</td>
<td>Branco and Rodrigues 2006; Cuesta-González et al., 2006; Bravo et al., 2012</td>
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<tr>
<td>Employees</td>
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<td>Branco and Rodrigues 2006; Cuesta-González et al., 2006; Bravo et al., 2012</td>
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<tr>
<td>Diversity and Inclusion</td>
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<td>Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011</td>
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<td></td>
<td></td>
<td>KLD; Branco and Rodrigues, 2006; Coupland 2006; Cuesta-González et al., 2006; McDonald and Rundle-Thiele, 2008; Scholtens, 2009</td>
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<tr>
<td>Training and Education</td>
<td>5/2/4c (para 18)</td>
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<td></td>
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<td>Branco and Rodrigues, 2006; Cuesta-González et al., 2006; Scholtens, 2009</td>
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<td>Career Progression</td>
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<td>Incentive Schemes</td>
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<td>Chapra, 1992; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011</td>
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<td>KLD; Branco and Rodrigues, 2006; McDonald and Rundle-Thiele, 2008; Bravo et al., 2012</td>
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<tr>
<td>Healthcare Benefits</td>
<td>5/2/4l (para 18)†</td>
<td>Chapra, 1992; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011</td>
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<td></td>
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<td>KLD; Branco and Rodrigues, 2006; Bravo et al., 2012</td>
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<td>Environmental Impact</td>
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</tr>
<tr>
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<td>Maali et al., 2006³</td>
</tr>
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<td>Raising Environmental Awareness</td>
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<tr>
<td>Category</td>
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<td>Source(s)</td>
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<td>-----------------------------------------------</td>
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<td>----------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Environmental Funding Conditions</td>
<td>5/3/3</td>
<td>Branco and Rodrigues, 2006; Cuesta-González et al., 2006; Coupland, 2006; Scholtens, 2009; Bravo et al., 2012</td>
</tr>
<tr>
<td>Socio-Economic Development (SED)</td>
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<td>Chapra, 2008; Maali et al., 2006; Aribi and Gao, 2010, 2011; Kamla and Rammal, 2013</td>
</tr>
<tr>
<td>Development of Human Capital</td>
<td>5/3/3e</td>
<td>Chapra, 1992, 2008; Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011</td>
</tr>
<tr>
<td>Financial Inclusion</td>
<td>5/3/3a</td>
<td>Chapra, 1992, 2008; Kamla and Rammal, 2013</td>
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</table>
### Religion-Specific Initiatives (RSI)

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<td>Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011; Kamla and Rammal, 2013</td>
</tr>
<tr>
<td>Facilitating Religious Duties</td>
<td>5/3/3g (para 26)²</td>
<td>Haniffa and Hudaib, 2007</td>
</tr>
<tr>
<td>Qard Hasan</td>
<td>5/3/1</td>
<td>Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao, 2010, 2011; Kamla and Rammal, 2013</td>
</tr>
</tbody>
</table>

### Notes

Some examples where the AAOIFI CSR Standard and CSR indices have been broadly interpreted to be used as supporting references in this study:

1. AAOIFI Recommendation 5/2/4l on occupational health and safety measures has been referenced here in order to separate banks that may have health and safety certification and/or training but do not provide additional health benefits for employees and vice versa.

2. AAOIFI recommendation 5/3/3 “Policy for social development and environment based investment quotas”: The recommended actions under 5/3/3 of the AAOIFI CSR standard have been interpreted broadly for referencing here. This AAOIFI recommendation is limited to investment quotas however; the CSP index above appreciates and includes any action that has a positive social, environmental and/or development impact that is undertaken by the bank either as part of an investment quota or otherwise.

3. Maali et al. (2006, p.279) includes in their index, two items “The amount and nature of any donations or activities undertaken to protect the environment” and “The projects financed by the bank that may lead to harming the environment” which have been broadly interpreted as supporting references here.

4. Maali et al. (2006, p.279) includes an item “The bank’s role in economic development” in their index. This item has been interpreted as a supporting reference here.
Chapter 6

Comparing the Corporate Social Performance of Islamic and Conventional Banks

6.1 Introduction

A comparison of Islamic and conventional banks’ corporate social performance (CSP) has eluded the literature thus far. As explained in chapter 5, this gap primarily exists because of two key methodological issues, the assumed incommensurability problem and the measurement problem. Having addressed both these issues in chapter 5, a comparison can now be made between the two industries.

The purpose of this chapter is to compare the CSP of GCC-based Islamic and conventional banks over the 2009 – 2011 period. To achieve this aim, this chapter is divided in three parts. In part 1, Islamic and conventional banks are assessed against the CSP Index developed in chapter 5. CSP scores for each bank are generated using the widely used dichotomous scoring method, where banks are allocated a score of 1 for each of the 25 social performance indicators (SPIs) they provide evidence-based disclosure on and 0 otherwise, with the overall CSP score being the sum of these. Using this CSP score, this chapter first answers the question: do Islamic banks, on average, have higher CSP scores than conventional banks? Then by comparing individual banks’ CSP scores, this chapter examines the level of intra-industry variation followed by a comparison of year-on-year CSP scores to investigate how CSP scores have changed across and within the two industries over the 2009-2011 period.

In part 2, this chapter investigates how the composition of CSP differs between Islamic and conventional banks and answers the question: are the most and least popular CSP dimensions and SPIs the same across the two industries? To achieve this, the six CSP dimensions are ranked in order of popularity for both industries and compared. The rank is determined by the average percentage of Islamic and conventional banks that have provided at least one evidence-based disclosure per dimension over the 2009-2011 period. Next, the most and least popular SPIs are identified and compared across the
industries. SPIs disclosed by more than 50% banks on average are classified as the most popular while SPIs disclosed by less than 5% banks on average are classified as least popular. This is followed by a comparison of the percentage of Islamic and conventional banks providing evidence-based disclosure per dimension and SPI to identify and discuss where differences between the two industries are statistically and practically significant. The difference over the 2009-2011 period is also examined to identify: firstly, if and how the composition of CSP has changed within both industries and secondly, how the changes compare across the two industries.

Finally, in part 3, a more in-depth analysis is conducted where Islamic and conventional banks are evaluated and compared using three social performance quantitative indicators (SPQIs), which provide a quantitative measure of banks’ performance on selected SPIs for which monetary and/or impact data could be collected. These SPQIs assess the extent to which a bank engages in a particular CSR activity, allowing for greater differentiation between individual banks and a more comprehensive comparison between the Islamic and conventional banking industries.

The remaining chapter is structured as follows. Section 6.2 identifies what results can be expected with regards to the comparison of Islamic and conventional banks’ CSP scores and composition in light of previous literature and theoretical framework presented in chapter 5. Section 6.3 describes the method and data. This includes a description of how the CSR scores are generated and details on how the three SPQIs are constructed. Section 6.4 presents the results and discussion. Finally, section 6.5 concludes the chapter.

**6.2 Comparing the Corporate Social Performance (CSP) of Islamic and Conventional Banks: What Can We Expect?**

**6.2.1 Comparing CSP Scores**

Islamic banking “is not just riba-free but also social-welfare oriented” (Chapra, 1985, p.174). This view has been long advocated by Islamic economists who argue that the ‘Islamic’ prefix necessitates ethical behaviour and social goals since the objective of sharia itself is to promote human welfare. From this basis, advocates argue that Islamic banking offers an ethical alternative to conventional banking as it is shaped by the
teachings of Islam. The Islamic banking literature has thus been dominated by the idea that Islamic banks are not just financial but also social institutions. CSR has therefore been declared as an essential, inseparable feature of Islamic banking, a requirement for Islamic banks to follow the principles of Islam in their entirety. Thus, according to this view, Islamic banks “are expected to be more socially responsible than their conventional counterparts” (Maali et al., 2006; Kamla et al., 2006; Haniffa and Hudaib, 2007, p.101; Dusuki, 2008; Warde, 2010; Farook et al., 2011; Aribi and Arun, 2015; Platonova et al., 2016).

Critics however argue that Islamic banks seek profits as aggressively as their conventional counterparts and are only interested in ‘big business’ (Kuran, 2004; Pollard and Samers, 2007; Warde, 2010; Belal et al., 2015). Only in theoretical models do Islamic banks operate in accordance with sharia’s ethical teachings. In practice, ethical and social goals seem to have very little impact on these banks behaviour. These institutions operate on sharia arbitrage basis and are “guilty of exploiting the pious” by selling products that do not comply with the letter or spirit of the sharia law (El-Gamal, 2006; Khan, 2010, p. 817). It is therefore unrealistic to expect Islamic banks, which do not even meet the law, to be more socially responsible than their conventional counterparts (Kuran, 2004; Kamla and Rammal, 2013).

Which of these two views is empirically supported remains to be tested.

**Change in CSP Scores**

The 2007 – 08 financial crisis is a prime example of a legitimacy threatening event. In the years immediately following the onset of the crisis (i.e. 2009-2011, analysed in this work), the international banking industry faced a significant loss of credibility, heightened customer dissatisfaction and increased pressure to demonstrate a socially responsible business profile (Bravo et al., 2012; Jizi et al., 2013). Although the crisis began in the West, the GCC banking industry was no exception to this international pressure. In such circumstances, the need to improve public image and defend operational legitimacy is of utmost importance. From the perspective of legitimacy theory, under such circumstances, CSR initiatives and related disclosures are likely to be higher as a response (Dowling and Pfeffer, 1975; Lindblom, 1994; Suchman, 1995; Deegan, 2002; Branco and Rodrigues, 2008). Therefore, one can expect a positive change in CSP scores over the 2009-2011 period in both Islamic and conventional
banks. It is a priori ambiguous however, whether Islamic or conventional banks should have greater improvement.

### 6.2.2 Comparing CSP Dimensions and Social Performance Indicators

According to the institutional theory, organisations such as Islamic and conventional banks, which operate within the same ‘organisational field’, develop homogenous characteristics (DiMaggio & Powell, 1983). From this theoretical perspective, differences in the composition of CSP between Islamic and conventional banks are unlikely to be significant. Furthermore, isomorphic processes, whether coercive, mimetic or normative, lead to organisations adopting similar management practices over time. This suggests that over time Islamic and conventional banks’ CSP composition will become uniform (DiMaggio & Powell, 1983; Carpenter & Feroz, 2001).

One key difference nevertheless, can be expected. The Islamic banking industry derives its legitimacy from its religious identity. Providing sharia compliant financial services is the raison d'être of the industry. As Farook et al., (2011) notes, Islamic banks rely on the Muslim public’s support and therefore need to demonstrate compliance with religious values. Chapra and Ahmed (2002) found that over 80% of Islamic banks depositors would withdraw their deposits if they found their banks failed to comply with sharia. Therefore to maintain their operational legitimacy and to portray an Islamic identity, it is reasonable to expect ‘Religion-specific Initiatives (RSI)’ to be the most popular CSP dimension in Islamic banks. While conventional banks in the GCC also face the pressure to conform to religious norms and to appear as good corporate citizens in the Muslim community (Kamla, 2007), conventional banks’ stakeholders do not expect the same level of dedication as do Islamic banks’ (Haniffa, and Hudaib, 2007).

‘Socio-economic Development’ (SED) is another CSP dimension that, according to the Islamic banking literature, should be higher in Islamic banks. Islamic economists have long advocated that Islamic banks are to play a social and developmental role in their societies, assist in economic regeneration, support small businesses and widen the access to credit through financial inclusion schemes. Islamic banks are therefore expected to be involved in such initiatives more than their conventional counterparts (Chapra 1985; Haniffa and Hudaib, 2007; Kamla and Rammal, 2013; Belal et al., 2015). Critics however disagree as Islamic banks are found to focus largely on trade
and short term financing, rather than long-term projects (Aggarwal and Yousef, 2000; Khan, 2010). It is a priori ambiguous whether Islamic banks would prioritise SED over conventional banks.

