Research in International Business and Finance 51 (2020) 101100

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length Article

Islamic finance development and banking ESG scores: Evidence from a cross-country analysis

Andrea Paltrinieri[a,*], Alberto Dreassi[b], Milena Migliavacca[c], Stefano Piserà[d]

[a] Department of Economics and Statistics, University of Udine, Via Tomadini 30/A, 33100, Udine, Italy
[b] University of Trieste, Italy
[c] Università Cattolica del Sacro Cuore (Milan), Italy
[d] University of Udine, Italy

ARTICLE INFO

JEL classification:
G21
G29

Keywords:
Islamic finance
ESG
CSR
Banking
IFDI

ABSTRACT

An extensive body of literature on CSR examined its effects on several business dimensions. However, little attention has been paid on the relationship between the growing role played by Islamic finance, its connection with sustainability and the drivers of such relationship.

Based on a sample of 224 banks from sixteen emerging and advanced countries in the period 2014–2017, this paper assesses whether and to what extent the development of Islamic financial markets relates to banks' sustainability strategies. We propose a novel perspective that includes the new Islamic Finance Development Indicator (IFDI), its components and how it relates to aggregate and individual ESG scores.

Our results show a positive relationship between IFDI and ESG scores that mostly revolves around the social pillar. This finding strengthens the generally acknowledged link between Islamic finance and sensitivity to social implications, despite gains in sustainability are subject to non-linearity.

1. Introduction

The literature on Corporate Social Responsibility (CSR) is rich. Since its inception, it provides a persuasive stakeholder-oriented alternative to the classical profit-maximization theory of the firm. Despite findings are still subject to academic debate, CSR engagement is often found beneficial in terms of profitability and risk reduction.

Several findings (f.i. Sassen et al., 2016; Hoje and Haejung, 2012; Cai et al., 2012) support a different sensitivity of specific business sectors to CSR in terms of firm-risk and firm-value. For banks, the literature provides evidence of gains in performance and risk-taking associated with a strategic involvement in CSR, in particular for the governance dimension. However, results are less conclusive for emerging markets.

A growing academic scrutiny involves CSR and Islamic finance, with the latter being expected to be more sensitive to sustainability due to its peculiar founding principles. However, in this field results are even more inconclusive, with results concentrated especially on the beneficial role on corporate ethics attributable to Sharia supervisory boards. Additionally, the existing literature is mainly focused on countries where Islamic finance is prominent, often on Islamic banks in contrast with their conventional counterparts or, more recently, linking their operations to the Socially Responsible Investments (SRI) research stream.

* Corresponding author at: Department of Economics and Statistics, University of Udine, Via Tomadini 30/A, 33100, Udine, Italy.
E-mail addresses: andrea.paltrinieri@uniud.it (A. Paltrinieri), adreassi@units.it (A. Dreassi), milena.migliavacca@unicatt.it (M. Migliavacca), steo–@hotmail.it (S. Piserà).

https://doi.org/10.1016/j.ribaf.2019.101100
Received 28 January 2019; Received in revised form 26 August 2019; Accepted 1 September 2019
Available online 04 September 2019
0275-5319/

The main motivation and related research questions of this study can be summarized as follows. Firstly, we contribute to the literature by filling the gap represented by CSR and banking in a cross-country setting with different stages of Islamic finance development. This main objective is significantly current and relevant, if we consider the recent promotion of Sustainable Development Goals (SDG) by the United Nations and in the light of the World Bank's call for exploiting sustainability benefits implicit in Islamic finance development potential (Ahmed et al., 2015).

RQ1. Is there a link between the development of Islamic finance in advanced and developing economies that supports its stronger role in promoting sustainability?

We contribute to the literature by empirically testing the hypothesis of Islamic finance as a system naturally designed to promote sustainable development and to encourage CSR in the global business context. Islamic finance, by limiting leverage, speculation and uncertainty, should positively contribute to CSR. This would imply a general interest also outside Islamic countries in achieving further development in order to promote social responsibility and sustainable financial solutions.

Moreover, this is the first paper adopting the Islamic Finance Development Indicator (IFDI) to address this issue, and to demonstrate which of its components are leading indicators of CSR.

Secondly, due to the composite nature of CSR scores, we are interested in measuring if the role played by Islamic finance is limited to social implications, as shown by existing literature, or extends to the environmental and governance pillars.

RQ2. Which of the components of CSR scores show a positive association with the development of Islamic finance?

Thirdly, we explore if the relationship between Islamic finance development and sustainability is non-linear and if a structural break exists in CSR gains that allows to assess how sizeable the future contributions in this area might be, provided that a causal relationship can be empirically tested.

RQ3. Is the development of Islamic finance a channel for further gains in CSR scores?

Our main results stress a positive, causal and non-linear relationship between Islamic finance development and sustainability, especially driven by the quantitative development and within the social pillar of CSR. Additionally, we corroborate the argument attributing to Islamic finance a significant role in achieving greater sustainability and the connected benefits.

The remainder of this paper is structured as follows. In Section 2 we review the relevant literature. In Section 3 we describe our dataset, variables and methodological strategy. In Section 4 we discuss our findings. Finally, Section 5 concludes our paper and summarizes our policy implications.

2. Literature review

2.1. CSR and the non-financial sector

Since its origins, the CSR theory provides a convincing stakeholder-oriented alternative to the classical shareholder-centric profit-maximization view of the firm, that involves environmental, social and governance business factors (Elkington, 1999).

Despite this apparent contrast[1], Dowell et al. (2000) provide seminal research on the positive effect of environmental performance on firms' market value. Since then, the impact of CSR on performance received greater academic scrutiny.

Without any ambition to thoroughly review this rich field of research, the increasing public attention on executive pay, company failures and volumes of sustainable investments, among others, underlines how there is no mutual exclusion between contributing to shareholder value and the triple bottom line approach (Kitzmueller and Shimshack, 2012).

More recent papers keep confirming the relationship between CSR and firms' market value (Ferrell et al., 2016): CSR engagement seems to reduce the detrimental link between managerial entrenchment and value. Cavaco and Crifo (2014) explore the same relationship on 300 firms over the period 2002–2007, showing that responsible behavior towards employees (the human resources dimension), as well as customers and suppliers (the business behavior dimension), appear as a complementary input that fosters financial performance, with mutual benefits and less conflicts between stakeholders. Targeting controversial firms, Cai et al. (2012) find evidence of a positive relationship between CSR engagement and firm value, supporting its role of a value-enhancer.

CSR has been also explored from a risk-management perspective. By investigating the impact of environmental, social and governance (ESG) factors on firms' riskiness, Sassen et al. (2016) find a strong negative effect of CSR on total and idiosyncratic risk. Moreover, they underline a strong influence only for the environmental and social dimensions.

Conversely, Becchetti et al. (2015) stress a positive relationship between CSR and idiosyncratic volatility, considering a sample of listed US firms in the period 1992-2010. They argue that CSR lowers specific stakeholders' risks through a negative impact on idiosyncratic volatility. Within the same stream of research, Jo and Na (2012) explore the sensitivity of controversial business sectors to CSR during the period 1991–2010 in the US, finding it greater than for non-controversial business. Consistently, Hoje and Haejung (2012) show that CSR engagement inversely affects firm risk in controversial industries. This finding is particularly interesting, if read inversely, for Islamic finance.

2.2. CSR and banking

The role of CSR has been widely explored also in the banking sector. Meng-Wen and Chung-Hua (2013) highlight three

[1] A remarkable seminal discussion of this controversy can be found in Fulton Friedman's article appeared in 1970 in the New York Times: www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html