According to the stakeholder management theory, banks prioritise their relationships with the most powerful stakeholders, those with the greatest control over resources required by the organisation (Gray et al., 1995a; Islam and Deegan, 2008). Banks are therefore likely to produce voluntary disclosure on issues which concern such stakeholder groups, to gain and maintain their support (Ullman, 1985; Gray et al., 1995a; Islam and Deegan, 2008). Employees are amongst the most important resource for banks and have been identified as one of the most important stakeholder group in the banking sector (Beekun and Badawi, 2005; Cuesta-Gonzales et al., 2006; Aribi and Arun, 2015). Prior studies e.g. Zeghal and Ahmed (1990) find that banks prioritise the employees dimension relative to other industries. In the specific context of the GCC, Kamla (2007) found the most common disclosure relates to the employee dimension, within which training and education is the most disclosed indicator. Aribi and Gao (2010) also find similar results. Accordingly, ‘Employees’ can be expected to be one of the top CSP dimensions in both Islamic and conventional banks. The relative priority attached to this dimension in either industry, however, cannot be a priori determined.

After Employees, Kamla (2007) finds the second-highest disclosure by Arab companies is on Customer relations category, within which the vast majority of disclosures relate to improving customer care. Few companies however provided any disclosure concerning satisfaction surveys or the feedback mechanisms to communicate with customers. Majority of the disclosures identified are of qualitative nature and general i.e. without specific evidence. Similar focus on qualitative disclosure is found in Aribi and Gao (2010) who finds customer service to be the most predominant disclosure issue in the GCC. In the non-GCC banking context as well, customers is one of the most prominent stakeholder groups (Cuesta-Gonzales et al., 2008). In the Spanish banking industry for example, Bravo et al., (2012) find customers to be the top ranking dimension followed by community. Nevertheless, as the previous studies have found majority of the disclosure on this dimension is qualitative (declarative) in the GCC, it is unclear how this will rank relative to other dimensions, especially as the CSP index in this work examines the presence of evidence-based disclosure. It is also unclear how the prioritisation of this dimension will differ across Islamic and conventional banks.
Related to customers, is the Community dimension. Clarke and Gibson-Sweet (1999) conclude that in highly visible industries such as banking, community-related CSR initiatives and their disclosure are especially prominent. These initiatives are aimed at both the local community and customers. With the branches on the high street, a positive reputation in the local communities is important for their continuous legitimacy and as part of stakeholder management (Branco and Rodrigues, 2008). These initiatives are also used to attract new consumers since the general public includes banks’ present and future customers. Thus, both Islamic and conventional banks are expected to engage in community initiatives. The exact composition and priority cannot be a priori determined. However, it is noted in prior literature that a notable aspect of community initiatives is charitable donations. Maali et al., (2006) finds that Islamic banks accentuate their charitable donations. Charitable donations may therefore be higher in Islamic banks than conventional counterparts, relative to other types of community initiatives.

Finally, as banking is a less environmentally-sensitive industry relative to others (e.g. mining), the Environment dimension tends to be one of the least prioritised (Branco and Rodriguez, 2008; Maalin et al., 2014). Repeatedly banking studies in the extant literature have found disclosures on the environment to be relatively low and in case of Islamic banks, even absent. It is therefore reasonable to expect that Environment may be one of the least prioritised dimension by banks and that the proportion of Islamic banks engaged in environmental CSR is lower than conventional banks (Maali et al., 2006; Kamla 2007; Mallin et al., 2014; Aribi and Arun, 2015; Platonova et al., 2016).

6.3 Method and Data
This chapter continues the analysis from chapter 5. The same dataset is therefore used, comprising of 47 GCC commercial banks, 12 full-fledged Islamic and 35 conventional banks, analysed over the 2009-2011 period.

6.3.1 Generating CSP Scores
To measure and compare the CSP of Islamic and conventional banks, this chapter uses the CSP Index developed in chapter 5. CSP is a multidimensional construct (Waddock and Graves, 1997). The CSP index captures this multidimensionality by assessing banks
performance on 25 social performance indicators (SPI) under six CSP dimensions: Community (4), Customers (3), Employees (6), Environment (5), Socio-economic Development (4) and Religion-specific Initiatives (3).

To calculate the CSP scores, a dichotomous scoring method is used in line with prior literature (see e.g. Haniffa and Hudaib, 2007; Branco and Rodrigues, 2008; Bravo et al., 2012; Kamla and Rammal, 2013; Aribi and Arun, 2015; Belal et al., 2015; Platonova et al., 2016). Banks are allocated a score of 1 for each SPI they provided evidence-based-disclosure on and 0 otherwise. The scoring approach is also additive, therefore the total CSP score per bank represents the number of SPIs a bank provided evidence-based-disclosure on and ranges from a minimum of 0 to a maximum of 25 (24) for Islamic (conventional) banks. When interpreting such scores, it is important to note that these numerical scores do not measure the intensity of the social initiatives, an evaluation of which requires impact and monetary data, neither of which are readily available nor possible to collect in many cases (Abbott and Monsen, 1979). Instead, the numerical CSP scores reflect the variety of different SPIs that a bank has provided evidence of engaging in thorough its annual report.

6.3.2 Constructing Social Performance Quantitative Indicators (SPQIs)

To further extend the literature on Islamic and conventional banks’ CSP comparison, this thesis also complements the dichotomous CSP score method with quantitative measures of selected SPIs, for which monetary or impact data could be collected from banks’ annual reports. Termed as Social Performance Quantitative Indicators (SPQIs), these assess the extent to which a bank engages in a particular CSR activity, allowing for greater differentiation between individual banks and a more comprehensive comparison between the Islamic and conventional banking industries. By adding further quantitative detail through the SPQIs, this chapter also contributes methodologically to the existing Islamic banking literature where this approach, of using both the dichotomous scoring method and quantitative measures, is currently absent.

To construct the SPQIs, the entire list of 25 SPIs constituting the CSP index was examined for presence of monetary and non-monetary quantitative disclosure.

---

171 The number of SPIs per dimension is given in the parenthesis.

172 Recall, from chapter 5, no conventional bank provided evidence of qard hasan thus the maximum score for conventional banks is 24.
analysis conducted in chapter 5 revealed that banks did provide some type of quantitative disclosure for majority of the 25 SPIs (see appendix 5.A for the complete list of SPIs and details on the nature of quantitative disclosure per SPI). The key challenge in constructing SPQIs however related not to the presence of quantitative disclosure but more importantly to the comparability of such disclosures across banks. This comparability problem arises due to the nature of disclosures banks have made. As CSR reporting is voluntary in the GCC banking industry and there is no sector-wide consensus shared by the Islamic and conventional banking industries on which performance metrics to use, banks have used different metrics to measure and report the intensity or impact of their social activities relating to each of the SPIs.

Take for example the SPI ‘training and education’ from the Employees dimension. A wide variety of quantitative disclosures have been provided by banks on this SPI. Banks making disclosure on the provision of training courses have measured it as either 1) the number of training courses or events held during the year, 2) the number of training days provided or 3) the number of training man-hours undertaken. Other banks have made disclosures on employee participation at such events, measured either as 1) the number of employees or 2) the percentage of employees attending training programs during the year. Finally, banks making monetary disclosures have either provided 1) the allocated training budget or 2) the costs associated with staff training and education incurred during the year. In each case, banks have clearly made quantitative disclosures. However drawing comparisons between individual banks and especially between the Islamic and conventional banking industries is difficult as numerous banks within and across the two industries over the 3-year sample period have not used the same performance metric. Furthermore, as some banks have provided different performance metrics year on year, it is also difficult to make comparisons for the same bank over time in some instances.

Similar comparability issues exist with other SPIs as well. For example, for the ‘customer engagement’ SPI from the Customers dimensions, results of customer satisfaction surveys have been presented as either 1) the percentage of customers satisfied or 2) the percentage improvement in year-on year customer satisfaction level. While both quantitative disclosures relate to customer satisfaction, disclosure 1 refers to the percentage of satisfied customers recorded for the year whereas disclosure 2 refers to the change in percentage of satisfied customers over the preceding year and thus the
two figures are not directly comparable. Popularity of the dichotomous scoring method that overcomes such comparability issues, by generating a single CSP score for each bank which takes into account the multidimensionality of CSP and enables comparisons to be made across banks, is thus understandable.

Nevertheless, for 3 SPIs comparable quantitative disclosures could be identified. These are Charitable Donations, Diversity and Inclusion and Qard Hasan. From these, the following 3 SPQIs are constructed: %Charitable Donations, %Women Representation in Leadership Roles (this relates to the ‘diversity and inclusion’ SPI173) and %Qard Hasan. Details of how the 3 SPQIs are defined and their significance is discussed below.

**% Charitable Donations**

To define a measure for ‘%Charitable Donations’, the 2012 report issued by the National Committee for Responsive Philanthropy (NCRP, 2012), which is the only independent watchdog investigating institutional philanthropic spending in the United States (Goldberg, 2013) was consulted. In its 2012 report, the NCRP investigates philanthropic practices of four US megabanks, namely Bank of America, Wells Fargo, Goldman Sachs and JPMorgan Chase. The report defines ‘cash giving as a percentage of total revenue’ as the “best metric” to measure banks’ philanthropic giving (NCRP, 2012, p.5) and highlights three key points taken into consideration when devising this metric. First, the report calls for philanthropic giving to include only cash donations, and therefore excludes non-cash i.e. in-kind donations. Amongst other points mentioned in the report, this approach overcomes incomparability problems across banks as well as the issues of double counting e.g. the monetary value of in-kind donations may already be included in the total donation value stated. Secondly, the report calls for cash donations to be measured as a proportion of revenue rather than profit or pre-tax profit, arguing that creative accounting practices can more easily manipulate the profit value than revenue, that revenue is a more stable measure of performance over time than

173 Recall from appendix 5.A, the ‘diversity and inclusion’ SPI includes evidence-based disclosure on leadership opportunities for women as well as employment opportunities for the disabled, special needs, ethnic minorities and/or other disadvantaged members of society. The %Women Representation SPQI only examines banks’ performance relating to leadership opportunities for women because although some banks have made disclosures specifically on employment opportunities for the latter disadvantaged groups, there aren’t sufficient number of banks making such disclosures to allow comparisons to be drawn across the Islamic and conventional banking industries specifically on these issues.
profit, and finally that measuring donations as a proportion of revenue shows “a bank’s true, long-term commitment to philanthropy regardless of fluctuations in profit” (NCRP, 2012, p.5). The NCRP report also highlights that measuring corporate giving as a percentage of revenue is in line with the approach adopted by the Committee Encouraging Corporate Philanthropy (CECP), the international CEO-led coalition of over 200 of the world’s largest companies, which works to design the corporate social strategy adopted by its members. Each year, the CECP produces the largest, internationally recognised industry-led research on corporate social investment. In evaluating the performance of multi-billion dollar companies from across the globe, the CECP also measures corporate giving as a percentage of revenue, thus supporting the NCRP metric. Finally, the NCRP report also emphasises the importance of looking at the average value of philanthropic giving over time, i.e. over the sample period examined, as the average over time overcomes yearly anomalies.

In line with the NCRP recommendations, %Charitable Donations is therefore defined here as ‘cash donations as a percentage of total revenue’.

\[
\text{%Charitable Donations} = \left( \frac{\text{Cash Donations}}{\text{Total Revenue}} \right) \times 100
\]

Evaluating banks using this SPQI offers new insights on the relative performance of Islamic and conventional banks’ level of charitable giving in the post financial crisis, 2009-2011, period. As noted earlier, prior literature finds that Islamic banks accentuate their charitable giving, relating this act to their religious identity (Maali et al., 2006). However, as there has been no comparison of the relative amount donated by banks in both industries thus far, it is a priori unknown whether Islamic banks do indeed donate a higher percentage of their revenue to charitable causes than their conventional counterparts. Comparing Islamic and conventional banks using this SPQI will therefore shed light on whether Islamic banks’ accentuated claims of charitable giving is mere marketing or reflection of genuine philanthropic behaviour.

% Women Representation in Leadership Roles

To evaluate banks’ performance on the second SPQI, ‘%Women Representation in Leadership Roles’, three measures are used. The first measure, %Board of Directors (henceforth %BoD) is defined as ‘the percentage of women on the board of directors’. This measure is calculated by dividing the number of female directors on each bank's board by the total number of directors and is reported in percentage terms.
1) %BoD (% Board of Directors) = \( \frac{\text{Number of women on BoD}}{\text{Total BoD Members}} \times 100 \)

The second measure % Senior Management Position (henceforth %SMP) is defined as ‘the percentage of women in senior management positions, excluding the board of directors’. This measure is calculated by dividing the number of women in senior management position (SMP) in each bank by the total number of SMP members, and is reported in percentage terms.

2) %SMP (%Senior Management Position) = \( \frac{\text{Number of women in SMP}}{\text{Total SMP Members}} \times 100 \)

Finally, the third composite measure %BoD&SMP is defined as ‘the percentage of women holding position on the board of directors and/or in senior management’. This measure is computed as: the number of women on BoD plus the number of women in SMP for each bank divided by the total number of BoD and SMP members, and is reported in percentage terms.

3) % BoD&SMP = \( \frac{\text{Number of women on BoD and/or in SMP}}{\text{Total BoD and SMP Members}} \times 100 \)

As the current Islamic banking CSR literature has not measured the extent of women representation in leadership roles, guidance in defining these measures was sought from the broader literature on business ethics, management and leadership particularly studies with a focus on gender diversity issues. The most common measure of gender diversity used in the extant literature is percentage of female directors (see e.g. Williams, 2003; Adams and Ferreira, 2009; Hafsi and Turgut, 2013; Isidro & Sobral, 2015), which is represented by the first measure, %BoD, in this work. While these aforementioned studies only focus on the presence of female directors, others such as Terjesen and Singh (2008) and Jurkus et al. (2011) also look at women representation in senior management positions. Industry analysts such as the MSCI ESG Research LLC\(^\text{174}\), which analyses and provides ratings for companies’ environmental, social and

\(^\text{174}\) Morgan Stanley Capital International (MSCI) is an international investment research firm which provides research-based indexes and analysis tools to institutional investors. MSCI ESG Research LLC provides research, analysis and ratings of company’s environmental, social and governance-related
governance-related practices, also uses two separate measures: the percentage of women on the board and the percentage of women in senior management position to assess a company’s workforce gender diversity (for details see MSCI, 2018).

As Jurkus et al. (2011) highlight it is important to use a broader measure of gender diversity by including women in senior management position in addition to the board of directors because firstly not many companies have female directors which leads to insufficient data and secondly because many companies without female directors may still have women in position of leadership such as higher management. Thus, focusing purely on %BoD may not be an accurate reflection of women representation in leadership roles for a particular company. Furthermore, as Terjesen and Singh (2008) explain, members of the senior management constitute the population from which new board members are commonly appointed. Thus, for women to be represented at the board level and move into the highest decision making position requires them to have some level of representation in position of senior management first. For FTSE 100 companies, Singh et al. (2007) found that of the newly appointed female directors, almost half held senior positions in financial institutions, a third in the public sector and a quarter in the charity sector. The lack of such higher management experience has been long noted as a key reason for low number of female directors (Burke, 1997; Oakley, 2000). Evaluating women representation in senior management therefore reflects the extent to which a company supports’ women empowerment at work, particularly their career prospects and progression.

Taking these points into account, this thesis also looks at women representation in senior management by using the second measure %SMP. Finally, in line with Jurkus et al. (2011)’s broader measure of gender diversity, the third composite measure %BoD&SMP takes into account women representation on both the board of directors and in senior management positions and thus provides an overall measure of women representation in leadership roles for each bank.

Although there has been no comparison of how well women are represented in leadership roles between Islamic and conventional banks in the GCC thus far, this is an important comparison which deserves investigation. Gender diversity and particularly practices. The ESG ratings are used to construct the MSCI ESG Indexes (for further details on MSCI gender diversity methodology, see MSCI, 2018)
women empowerment within the workplace has become an important topic of debate globally. While this subject is undergoing intense scrutiny and has received considerable attention in the Western world, both in research and the media, interest in this topic is growing in non-western contexts. In the GCC, the debate on the role of women in society and more specifically in the workplace has gained significant prominence in recent years. Many academics and social activists have noted that the GCC has amongst the highest female literacy rates in the world, with female educational attainment being higher than male counterparts in all 6 GCC countries. Yet for decades, women representation in the labour force has been marginal (Krause, 2009; Young, 2016). The 2014 Global Gender Gap report by the World Economic Forum illustrates this paradox, as women in the GCC are well-educated relative to international standards but lag behind in economic participation. In the traditionally patriarchal GCC society, where gender segregation is an established norm, there are considerable social, cultural and institutional barriers which hinder women’s economic participation (Kelly, 2009; Randeree, 2012; Young, 2016).

Despite the challenges, trends have been changing over the last two decades, as women participation rates have been rising in all GCC states. This is partly driven by social pressures and partly by economic conditions and government policy. Over the last two decades, the GCC states have not only undergone liberalisation of cultural and social norms but are also evolving into knowledge-based economies, with member states actively trying to reduce dependence on oil and gas as the primary source of revenue and, more importantly, on foreign labour. As a result, GCC governments have actively encouraged companies to recruit locally and have focused on integration of women into the labour force, in recognition of their importance as an underused resource for the country (Kelly, 2009; Krause, 2009; Randeree, 2012; Young, 2016). Since the mid-2000s especially, state leaders, including notable monarchs, have vigorously encouraged women empowerment schemes (Kelly, 2009; Krause, 2009; Randeree, 2012), promoting women as the “next generation of GCC working professionals” (Buttorff, 2018, p.2) and a sign of “GCC’s modernity” (ibid, p.5). Even in Saudi Arabia, known to be the most conservative of the 6 GCC nations, women empowerment is part
of the ‘Saudi 2030 Vision’\textsuperscript{175}, whereby increasing women participation in the private sector specifically is deemed an important developmental goal (Young, 2016). Empowering women and encouraging participation in the workforce is now also considered an important part of companies’ CSR. Many are addressing this CSR issue through ‘nationalisation of the workforce’ schemes, which target employment and career progression opportunities towards national citizens. These schemes have been a key driver increasing women participation in the workforce, opening up employment opportunities for national women as companies aggressively recruit to meet set quotas. Nevertheless, it is notable that despite the rise in women participation rates, at present few women are found in senior management and executive roles (Kelly, 2009; Young, 2016).

Given this context, it can be expected that only a minority of banks would have women in leadership positions. However, with changing trends and increased social pressure, both the stakeholder and institutional theory (particularly mimetic and normative isomorphism), suggest that the change in %women representation is likely to be positive. The difference between Islamic and conventional banks however is more difficult to predict a priori, as both operate in the same social and cultural environment and thus face the same challenges. It is therefore important to look at both the percentage of banks from each industry that have women represented in leadership positions as well as the percentage of senior management & executives that are female in order to compare the two industries. This will be achieved using the three measures defined above.

\%Qard Hasan

To define a measure for the third and final SPQI, \%Qard Hasan, prior Islamic banking literature was consulted. At present, Islamic banking CSR studies use the dichotomous scoring method to evaluate banks on the provision of qard hasan, i.e. allocating a score of 1 if a bank provides qard hasan and 0 otherwise (see e.g. Maali et al., 2006; Haniffa and Hudaib, 2007; Aribi and Gao 2010; 2011; Kamla and Rammal, 2013; Mallin et al.,

\textsuperscript{175} Saudi Vision 2030 refers to the plan Saudi Arabia has drawn up to express the country’s long-term goals. These include a move towards reducing the country’s dependence on oil, diversification of its economy, development of public sector services (including education, health, infrastructure etc.) as well as addressing notable social issues. The vision explicitly mentions “to increase women’s participation in the workforce” as part of its vision (for further details, see www.vision2030.gov.sa/en)
To define a quantitative measure for qard hasan, this thesis therefore takes into consideration the parallel drawn between qard hasan and PLS financing, which was highlighted in chapters 2 and 5 as well as by Pollard and Samers (2007). As noted earlier in this thesis, both qard hasan and PLS financing are considered to be “the most ‘Islamic’” forms of financing by many Islamic scholars, the former is the ‘not-for profit’ while the latter is the ‘for profit’ alternative to interest-bearing loans (Pollard and Samers, 2007, p.315). As discussed in chapter 4, ‘PLS financing as a percentage of total financing’ is the most common measure used in prior literature to examine the extent to which Islamic banks provide the ideal ‘for-profit’ alternative to interest-bearing loans (see e.g. Aggarwal and Yousef, 2000; Chong and Liu, 2009). Similar metric for qard hasan can also be devised to evaluate the extent to which Islamic banks provide the ‘not-for-profit’ alternative to interest-bearing loans. Accordingly, %Qard Hasan, is defined in this work as ‘qard hasan as a percentage of total financing’. It is calculated by dividing the amount of qard hasan provided by a bank by its total financing value and is reported in percentage terms.

\[
\% \text{Qard Hasan} = \left( \frac{\text{Qard Hasan}}{\text{Total Financing}} \right) \times 100
\]

While the dichotomous scoring method will illustrate how many Islamic banks provide qard hasan, the %qard hasan SPQI will allow further differentiation between individual Islamic banks based on the percentage of their financing portfolio which is in the form of qard hasan. As chapter 4 showed, there is considerable intra-industry variation in the level of PLS financing provided by individual Islamic banks. Similar variation could also exist in the level of qard hasan within the industry. As the abovementioned Islamic banking CSR studies have not evaluated what percentage of Islamic banks is in qard hasan form and how it compares across banks, it is apriori unclear the how much variation exists in the industry. By comparing %qard hasan levels between Islamic banks, this chapter will therefore offer additional insights contributing to the existing Islamic banking literature.

Before results for the three SPQIs are discussed, the next section will first discuss results from the dichotomous CSP scoring method.
6.4 Results and Discussion

6.4.1 Comparing CSP Scores between Islamic and Conventional Banks

Using the dichotomous scoring method, CSP scores are calculated for each Islamic and conventional bank. Results are presented in Table 6.1. Columns headed: ‘2009 – 2011’ list each bank’s yearly CSP score; ‘3 yr. Average’ lists each banks’ average score over the sample period; ‘3 yr. Cumulative’ score is the number of different SPIs each bank provided evidence-based disclosure on, at least once during the sample period and ‘Change’ is calculated as the 2011 CSP score minus the 2009 score. The range and average CSP score as well as the standard deviation for each industry are also presented.

As results from table 6.1 show, the average CSP scores for Islamic and conventional banks is extremely similar. There is no difference between Islamic and conventional banks’ average CSP score for 2009, only one point difference for 2010, the 3 yr. average and cumulative scores and two point difference for 2011. Given these scores, as one would expect, the t-test results confirm that for all categories, the difference between average CSP scores for Islamic and conventional banks is not statistically significant. As the CSP scores for Islamic (conventional) banks for the years 2010 and 2011 (2009 and 2010) are skewed, the Mann-Whitney U test176 was also conducted, which produced similar results177. Thus, empirical evidence does not support the expectation that Islamic banking is more socially responsible, as advocated in the literature.

176 The Shapiro-Wilk normality test was used. Results indicated that the null was rejected at 5% level of significance for Islamic (conventional) banks’ CSP scores for the years 2010 and 2011 (2009 and 2010). As there are 12 Islamic banks in the sample (the sample size is relatively small), the Mann-Whitney U test was also conducted to test for difference between the groups.
177 Difference in CSP scores between conventional banks with and without Islamic windows was also tested. No significant difference was identified. As mentioned earlier in chapter 5, it is expected that decisions related to CSR activities are made at the parent conventional bank rather than at the Islamic window level (subsidiary or branch) level, thus it is unsurprising that the presence of an Islamic window operation has no clear impact on the CSP of conventional banks.
<table>
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<tr>
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Table 6.1: CSP Scores for Islamic and Conventional Banks

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<td>4</td>
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</tbody>
</table>

Change is calculated as 2011 CSP score minus the 2009 score

It is important, however, to look beyond industry averages especially in light of chapter 4 results. Similar to PLS levels, here too, results indicate considerable intra-industry variation in both the Islamic and conventional banking industries. Over the 3 years, CSP scores range from a minimum of 1 to a maximum of 17 in Islamic banks and 0 to 18 in conventional banks. There are several Islamic banks which have higher CSP score than conventional banks and vice versa. The 3 yr. average CSP score, for example, is higher in 42% (40%) of Islamic (conventional) banks than the 3 yr. industry average for conventional (Islamic) banks. Unlike PLS financing levels however, no range of CSP scores systematically differentiates Islamic from conventional banks. Thus, the notable difference in CSP scores exists at the bank rather than the industry level.

Comparing the cumulative with the yearly CSP scores for each bank reveals interesting insights. Take ABG’s CSP scores for example, which are 4(2009), 5(2010) and
6(2011). Its cumulative score however, indicates that over the three years the bank actually provided evidence-based disclosure on 8 different SPIs. This pattern i.e. higher cumulative than yearly CSP score is found in almost 75% of the sample banks and is reflected at the industry level. As the industry cumulative score demonstrates, Islamic banks provided evidence-based disclosure on 9 and conventional banks on 8 different SPIs respectively, amounting to a third of the of the SPIs in the CSP Index. These patterns signify that banks are covering a greater variety of SPIs over the three-year period than the yearly CSP scores suggest.

Two important and interesting inferences can be drawn from this finding. Firstly, the difference between yearly and cumulative scores indicates that banks are substituting between different types of CSR initiatives, choosing to undertake new initiatives in some years whilst ceasing to continue others. Take ABG as the example. To have added 4 different SPIs to its 2009 score, whilst the yearly scores demonstrate the addition of 1 per year implies that the bank must have replaced 2 of its existing SPIs from either 2009 or 2010 with two alternative ones by 2011. Substituting between SPIs seems to be a pragmatic strategy adopted by GCC banks to cover a variety of CSR initiatives, appealing to a wider stakeholder base whilst spreading the cost across different years.

Secondly, the discrepancy between the cumulative and the yearly CSP score also suggests that banks may be choosing to undertake only a certain number of CSR initiatives each year, perhaps to keep the expense on social responsibility at a certain (manageable) level. The two banks with the highest cumulative score of 20 (ADIB) and 22 (ADCB) provided evidence of no more than 17 and 18 SPIs in a single year respectively. Interestingly, both these banks with the highest cumulative score are from the same country i.e. UAE. Closer inspection, however, does reveal that there is no significant country-level difference in CSP scores. Instead, there is notable variation in CSP scores within individual countries. Any institutional differences across the six GCC countries therefore do not appear to have the defining influence on banks’ overall CSP score, unlike the case for PLS financing.

Next, consider the change in CSP scores. Over the 2009-2011 period, CSP scores have, on average, increased in both Islamic and conventional banking industries by 3 and 1
point respectively. T-tests confirm that the increase in both industries is statistically significant at 5% level, although the difference between the two industries is not\textsuperscript{178}.

Analysing year-on-year changes shows interesting comparison between the two industries. In the Islamic (conventional) banking industry, over the 2009-2010 period, CSP scores increased for 25% (54%), remained unchanged for 50% (29%) and decreased for 25% (17%) banks. Over the 2010-2011 however, CSP scores increased for 75% (24%), remained unchanged for 17% (29%) and decreased for 8% (37%) of Islamic (conventional) banks. Thus, the increase in Islamic banks’ CSP over the three-year period is driven largely by the rise over the 2010-2011 period in contrast to conventional banks, which experienced a more notable improvement during the 2009-2010 period.

The impact of the global financial crisis is one possible explanation for these differing patterns of increase in CSP scores between Islamic and conventional bank. As Hasan and Dridi (2010) find, the 2007-08 crisis affected Islamic and conventional banks differently. Initially in 2008, the impact on conventional banks was much greater than Islamic banks. However in 2009 this changed. As the impact of the financial crisis moved into the real economy, Islamic banks, which have a much higher concentration in real estate than conventional counterparts, suffered much larger decline in profitability. This was exacerbated by the risk management practices in some banks. While conventional banks begun their recovery process in 2009, the decline in Islamic banks profitability only began to stabilise in 2010 (Ernst & Young, 2011).

Notice, how for both Islamic and conventional banks, the largest increase in CSP scores has appeared 1 year after the most impactful crisis year, i.e. for conventional (Islamic) banks, the greatest impact of the crisis is in 2008 (2009) and the rise in CSP scores is most notable in 2010 (2011). To understand this fully, note that there are likely to be two forces at play: economic well-being and legitimacy. By reducing or maintaining their social activities, banks have understandably focused on their economic well-being following the crisis. Once secured, as part of the recovery strategy, there has been much greater emphasis on reducing the legitimacy gap. What is also interesting is that a higher percentage of conventional banks have reduced their CSP scores in 2011 relative

\textsuperscript{178} The p values are: 0.02 for Islamic banking and 0.01 for conventional banking. The data on Change in CSP scores did not fail the Shapiro-Wilk normality test, therefore only the t-test results are reported.
to 2010. This is also in line with legitimacy theory which postulates that when a threat such as the financial crisis arises, organisations increase their efforts towards social initiatives to address any legitimacy gaps, reducing them as the perceived threat lessens over time. Overall, it appears that, as in other industries, Islamic and conventional banks in the GCC also engage in CSR initiatives to attain organisational legitimacy particularly after a threat event (see e.g. Cho and Patten, 2007; Branco and Rodrigues, 2008; Du et al., 2012; Bravo et al., 2012).

Finally, the considerable intra-bank variation that is evident in table 6.1 is another notable finding from this analysis. As table 6.1 shows, the change in CSP scores in some banks has been quite dramatic. QIB for example increased its CSP scores by 11 points, whilst others such as ASB and BB have reduced by 3 points in the three-year period. Comparing banks’ year-on-year CSP scores also indicates that some banks have relatively stable CSP whilst others portray a more volatile CSP trend. AKB for example, has shown a gradual improvement in CSP, with its score increasing from 5(2009), 7(2010) to 9(2011) compared to ADIB which records a significant reduction in CSP scores from 10 (2009) to 3 (2010) followed by a rise to 17 (2011). Of course the impact of the crisis, the importance attached to CSP and associated strategies are likely to differ between individual banks based on their idiosyncratic characteristics. Thus, the level of intra-bank variation, illustrated in table 6.1, is understandable. These results are also consistent with prior literature, which finds that CSR disclosure levels vary year-on-year within the same organisation both in the (Islamic) banking and non-banking industries, even outside of a legitimacy-threatening event (Haniffa and Hudaib, 2007; Branco and Rodrigues, 2008; Patten and Zhao, 2014; Aribi and Arun, 2015; Platonova et al., 2016). Overall, results show that there is considerable variation in CSP scores within banks as well as between banks in both industries. Ironically, the only point of similarity is in the average CSP scores of the two industries. Whether such similarity exists at the dimension and SPI level is investigated next.

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179 It must be noted, that the general trend of course does not represent each individual bank, as the effect of the financial crisis differs in each institutions based on its idiosyncratic characteristic.

180 Only five banks have the same CSP score in 2011 as 2009. However, even in these banks, two experienced an increase in their CSP scores in 2010, going back to the original score of 2009 in 2011.
6.4.2 Decomposing CSP: Comparing CSP Dimensions and Social Performance Indicators

In this section, the most and least popular CSP dimensions and SPIs are examined. Table 6.2 lists the six CSP dimensions in rank order, from the most to the least popular, in both Islamic and conventional banks. As table 6.2 shows there is clear difference in the top ranking dimensions in both industries. Religion-specific initiatives (RSI) is the most popular dimension in Islamic banks, while Employees, the most popular dimension in conventional banks, is second most popular in Islamic banks. These results are consistent with both the legitimacy and stakeholder management theory as was described in section 6.2.1. While employees are considered the most powerful stakeholders for banks (Beekun and Badawi, 2005; Cuesta-Gonzales et al., 2006; Aribi and Arun, 2015), Islamic banks' operational legitimacy relies on their religious identity and thus it is understandable why RSI is given most prominence.

Table 6.2: Most/Least Popular CSP Dimensions

<table>
<thead>
<tr>
<th>Rank</th>
<th>Islamic</th>
<th>Conventional</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Religion-specific Initiatives (RSI)</td>
<td>Employees</td>
</tr>
<tr>
<td>2</td>
<td>Employees</td>
<td>Socio-Economic Development (SED)</td>
</tr>
<tr>
<td>3</td>
<td>Community</td>
<td>Community</td>
</tr>
<tr>
<td>4</td>
<td>Socio-Economic Development (SED)</td>
<td>Religion-specific Initiatives (RSI)</td>
</tr>
<tr>
<td>5</td>
<td>Customers</td>
<td>Customers</td>
</tr>
<tr>
<td>6</td>
<td>Environment</td>
<td>Environment</td>
</tr>
</tbody>
</table>

Ranking is based on the average percentage of banks providing at least one evidence-based disclosure per CSP dimension over the 2009-2011 period. These are listed in order of popularity (from most to least popular).

The least popular dimensions, customers and environment are the same in both Islamic and conventional banks. The finding that environment is the least popular dimension in both Islamic and conventional banks is in line with prior literature, as it is a reflection of how pertinent the industry considers the issue of environment relative to other stakeholder issues (Maali et al., 2006; Kamla 2007; Mallin et al., 2014; Aribi and Arun, 2015; Platonova et al., 2016). However, it is notable that customers, one of the important stakeholder groups, is the second least popular dimension. One possible reason for this may be the nature of disclosure provided by banks. As noted in Kamla (2007) and Aribi and Gao (2010), Islamic and conventional banks in the GCC in general provide largely qualitative (declarative) disclosure on customer relations in their
annual reports. As the CSP index used in this work specifically looks at evidence-based disclosure, this low ranking may be a reflection of the nature of disclosure provided. The declarative disclosure itself is reflective of a lack of initiatives in this dimension. As Kamla (2007) points out few Arab companies engage in satisfaction surveys or feedback mechanisms to communicate with customers, thus customer engagement initiatives are lacking in the GCC. Thus, there is a need for both an increase in greater customer related initiatives and improvement in disclosure practices.

Notice, community is the third ranking dimension in both Islamic and conventional banks. As highly visible institutions, community-related CSR initiatives are important for the public image of both Islamic and conventional banks (Clarke and Gibson-Sweet, 1999; Branco and Rodrigues, 2008). What is notable however is the ranking of socio-economic development (SED). Contrary to the expectations expressed in the literature regarding Islamic banks and their role in socio-economic development (Chapra 1985; Haniffa and Hudaib, 2007; Kamla and Rammal, 2013; Belal et al., 2015), results show that in practice, conventional banks on average prioritise SED dimension more than Islamic banks.

The most popular SPIs as table 6.3 shows are identical in both Islamic and conventional banks, with the addition of zakah in Islamic banks. These are training and education, development of human capital and charitable donations. These results are consistent with prior literature (Maali et al., 2006; Kamla, 2007; Aribi and Gao, 2010). All four of the least popular SPIs in Islamic banks are from the environment dimension, which is consistent with the findings at the dimension level. In contrast conventional banks have two from the environment dimension, one from the employee dimension namely occupational health and safety and qard hasan which, as indicated in chapter 5, is absent in conventional banks. Although, conventional banks prioritise employee dimension the most, they clearly differentiate between individual SPIs as occupational health and safety is one of the least popular. This highlights the importance of looking not only at the CSP dimension level but also at the composition of each dimension to identify priorities within and between the Islamic and conventional banking industries.
Table 6.3: Most/Least Popular Social Performance Indicators

<table>
<thead>
<tr>
<th>Most Popular Social Performance Indicators (On Average &gt; 50% Banks)</th>
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</thead>
<tbody>
<tr>
<td>Islamic</td>
</tr>
<tr>
<td>Training and Education</td>
</tr>
<tr>
<td>Development of Human Capital</td>
</tr>
<tr>
<td>Charitable Donations</td>
</tr>
<tr>
<td>Zakah</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Least Popular Social Performance Indicators (On Average &lt; 5% Banks)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic</td>
</tr>
<tr>
<td>Green Products</td>
</tr>
<tr>
<td>Environment Funding Conditions</td>
</tr>
<tr>
<td>Energy Conservation</td>
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<tr>
<td>Environment Awareness</td>
</tr>
</tbody>
</table>

The social performance indicators (SPIs) are not listed in rank order. Instead, to make it easy for the readers to see similarities and differences, SPIs common in both industries' most and least popular categories are presented next to each other.

To take a more in-depth look at the results, table 6.4 presents the percentage of banks providing evidence-based disclosure for each of the CSP dimensions and individual social performance indicators. As table 6.4 shows, there are only a few cases where the difference between Islamic and conventional banks is statistically significant. Thus in general, the composition of CSP does not differ too much between Islamic and conventional banks. This finding is in line with the institutional theory which postulates that organisations operating within an organisational field develop homogenous characteristics (DiMaggio & Powell, 1983). This significant differences exist in 1/6 CSP dimensions (religion specific initiatives) and 5/25 SPIs, of which the difference is statistically significant in each year only for 2 SPIs, whilst for the other 3 SPIs the difference is not significant in all three years. Looking at the average percentage of banks, the difference between Islamic and conventional banks is statistically significant for 4/25 SPIs, of which 3 belong to the religion specific initiatives (RSI) dimension. Thus, the difference between Islamic and conventional banks is largely driven by the RSI dimension. Given earlier discussions, this result is unsurprising, as Islamic banks’ operational legitimacy relies on their religious identity whereas for conventional banks this is not the case.
Table 6.4: Percentage of Banks Providing Evidence-based Disclosure per CSP Dimension and Social Performance Indicator

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<td>Community</td>
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<td>63%</td>
<td>58%</td>
<td>60%</td>
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<td>72%</td>
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<td>Socio-Economic Development (SED)</td>
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<td>37%***</td>
<td>92%***</td>
<td>37%***</td>
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<td>Charitable Donations</td>
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<td>8%</td>
<td>6%</td>
<td>17%</td>
<td>6%</td>
<td>11%</td>
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<td>9%</td>
<td>-3%</td>
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cont.
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<th>CSP Dimensions &amp; Indicators</th>
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<th>2010</th>
<th>2011</th>
<th>3 yr. Average</th>
<th>Difference over Period</th>
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<td></td>
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<td>Islamic</td>
<td>Conventional</td>
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<td><strong>Environment</strong></td>
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<td>Environmental Impact</td>
<td>8%</td>
<td>11%</td>
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<td>20%</td>
<td>8%</td>
</tr>
<tr>
<td>Green Products</td>
<td>0%</td>
<td>6%</td>
<td>0%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Energy Conservation</td>
<td>8%</td>
<td>6%</td>
<td>0%</td>
<td>9%</td>
<td>8%</td>
</tr>
<tr>
<td>Environment Awareness</td>
<td>8%</td>
<td>20%</td>
<td>8%</td>
<td>17%</td>
<td>0%</td>
</tr>
<tr>
<td>Environment Funding Conditions</td>
<td>8%</td>
<td>3%</td>
<td>0%</td>
<td>3%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Socio-Economic Development (SED)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Support for Small and Medium Enterprises</td>
<td>8%</td>
<td>11%</td>
<td>17%</td>
<td>20%</td>
<td>58%</td>
</tr>
<tr>
<td>Infrastructure Development</td>
<td>25%</td>
<td>9%</td>
<td>8%</td>
<td>11%</td>
<td>42%**</td>
</tr>
<tr>
<td>Development of Human Capital</td>
<td>50%</td>
<td>60%</td>
<td>42%</td>
<td>66%</td>
<td>75%</td>
</tr>
<tr>
<td>Financial Inclusion</td>
<td>17%</td>
<td>11%</td>
<td>8%</td>
<td>11%</td>
<td>33%</td>
</tr>
<tr>
<td><strong>Religion-specific Initiatives (RSI)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zakah</td>
<td>92%***</td>
<td>31%***</td>
<td>92%***</td>
<td>31%***</td>
<td>92%***</td>
</tr>
<tr>
<td>Facilitating Religious Duties</td>
<td>33%**</td>
<td>9%**</td>
<td>17%</td>
<td>9%</td>
<td>50%***</td>
</tr>
<tr>
<td>Qard Hasan</td>
<td>25%***</td>
<td>0%***</td>
<td>25%***</td>
<td>0%***</td>
<td>25%***</td>
</tr>
</tbody>
</table>

***, ** denote significance at the 1%, and 5% levels respectively. Following the literature, 5% level of significance has been used as the cut-off point. To test if there is a statistically significant difference in the proportion of Islamic and conventional banks, the Boschloo Exact Test has been used. The most common test used for this purpose is Chi squared test. However it is not appropriate given the small sample size and with frequencies for several SPIs being less than five and even 0 in some cases. A possible alternative is the Fisher Exact Test. The Fisher Test however computes the p value, assuming the margins of the 2x2 table are fixed (both columns and rows). This assumption is not appropriate for this work as only the total number of banks is fixed, while the number of banks disclosing per CSP dimension and SPI are not prefixed. The alternative to Fisher’s Test when only one margin is fixed is the Barnard Test. Boschloo Test is a type of Barnard test, which uses Fisher’s p value to calculate the ‘as or more extreme’ tables; it is uniformly more powerful than Fisher (see Lydersen et al., 2009 for details).

a To test if the change in proportion of Islamic/conventional banks disclosing between 2009 and 2011 is statistically significant, the McNemar Test has been used. Support for Small and Medium Enterprises is the only instance where results indicate statistical significance.
Looking at the individual SPIs, it is clear that zakah is driving the difference between Islamic and conventional banks at the RSI dimension level. It is also notable that within RSI, the difference between Islamic and conventional banks is not statistically significant for ‘facilitating religious duties’ in all three years. This is also the only SPI in the RSI dimension for which the percentage of Islamic banks change during the sample years as there is no change in the percentage of banks disclosing on zakah and qard hasan. Overall, excluding RSI (zakah and qard hasan), there is no statistically significant difference in the percentage of Islamic and conventional banks providing evidence-based disclosure for the CSP dimensions and SPIs which is systematic throughout all 3 years.

Although not statistically significant, the differences between Islamic and conventional banks do nevertheless hold practical significance and therefore are discussed here. The focus of the discussion is on identifying which dimensions and SPIs are higher/lower in Islamic banks relative to conventional counterparts, as that’s an indication of their priority. As table 6.4 shows, the percentage of Islamic banks is higher than conventional banks in each year for RSI and its three constituent SPIs, namely zakah, facilitating religious duties and qard hasan as well as for charitable donations. The latter is in line with Maali et al (2006)’s finding that Islamic banks put emphasis on charitable donations.

The percentage of Islamic banks is lower than conventional banks in each year for the Employees dimension and the following SPIs: healthcare campaigns, culture, diversity and inclusion, training and education, career progression, environmental impact and environmental awareness. On average, of the six CSP dimensions, Islamic banks are higher in community and RSI and lower in the other four. In the environment dimension, on average, Islamic banks are lower for all its constituent SPIs. This is in line with prior literature which finds that Islamic banks do not tend to show much concern for the environment and at times make no disclosures on this dimension in their annual reports (Maali et al., 2006; Kamla 2007; Mallin et al., 2014; Aribi and Arun, 2015; Platonova et al., 2016). Results are mixed for the other four dimensions excluding RSI for which Islamic banks are higher on average.

Looking at the individual years, it is notable that in 2010, the percentage of Islamic relative to conventional banks is lower for 5 of the 6 dimensions and for all SPIs in the
environment and socio-economic development (SED) dimension. These are largely driven by an increase in the percentage of conventional banks, rather than a decrease in Islamic banks (which is the case with 3/4 SPIs in the SED dimension). In 2011, the results for Islamic banks improve as they become higher for 4 of the 6 dimensions, with a remarkable turnaround for SED, going from lower to higher for all its constituent SPIs. In the customers dimension as well, Islamic banks turn from being lower in 2 to higher in all 3 SPIs. Performance improves in the environment and community dimensions as well, with a higher percentage of Islamic banks in 2/5 and 2/4 SPIs respectively. These changes are driven primarily by a rise in the percentage of Islamic banks. Although conventional banks have also seen an increase in most SPIs over the 2010-2011 period, this increase is modest relative to Islamic banks for which the change is much more pronounced, increasing in some cases by 17% – 42% points with the largest rise in SED’s SPIs (25% – 41% points). These results are not only consistent with findings discussed in section 6.4.1, where it was noted that the improvement in CSP scores in conventional (Islamic) banks was primarily in 2010 (2011), due to the differing effects of the financial crisis, but are also complimentary providing further insights into how the composition of CSP changed during those years.

Looking at the overall change now (2009 – 2011), it is notable that the difference between Islamic and conventional banks is statistically significant only for the customers dimension. While conventional banks have seen a modest increase of 3% points, Islamic banks have increased by 34% points. The percentage of Islamic banks have increased by the same amount in SED as well, however, for this dimension, the increase in conventional banks is also notable (17% points) and thus the difference between the two is not statistically significant. For the individual SPIs, there is a statistically significant difference for: avenue for donations, occupational health and safety and support for SMEs. The significant result regarding the first two indicates that Islamic banks have made considerable effort to adopt SPIs present in the conventional banking industry. In addition to avenue for donations and occupational health and safety, Islamic banks have also adopted the following SPIs over the course of the three years: healthcare campaigns, customer service skills, and green products. Particularly in the case of healthcare campaign, the difference in Islamic and conventional banks has gone from being highly significant in 2009 to not significant in 2011. These results are indicative of mimetic isomorphism. It is notable however that, contrary to the views of
its proponents, Islamic banking industry appears to follow, rather than lead the CSR movement in the GCC banking industry.

The largest increase in any SPI is in support for SMEs (50%). This is the only SPI for which the change in the proportion of Islamic banks between 2009 and 2011 is statistically significant. Given these results, naturally two questions arise: what is driving the increase in Customers and SED in Islamic banks and particularly support for SMEs which has increased by 50% points in 3 years.

Although not obvious to those outside of the industry, however both the customers dimension and support for SMEs share one common factor: these are delineated as areas of growth opportunities for Islamic banks during the 2010-2012 period by industry analysts. The World Islamic Banking Competitiveness Report, produced with Ernst & Young (henceforth the Report), provides yearly overview of the global Islamic banking industry, indicating areas of growth and concern and makes recommendations on the direction the industry should follow. The main message in its 2011 Report was that a “customer centric operating model” is required “to drive future (sustainable) growth” in this industry (p.4), as Islamic banks now compete for customers who are open to both Islamic and conventional banking. It further emphasised ‘SME banking’ as a key growth opportunity for the industry. Moreover, it also encouraged Islamic banks to get involved in infrastructure projects as many GCC governments, as a response to the financial crisis, have committed to spending on large infrastructure projects (Ernst & Young, 2011). Results for 2011 reflect Islamic banks acting on this, as the difference in the percentage of Islamic and conventional banks engaging in ‘infrastructure development’ has become statistically significant in 2011, while it was not in the previous two years.

Given the above, it is quite obvious that Islamic banks CSP especially areas the industry is concentrating and growing on is driven by profit and market share concerns, and not altruistic objectives as many in the Islamic banking CSR literature suggest.

6.4.3 Evaluating and Comparing Banks on the Social Performance Quantitative Indicators (SPQIs)

To complement the above analysis with a more in-depth comparison, this section evaluates Islamic and conventional banks’ performance using the three SPQIs defined
in section 6.3.2. First, the relative performance of Islamic and conventional banks is examined on %charitable donations, followed by the three measures designed to assess %women representation in leadership roles and finally, Islamic banks are evaluated on the level of %qard hasan they provide. Results for each SPQI are discussed sequentially below.

%Charitable Donations

As the earlier analysis and discussion in section 6.4.2 highlighted, the percentage of Islamic banks providing evidence-based disclosure on the SPI ‘Charitable Donations’ is higher than conventional banks for each of the three years analysed. By comparing the %charitable donations made by Islamic and conventional banks, this section investigates whether the level of charitable donations i.e. the percentage of revenue a bank has donated to charitable causes, is also higher in Islamic banks. As the definition of %charitable donations includes only cash donations, any banks which made disclosures of in-kind donations but did not provide a monetary value of their donations could not be included in this analysis. Thus due to data limitations, only a subset of the sample banks are assessed using this SPQI.

Results for each year, the three-year average and change in %charitable donations are presented in table 6.5. As the figures show, the three-year average for Islamic and conventional banking industries is almost identical at 0.68% and 0.63% respectively. There is a difference in the annual average %charitable donation levels, which is higher in Islamic banks for both 2009 and 2010 however the difference is not statistically significant. Although the literature finds that Islamic banks accentuate their charitable giving (Maali et al., 2006), results from this study show that on average Islamic banks do not show evidence of donating a higher percentage of their revenue to charitable causes compared to their conventional counterparts.

While the average donation levels are relatively similar, there are differences between the industries. As the 3-year standard deviation shows, there is greater variation within the conventional banking industry (0.73%) compared to Islamic banking (0.22%). The maximum and minimum also reflect this as the range for the 3-year average %charitable donations ranges from 0.40% to 0.92% in Islamic banks compared to 0.11% to 2.11% in conventional banks. Yearly standard deviations also show that variation is consistently higher for conventional banks relative to Islamic
Table 6.5: Percentage Charitable Donations by Islamic and Conventional Banks

<table>
<thead>
<tr>
<th>Banks</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>3 yr. Average</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Islamic Banks</td>
<td></td>
</tr>
<tr>
<td>ABG</td>
<td>1.66%</td>
<td>0.76%</td>
<td>0.35%</td>
<td>0.92%</td>
<td>-1.30%</td>
</tr>
<tr>
<td>ASB(^a)</td>
<td>-</td>
<td>0.92%</td>
<td>0.42%</td>
<td>0.67%</td>
<td>-0.50%</td>
</tr>
<tr>
<td>BAJ</td>
<td>1.04%</td>
<td>0.54%</td>
<td>0.60%</td>
<td>0.73%</td>
<td>-0.44%</td>
</tr>
<tr>
<td>BISB</td>
<td>-</td>
<td>-</td>
<td>0.76%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>KFH</td>
<td>-</td>
<td>-</td>
<td>0.57%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>QIB(^b)</td>
<td>0.25%</td>
<td>0.55%</td>
<td>-</td>
<td>0.40%</td>
<td>0.30%</td>
</tr>
<tr>
<td>Min.</td>
<td>0.25%</td>
<td>0.54%</td>
<td>0.35%</td>
<td>0.40%</td>
<td>-1.30%</td>
</tr>
<tr>
<td>Max.</td>
<td>1.66%</td>
<td>0.92%</td>
<td>0.76%</td>
<td>0.92%</td>
<td>0.30%</td>
</tr>
<tr>
<td>Median</td>
<td>1.04%</td>
<td>0.66%</td>
<td>0.57%</td>
<td>0.70%</td>
<td>-0.47%</td>
</tr>
<tr>
<td>Mean</td>
<td>0.98%</td>
<td>0.69%</td>
<td>0.54%</td>
<td>0.68%</td>
<td>-0.48%</td>
</tr>
<tr>
<td>St. Dev</td>
<td>0.70%</td>
<td>0.18%</td>
<td>0.16%</td>
<td>0.22%</td>
<td>0.66%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Conventional Banks</td>
<td></td>
</tr>
<tr>
<td>ANB</td>
<td>0.12%</td>
<td>0.15%</td>
<td>0.06%</td>
<td>0.11%</td>
<td>-0.07%</td>
</tr>
<tr>
<td>AUB</td>
<td>0.14%</td>
<td>0.14%</td>
<td>0.12%</td>
<td>0.13%</td>
<td>-0.02%</td>
</tr>
<tr>
<td>BBK</td>
<td>1.94%</td>
<td>1.56%</td>
<td>1.42%</td>
<td>1.64%</td>
<td>-0.53%</td>
</tr>
<tr>
<td>BMIB</td>
<td>0.10%</td>
<td>0.14%</td>
<td>0.37%</td>
<td>0.20%</td>
<td>0.27%</td>
</tr>
<tr>
<td>BOS</td>
<td>0.33%</td>
<td>0.36%</td>
<td>0.37%</td>
<td>0.36%</td>
<td>0.04%</td>
</tr>
<tr>
<td>DB</td>
<td>-</td>
<td>0.01%</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>NBAD</td>
<td>0.40%</td>
<td>0.48%</td>
<td>0.64%</td>
<td>0.51%</td>
<td>0.24%</td>
</tr>
<tr>
<td>NBB</td>
<td>1.94%</td>
<td>1.25%</td>
<td>3.14%</td>
<td>2.11%</td>
<td>1.20%</td>
</tr>
<tr>
<td>NBO</td>
<td>0.12%</td>
<td>0.13%</td>
<td>0.18%</td>
<td>0.15%</td>
<td>0.06%</td>
</tr>
<tr>
<td>NCB</td>
<td>0.44%</td>
<td>0.58%</td>
<td>0.44%</td>
<td>0.49%</td>
<td>0.01%</td>
</tr>
<tr>
<td>Min.</td>
<td>0.10%</td>
<td>0.01%</td>
<td>0.06%</td>
<td>0.11%</td>
<td>-0.53%</td>
</tr>
<tr>
<td>Max.</td>
<td>1.94%</td>
<td>1.56%</td>
<td>3.14%</td>
<td>2.11%</td>
<td>1.20%</td>
</tr>
<tr>
<td>Median</td>
<td>0.33%</td>
<td>0.26%</td>
<td>0.37%</td>
<td>0.36%</td>
<td>0.04%</td>
</tr>
<tr>
<td>Mean</td>
<td>0.62%</td>
<td>0.48%</td>
<td>0.75%</td>
<td>0.63%</td>
<td>0.13%</td>
</tr>
<tr>
<td>St. Dev</td>
<td>0.76%</td>
<td>0.52%</td>
<td>0.98%</td>
<td>0.73%</td>
<td>0.46%</td>
</tr>
</tbody>
</table>

\(^a\) \(^b\) denote missing values i.e. where banks did not provide either evidence-based disclosure on charitable donations or only mentioned in-kind donations without stating a monetary value in their annual reports.

\(^a\) Change is calculated as %charitable donations made in 2011 minus %charitable donations made in 2010.

\(^b\) Change is calculated as %charitable donations made in 2010 minus %charitable donations made in 2009.
counterparts in each year, and while the variation in charitable donations within the Islamic banking industry has reduced, from standard deviation of 0.70% in 2009 to 0.16% in 2011, for conventional banks it has increased from 0.76% to 0.98%. Change in the average charitable donations over the 2009-2011 also differs between the industries as it is negative for Islamic banks (-0.48%) but positive (0.13%) for conventional banks. Moreover, as the difference in the mean and median values indicates, the distribution for conventional banks is skewed to the left, in contrast to Islamic banks which is skewed to the right (except for 2010).

Differences between banks within each industry are also noticeable. Two banks from each industry particularly stand out, namely, ABG and BAJ in the Islamic and BBK and NBB in the conventional banking industry as these banks have made donations exceeding 1% of their revenue in at least one year during the sample period. While 3 of these 4 banks have showed a reduction in charitable donations over the sample period, the most notable of which is in ABG (-1.30%), NBB has shown an increase of 1.20%, leading to its donation level exceeding 3% of its revenue. In contrast, there are also banks such as ANB and NBO where charitable donation is below 0.20% of their revenue. Thus, as table 6.5 shows there is considerable heterogeneity in the level of charitable donations and change in this over the sample period between individual banks, within and across the two industries.

Finally, it is also notable that there is no clear correlation between the level of charitable donation and the overall CSP score for a bank (refer to table 6.1 for CSP scores). Thus, banks that engage in greater variety of CSR initiatives do not necessarily donate a higher percentage of their revenue to charitable causes. Similarly, banks that donate a higher percentage of their revenue to charitable causes do not shy away from undertaking a variety of other CSR initiatives. In line with previous literature (see e.g. Waddock and Graves, 1997; Chen et al., 2008) this study’s findings also confirm the value of using a multidimensional instrument (such as the CSP index) over a single indicator (e.g. %donation) as the latter does not reflect a firm’s overall social performance.

**% Women Representation in Leadership Roles**

This subsection evaluates Islamic and conventional banks’ performance on the issue of women representation in leadership roles, using the three measures, %BoD, %SMP and
BoD&SMP defined in section 6.3.2. Data for these three Women Representation measures has been collected from banks’ annual reports. Where banks did not provide details of their board of directors and/or senior management, relevant data to calculate these measures could not be collected, leading to some missing observations.

Table 6.6 presents the percentage of Islamic and conventional banks which have women represented on their board of directors (BoD) and/or in senior management positions (SMP). As the figures show, the percentage of banks where women are represented in higher management has increased over the 2009-2011 period in both the Islamic and conventional banking industries. The only exception is the percentage of conventional banks with women in SMP which increased in 2010 but fell back to its 2009 level in 2011. Nevertheless, the general trend is positive as the percentage of banks where women hold positions on the BoD and/or SMP has increased. This finding is in line with the stakeholder and institutional theory (particularly mimetic and normative isomorphism) which, as discussed earlier, suggest that women representation will expectedly increase given the context of changing attitudes towards women in the workplace, rising social pressure and significance of women empowerment initiatives in the GCC countries (Kelly, 2009; Krause, 2009; Randeree, 2012; Young, 2016).

<table>
<thead>
<tr>
<th>Year</th>
<th>Islamic</th>
<th>Conventional</th>
<th>Islamic</th>
<th>Conventional</th>
<th>Islamic</th>
<th>Conventional</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>0%</td>
<td>6%</td>
<td>8%</td>
<td>20%</td>
<td>8%</td>
<td>26%</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>11%</td>
<td>17%</td>
<td>23%</td>
<td>17%</td>
<td>31%</td>
</tr>
<tr>
<td>2011</td>
<td>8%</td>
<td>17%</td>
<td>17%</td>
<td>20%</td>
<td>25%</td>
<td>37%</td>
</tr>
<tr>
<td>Change</td>
<td>8% 11%</td>
<td>8% 0%</td>
<td>8%</td>
<td>17%</td>
<td>11%</td>
<td></td>
</tr>
</tbody>
</table>

Change is calculated as the percentage of banks with women representation in leadership roles in 2011 minus the 2009 value.

The overall improvement in women representation is notably greater in the Islamic banking industry as the percentage of Islamic banks where women are represented on the BoD and/or in SMP roles has increased by 17% points, compared to the conventional banking industry where the percentage has increased by 11% points (column 3). Nevertheless, as the figures in table 6.6 show, the actual percentage of Islamic banks with women representation is consistently lower than the percentage of conventional banks for all three measures and throughout the three years analysed.
Therefore, while the Islamic banking industry has shown a greater improvement overall, when the two industries are compared on the percentage of banks that have women represented in leadership positions, the conventional banking industry clearly outperforms its Islamic counterpart.

Results from table 6.6 (column 1 and 2) also show that in both the Islamic and conventional banking industries, the percentage of banks with female directors is lower than the percentage of banks where women hold senior management positions. This finding is also consistent with the global trend as prior research has shown that most companies do not have female directors, although many such companies do have female representation in other senior management roles (Terjesen and Singh, 2008; Jurkus et al., 2011; MSCI, 2018). Moreover, as table 6.6 shows, relative to the Islamic banking industry, which has progressed from having no banks with female directors in 2009 to 8% in 2011, the percentage of conventional banks with female directors has almost trebled over the sample period (from 6% to 17%). Thus, results show that although the overall improvement is greater in the Islamic banking industry (as shown in column 3), conventional banks have made greater progress on the issue of representing women at the highest decision making position (BoD). These findings provide support for the approach adopted in this study, that is, to evaluate gender diversity within and across industries through multiple (composite and specific) measures, as advocated in prior literature and by industry analysts (Terjesen and Singh, 2008; Jurkus et al., 2011; MSCI, 2018), since the different measures not only provide greater insight but also lead to different conclusions.181

Table 6.7 shows the percentage of the BoD and/or senior management teams that are female, in banks where women are represented in higher management. As the lower panel of the table shows, on average, over the 2009-2011 period, 10-12% of the BoD and 8-11% of senior management teams comprise of female members in GCC banks. There is almost no difference in the mean and median percentages for the BoD however the median percentage of women members is slightly lower than the mean for senior

181 As mentioned earlier, when the two industries are compared using the composite measure i.e. the percentage of banks where women are represented on the BoD and/or in SMP, the Islamic banking shows a greater improvement, however, when the industries are compared using the single measure i.e. the percentage of banks where women are represented on the BoD specifically, conventional banking outperforms its Islamic counterpart.
Table 6.7: Percentage Women Representation in Leadership Roles: Board of Directors (BoD) and/or in Senior Management Position

<table>
<thead>
<tr>
<th>Banks</th>
<th>Board of Directors</th>
<th>Senior Management</th>
<th>BoD and/or Senior Management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Islamic Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ADIB</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BYB</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>KFH</td>
<td>0%</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Conventional Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BB</td>
<td>0%</td>
<td>-</td>
<td>0%</td>
</tr>
<tr>
<td>BBK&lt;sup&gt;a&lt;/sup&gt;</td>
<td>-</td>
<td>0%</td>
<td>9%</td>
</tr>
<tr>
<td>BM</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BMI&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BS</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>CBD</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>CBI</td>
<td>0%</td>
<td>0%</td>
<td>11%</td>
</tr>
<tr>
<td>CBK</td>
<td>0%</td>
<td>17%</td>
<td>13%</td>
</tr>
<tr>
<td>DB</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>FB</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>NBK</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>NBO</td>
<td>9%</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>OAB</td>
<td>0%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>SHB</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>

cont.
Table 6.7: Percentage Women Representation in Leadership Roles: Board of Directors (BoD) and/or in Senior Management Position

<table>
<thead>
<tr>
<th></th>
<th>Board of Directors</th>
<th>Senior Management</th>
<th>BoD and/or Senior Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min.</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Max.</td>
<td>0%</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min.</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Max.</td>
<td>10%</td>
<td>17%</td>
<td>13%</td>
</tr>
<tr>
<td>Median</td>
<td>10%</td>
<td>17%</td>
<td>13%</td>
</tr>
<tr>
<td>Mean</td>
<td>10%</td>
<td>12%</td>
<td>11%</td>
</tr>
<tr>
<td>St. Dev</td>
<td>1%</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>No' of Banks</td>
<td>2</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>% of Sample</td>
<td>4%</td>
<td>9%</td>
<td>15%</td>
</tr>
</tbody>
</table>

GCC Banking Industry Level (includes Islamic and Conventional Banks)

<table>
<thead>
<tr>
<th></th>
<th>Board of Directors</th>
<th>Senior Management</th>
<th>BoD and/or Senior Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min.</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Max.</td>
<td>0%</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min.</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Max.</td>
<td>10%</td>
<td>17%</td>
<td>13%</td>
</tr>
<tr>
<td>Median</td>
<td>10%</td>
<td>17%</td>
<td>13%</td>
</tr>
<tr>
<td>Mean</td>
<td>10%</td>
<td>12%</td>
<td>11%</td>
</tr>
<tr>
<td>St. Dev</td>
<td>1%</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>No' of Banks</td>
<td>2</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>% of Sample</td>
<td>4%</td>
<td>9%</td>
<td>15%</td>
</tr>
</tbody>
</table>

*a* Change is calculated as 2011 value for all three measures minus 2010 value. 
*b* Change is calculated as 2011 value minus 2010 value for %SMP and %BoD&SMP. 
*c* These are calculated using only the banks which have positive %women representation ratios (includes both Islamic and conventional banks). 
*d* This percentage is calculated using the total sample figure (i.e. 47 GCC banks) which includes Islamic and conventional banks.
management. There is also greater variation in senior management teams as the standard deviation ranges between 5-10%, compared to BoD which has a standard deviation of 1-3%. Column 3 shows that women comprise almost 5% of the higher management teams, i.e. including BoD and senior management, in GCC banks and that the mean and median are almost identical.

Comparing the two industries shows that in banks where women hold position on the BoD and/or SMP, the percentage of women on these teams, for most banks, is similar to the industry average. There are however notable exceptions especially in the conventional banking industry, that have notably higher percentage of their BoD and/or senior management comprising of female members. In BB, for example, women constitute 17% of higher management compared to the industry average of 6% in 2011 (column 3) and the percentage is even higher, 27%, for senior management position. Similarly, CBK has had 17% female directors in 2010, which although reduced to 13% in 2011, is still higher than the industry average. The percentage of women in Islamic banks’ higher management however, is largely on par with the industry average.

Results also show that in all banks with female directors, the proportion of women on BoD has either remained the same or there has been an increase. In senior management teams however, there has been both positive and negative change over the sample period in different banks. The most notable is NBK where the percentage of females in SMP has reduced from 33% (2009) to 9% (2011). Such a significant change has not been observed in the Islamic banking industry.

Overall, comparison of %women representation measures between Islamic and conventional banking industries show that, not only are there fewer Islamic banks where women hold position in higher management but the proportion of women in these teams tends to be lower as well compared to conventional banks. Empirical evidence therefore suggests that the conventional banking industry outperforms its Islamic counterpart in terms of representing women in higher management positions.

While both Islamic and conventional banks face the same social pressures, it is notable that the Islamic banking industry lags behind its conventional counterpart since the absolute percentage of banks with women representation is lower in the Islamic banking industry. The proportion of female members in higher management teams is also lower.
than several conventional banks. Is this poorer performance an Islamic banking specific issue? Prior research indicates that it is not. Malaysian Islamic financial institutions for example, not only boast several women executives but also several female sharia scholars. The country has also had a female central bank governor working to promote Islamic finance and appointed its second female scholar on the country’s Shariah Advisory Council in 2011. Indonesia also has six women on the country’s National Sharia Council. In contrast, no Islamic bank in the GCC has a female member on the Sharia Supervisory Board and none of the women in higher management hold the top chief executive position. The difference between countries may primarily be driven by cultural differences as the GCC is known to be more conservative than Malaysia (Omar and Permatasari, 2011). This conservatism may be reflected more strongly in Islamic banks than conventional counterparts in the region and the possibility that the presence of a male-only Sharia Supervisory Board in Islamic banks may have an influence remains to be investigated. More research is required in this area, which is beyond the scope of this thesis.

%Qard Hasan
This section evaluates Islamic banks on the final SPQI, %qard hasan. As the amount of qard hasan a bank provides is recorded in the notes to their financial statements even Islamic banks that did not publish voluntary CSR reporting can be assessed against this SPQI. Thus, the entire sample of 23 Islamic banks analysed earlier in the thesis (in chapter 4) were examined\textsuperscript{182}. Only 5 provided evidence of offering qard hasan. Of these 5 banks, %qard hasan could not be calculated for ASB, as the figure reported in the banks’ annual report did not provide a breakdown to determine the value of qard hasan relating to each individual year. Results for the remaining 4 banks are presented in table 6.8.

\textsuperscript{182} Recall from chapter 5 (section 5.4.1), banks which produced only the mandatory financial statements as opposed to a complete annual report (with voluntary CSR disclosure) could not be included in the CSP study. This resulted in 12 of the 23 Islamic banks being included in the analysis for chapter 5 and 6.
As Table 6.8 shows, there is considerable difference in %qard Hasan between SIB and the other 3 banks. Over the 2009-2011 period, %qard Hasan ranges from 3% to over 10% in SIB, compared to 0% to 0.22% in the other banks. Both BISB and DIB have extremely similar levels of %qard Hasan, on average 0.02% and 0.01% respectively and while ABG does have higher %qard Hasan with an average of 0.18%, all are negligibly low compared to SIB which has an average of 6.93%. The change in %qard Hasan over 2009-2011 period also shows similar variation between banks. While SIB has increased its %qard Hasan by more than 7% points, in ABG %qard Hasan has reduced by 0.06% points while BISB has almost maintained its level, increasing by only 0.01% points and DIB has reduced by 0.02% points to reach 0% qard Hasan in 2011. Thus, for each year, the 3-yr average and the change over sample period, SIB clearly stands out as an outlier with noticeably higher level of %qard Hasan. The impact of SIB on the industry average is also clear. With SIB included, the industry average %qard Hasan ranges from 0.86% in 2009 to 2.68% in 2011, with a 3-year average of 1.78%. Excluding SIB, the yearly and 3-year industry average %qard Hasan does not even amount to 0.1%, similar to the median. The industry 3-year average falls from 1.78% to 0.07% with the standard deviation ranging around 0.1% throughout the 3 years.

Closer study of these banks’ annual reports reveals the possible reason for the relatively higher level of %qard Hasan in SIB. What is noticeably different between SIB and the
other banks is how qard hasan is offered by the bank. BISB (and ASB) specifically highlight qard hasan as a mechanism through which the bank discharges its social responsibility and therefore considers qard hasan to be an activity similar to making charitable donations. ABG and DIB treat qard hasan as peripheral to their core financing activity, recording it as part of ‘other assets’ on their balance sheet. SIB however offers qard hasan as one of the main financing options to its customers, similar to how murabahah and other financing contracts are offered. Unsurprisingly, it therefore holds a much higher percentage of its financing portfolio in qard hasan form compared to other Islamic banks. To understand why SIB alone offers qard hasan as one of its main financing options while other banks do not requires further research. Future studies should therefore consider conducting a case study investigation into SIB and its choice of financing contracts, which is beyond the scope of this thesis.

Finally, it must be noted that the above results show the benefit of evaluating banks’ CSP using quantitative measures (i.e. the SPQIs developed in this thesis). While the dichotomous scoring method puts all Islamic banks that provide qard hasan in the same category, %qard hasan allows further differentiation between individual banks and illustrates the considerable amount of intra-industry variation that exists, which requires further investigation. Future studies should therefore complement the popular dichotomous scoring method with additional quantitative measures where possible as these not only provide new insights but also open up avenues for further research.

6.5 Conclusion

The aim of this chapter was to compare the corporate social performance (CSP) of GCC-based Islamic and conventional banks over the 2009 – 2011 period. To achieve this aim, this chapter was divided in three parts. In part 1, Islamic and conventional banks were assessed against the CSP Index developed in chapter 5, using a dichotomous scoring method to generate CSP scores. Using these CSP scores, this chapter first answered the question: do Islamic banks, on average, have higher CSP scores than conventional banks? By comparing banks’ CSP scores, this chapter also examined the level of intra-industry variation and changes in year-on-year CSP scores to investigate how CSP scores have changed across and within the two industries over the 2009-2011 period. In part 2, this chapter investigated how the composition of CSP differs between Islamic and conventional banks to answer the question: are the most
and least popular CSP dimensions and SPIs the same across the two industries? Finally, in part 3, a more in-depth analysis was conducted where banks were assessed and compared using three social performance quantitative indicators (SPQIs) constructed in this chapter to provide a quantitative measure of banks’ performance on selected SPIs for which monetary and/or impact data could be collected.

As this chapter showed, on average, there is no difference between Islamic and conventional banks’ CSP scores. Therefore, contrary to the expectations and the claims made by the industry, Islamic banks do not present an ethical alternative to their conventional counterparts. Instead there is considerable variation within the Islamic and conventional banking industries, with CSP scores varying between banks and within individual banks over time. At the CSP dimensions level, results showed that the difference between Islamic and conventional banks is only significant for religion-specific initiatives. This result is driven by zakah, which is due to the regulatory environment, as 75% of Islamic banks are required to report on or pay zakah either by industry regulation or state law.

Furthermore, this study found that on average, the most and least popular SPIs are almost identical in both industries. However, year on year comparisons showed a complex picture, highlighting that CSP is not only multidimensional but also dynamic. The biggest changes in Islamic banks’ CSP are increases in the customers dimension and in support for SMEs. In both cases, the increase appears to be driven by profit and market share motives.

Comparison using the three SPQI’s indicated that on average, the percentage of charitable donations made by Islamic and conventional banks does not differ significantly, and while Islamic banks have made greater improvement in representing women in leadership positions, conventional banks tend to generally outperform their Islamic counterparts on this issue. Finally comparison of %qard hasan between Islamic banks further illustrated the considerable amount of intra-industry variation that exists, which requires further research.

**Limitations and Implications for Future Research**

This study compares the CSP of 12 Islamic and 35 conventional banks located in the GCC for the years 2009-2011. To extend this work, three suggestions are made based on the limitations of this work. First, increasing the sample size should be considered.
Second, increasing the number of years analysed would also be helpful in assessing the changes in CSP more broadly. Third, this chapter does not investigate what are the determinants CSP. Future studies should therefore examine what factors can explain why CSP scores are higher in some banks than others.

**Contributions**

To the best of my knowledge, this is the first study to compare the CSP of Islamic and conventional banks. It shows that Islamic banks in practice do not offer an ethical alternative to conventional counterparts. Furthermore, by decomposing CSP at its dimension and individual SPI level, this chapter also highlights that differences between Islamic and conventional banks are more subtle than broad generalisations suggest. Finally, this chapter also contributes to the literature by constructing and using three SPQI’s to compare Islamic and conventional banks’ CSP, complementing the dichotomous scoring method commonly used in the CSR literature to further differentiate between individual banks. In doing so, this is also the first study, to the best of my knowledge, which compares how the percentage of donations made by banks and women representation in leadership roles differs between the Islamic and conventional banking industries.

Finally, the next chapter concludes this thesis.
Chapter 7

Conclusion

7.1 Introduction
There were four questions posed at the beginning of this thesis. These questions are reproduced below followed by a summary of the each of chapters, explaining how these questions were answered in this thesis.

7.2 Research Questions
1. How and why has the Islamic banking industry diverged from its PLS-oriented theory towards non-PLS oriented practices?
2. Are some Islamic banks operating closer to the principle of PLS than others, and therefore can be considered more Islamic? If so, what factors enable some banks to provide more PLS financing than others?
3. Can a single research instrument be used to compare the corporate social performance of Islamic and conventional banks?
4. How does the corporate social performance (CSP) of Islamic and conventional banks differ?

7.3 Summary of Chapters
Chapter 2 introduced the central concepts including the three key prohibitions of Islamic law which are directly relevant for the financial aspect of Islamic banking. The meaning and scope of sharia and the prohibition of riba were explained in detail due to their importance and relevance for the discussions presented in chapter 3 and 4. The prohibitions of gharar and haram industries were covered more concisely and implications of all three prohibitions for Islamic banking were explicitly stated. By addressing the common misconceptions held about these concepts, the chapter provided a sound foundation to build further discussions on.

Chapter 3 presented a detailed account of the development of Islamic banking and explained how and why the industry deviated from its PLS-oriented theory to non-PLS
oriented practices. The chapter presented the historical context and provided a description of the theoretical model of Islamic banking. This was followed by an in-depth account of the three different phases Islamic banking underwent in its transition from theory and to reality. Controversies related to Islamic banking products as well as the sharia certification process were also discussed at length. Finally a four-part analysis explained why the divergence between theory and practice of Islamic banking was inevitable, by discussing: transaction costs, impact of the institutional environment, incompatibility between the theoretical model of Islamic banking and the roles of a commercial bank and finally the inconsistency between principles of commercial banking and Islamic finance. The chapter concluded that no present-day Islamic commercial bank can be fully consistent with Islamic principles and raised the question whether some banks could be considered more Islamic than others, setting the motivation for the question addressed in chapter 4.

Chapter 4 used two measures of PLS to assess and compare Islamic and conventional banks on the PLS criteria. Contrary to the implicit assumption made in the literature, the chapter showed that there is considerable variation in PLS levels between individual Islamic banks, both in PLS financing levels and PLS-MEA levels. The chapter identified a typology of Islamic banks with three distinct groups initially using a single year’s (2012) data. Using cluster analysis and multiple years of data (2009 – 2012), the chapter validated the presence of heterogeneous (strategic) groups in the Islamic banking industry, following distinct, quasi-conventional, hybrid, and PLS-oriented business models. The final part of the chapter examined the question: why do some banks have higher levels of PLS financing than others? Mundlak (1978)’s approach was used to estimate the relationship between PLS financing and factors identified from the literature as its potential determinants. Results showed that there is some support to suggest that diseconomies of scale exist in the provision of PLS financing as the size of a bank and PLS financing levels are negatively related. Contrary to the proposition posed in prior literature, a positive relationship is found between deposit ratio and PLS financing. Most importantly, results from this study illustrate clear cross-country variation in PLS levels within the GCC region, suggesting that the institutional environment matters in enabling adherence to religious principles, by reducing transaction costs associated with PLS financing.
Chapter 5 addressed the question of whether a single research instrument can be used to assess and compare the CSP of Islamic and conventional banks. The chapter discussed the concept of CSR based on Carroll (1979)’s widely-cited definition and presented the theoretical framework based on legitimacy, stakeholder, and institutional theory. In light of these, the chapter explained why the assumption that religious-CSR is category particular to Islamic banking, as asserted in the current literature (Belal et al., 2015), is inconsistent with the conceptual and theoretical basis of CSR. It then addressed the challenge of measuring CSP. By reviewing previous literature and building on the established link between comprehensive reporting and performance, this chapter made the case for evidence-based disclosure to be used as a more objective means to assess CSP from social reporting. Using this evidence-based disclosure criterion, the chapter undertook in-depth content analysis of 47 banks’ annual reports for the years 2009-2011 and from this, the CSP index was constructed. The multidimensional CSP index covers 25 social performance indicators within 6 dimensions namely: Community, Customers, Employees, Environment, Socio-economic Development and Religious-specific Initiatives. By comparing which social performance indicators are absent in Islamic/conventional banks, this chapter also provided empirical evidence which invalidates the assumption that religious CSR is a category particular to Islamic banking. Finally, it identified qard hasan as the only religiously inspired initiative unique to Islamic banking and drew parallel between PLS financing and qard hasan.

Chapter 6 used the CSP index constructed in chapter 5 to compare the level and composition of CSP between Islamic and conventional banks. In drawing comparisons, the chapter asked two questions. First, do Islamic banks, on average, have higher CSP scores than conventional banks? Second, how does the composition of CSP differ between Islamic and conventional banks? E.g. are the most/least popular CSP dimensions and social performance indicators the same? For these questions, the difference over the 2009-2011 period was also examined to identify: firstly, if and how the level and composition of CSP has changed within both industries and secondly, how the changes compare across the two industries. To further extend the literature on Islamic and conventional banks’ CSP comparison, the chapter also complemented the dichotomous CSP score method with quantitative measures of selected social performance indicators developed in chapter 5, for which monetary or impact data could be collected from banks’ annual reports. Termed as Social Performance
Quantitative Indicators (SPQIs), these assessed the extent to which a bank engages in a particular CSR activity, allowing for greater differentiation between individual banks and a more comprehensive comparison between the Islamic and conventional banking industries. The chapter made the following conclusions. On average, there is no difference between Islamic and conventional banks’ CSP scores. Thus contrary to the expectations and the claims made by the industry, Islamic banks do not present an ethical alternative to their conventional counterparts. Rather, there is considerable variation within the Islamic and conventional banking industries, with CSP scores varying between banks, and within individual banks over time. At the CSP dimensions level, the difference between Islamic and conventional banks is only significant for religion-specific initiatives, a result that is driven by zakah. On average, the most and least popular SPIs are almost identical in both industries. However, year on year comparisons show a complex picture, highlighting that CSP is not only multidimensional but also dynamic. The biggest changes in Islamic banks’ CSP are increases in the customers dimension and in support for SMEs. In both cases, the increase is driven by profit and market share motives. Finally, comparison made using the three SPQI’s indicated that on average, the percentage of charitable donations made by Islamic and conventional banks does not differ significantly, and while Islamic banks have made greater improvement in representing women in leadership positions, conventional banks tend to generally outperform their Islamic counterparts on this issue. Comparison of %qard hasan between Islamic banks further illustrated the considerable amount of intra-industry variation that exists between banks, which requires further research.
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