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THE IMPACT OF ZAKĀT CONTRIBUTION ON THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN MALAYSIA

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Abstract

Islamic banks in Malaysia are beginning to respond to calls for financial services that are responsible in providing social development impacts to the nation. Malaysia's value-based intermediation strategy, initiated by the Bank Negara Malaysia is expected to move the Islamic finance industry to the next level of sustainable and long term economic development. Islamic banks are expected to not only focus on profit but also on contribution to societies through Islamic social finance. The traditional methods of Islamic social finance especially on the contribution of zakāt, waqf and ṣadaqah have been used to provide for the basic means of livelihood for the poor. Not only that, this shows that Islamic banks do not only concern on making profits but making contribution to the societies by involving in Islamic social finance through corporate social responsibility. Specifically, this study examines the impact of corporate social responsibilities particularly on the application of Islamic social finance which is zakāt contribution by Islamic banks on their financial performances namely return on assets, return on equity and operating profit. This study focuses on Islamic banks in Malaysia from 2011 to 2018. The financial information is extracted from Fitch Connect and annual reports of the respective Islamic banks which include 15 Islamic banks in Malaysia. The panel regression method was adopted to explain the three models and examine the impact of Islamic social finance on the financial performances of Islamic banks. The findings show that zakāt contribution has positive significant impact on Islamic banks'

financial performance namely operating profit. Hence, the findings of this study offer policy implications by providing empirical evidence on the importance of Islamic social finance on the financial performance of Islamic banks.

Keywords: Islamic Social Finance, Corporate Social Responsibility, *Zakāt*, Islamic Banks, Financial Performance

1.0 Introduction

Islamic social finance sector comprising of *zakāt*, *waqf*, *ṣadaqah* as well as non-profit microcredit financing has become the main focus for Islamic banking and finance nowadays to address the issue of poverty, inequality of social and economic status and to meet the need of the poor. Apart from the regular corporate social responsibility (CSR) activities, some Islamic banks are starting to focus on diversifying their non-profit activities through *zakāt*, *ṣadaqah* and *waqf*. This is evidenced by the recently launched of the Synergy *Waqf* Project by the five Islamic banks and one full-fledged Islamic development financial institution namely Maybank Islamic, Affin Islamic Bank, Bank Islam Malaysia, Bank Muamalat Malaysia, RHB Islamic Bank and Bank Kerjasama Rakyat Malaysia, respectively. Technically, *zakāt*, *waqf* and *ṣadaqah* can be part of the bank's CSR. This is due to the perception that doing good via CSR activities can portray the institutions' value and install the stakeholders' trust towards the institutions. Nevertheless, the main intention or objective of *zakāt* contributions was never merely to increase a person's wealth but for poverty eradication and ensuring good circulation of wealth in the society.

The objectives of this study is threefold. First, it explains the importance of *zakāt* as one of the CSR important components in relation to Islamic social finance. Second, the paper examines the effect of CSR which is measured by one of the components of Islamic social finance which is *zakāt* contribution on financial performance, namely return on assets (ROA), return on equity (ROE) and operating profits of Islamic banks in Malaysia from 2011 to 2018. Third, this study offers valuable policy implications and

recommendations for Islamic banks to get involved more seriously in Islamic social finance and in promoting CSR.

2.0 Review of the Literature

2.1 Overview of *Zakāt*

Al-Qardawi¹ analyses the linguistic as well as technical meaning of *zakāt* from *Sharī'ah* perspective and states that *zakāt* originates from an Arabic word which means something growing, increasing, blessing and also means cleanliness and betterment. He explains further that the linguistic meaning of *zakāt* differs according to different contexts. The meaning of growing is appropriate in the context of plant, while the term increasing is suitable for things or asset. The words cleanliness and betterment are referring to the context of human. Basically, all these literal meanings of *zakāt* complement each other to arrive at the concrete literal meaning of *zakāt* which is becoming a better person by cleaning, cleansing or purifying his income or wealth through the payment of *zakāt* in order to gain *barakah* in his wealth or life. The cleanliness also means internal purification of the *zakāt* payer after he completed the obligation of the third pillar of Islām. Internal purification can be achieved by sharing his wealth with the poor and the needy and he feels contented by doing so.

The technical meaning of *zakāt* from the *Sharī'ah* perspective refers to the determined share of wealth prescribed by Allah (ﷻ) to be distributed among the deserving categories. Therefore, it is clear that *zakāt* is in fact a tool of wealth circulation. It reduces the gap of socio economic by preventing the poor becomes poorer. In the context of Islamic banking, paying *zakāt* on behalf of the owner which are the Muslims' shareholders can hopefully increase *barakah* in the bank's business and simultaneously deliver core values to the stakeholders. This is explained by the following Qur'anic verse (*At-Taubah: 60*), "*zakāt* is for the poor and the needy and those who

¹ Yusuf al-Qardawi, *Fiqh al-Zakah - Comparative Study of Zakāt, Regulations and Philosophy in the Light of Qur'an and Sunnah*, volume II (Jeddah: Scientific Publishing Centre King Abdulaziz University, 1968).

are employed to administer and collect it, and for those whose hearts are to be won over, and for the freeing of human beings from bondage, and for those who are overburdened with debts and for every struggle in Allah's cause, and for the wayfarers: this is a duty ordained by Allah (s.w.t), and Allah (s.w.t) is the All-Knowing, the Wise".

According to Al-Qardawi², *zakāt* has its own implication on religion, economy and social in terms of providing social security and solidarity which is closely related to contributing to the development of Islamic economics. Mahomed³ adds that *zakāt* improves the economic cycle whenever there is a movement of wealth from the one who has excess in wealth but low marginal of needs to the one who is in deficit but having high marginal of needs and consumption. This view is supported by Al-Qardawi⁴ who believes that in the concept of *zakāt*, there is the right of the poor in the wealth of the rich imposed by the true owner of the resources in this world which is Allah (ﷻ) and men are only entrusted to manage all the wealth in rightful ways by giving away a portion of the wealth managed by him. By giving *zakāt*, it does not lower the status of its receiver nor enhances the ethical or social status of the giver but it cleans the soul, increases the *barakah* in the wealth and at the same time, *zakāt* payer can have an opportunity to help people get out from the difficulties and hardship.

2.2 *Regulatory and Policy Framework for Zakāt on Business for Islamic Banks in Malaysia*

The core values underpinning the Islamic banking activities and business operations are mutual risk and profit sharing, fair and justice in conducting their daily transactions and the avoidance of the impermissible activities such as *ribā*, *maysir* as well as *ḥarām* activities.

² Ibid.

³ Z. Mahomed, "Zakah, Islamic Wealth Management and Wealth Effects", *CIAWM Bulletin* (1) (2016), 14-16.

⁴ Y. Al-Qardawi, (Jeddah: Scientific Publishing Centre King Abdulaziz University, 1968), op. cit.

In order to continuously promote the *Sharī'ah* values upheld by the Islamic banks, these institutions which are considered as *shakhsyah i'tibāriyyah* are obliged to pay *zakāt* in accordance to the 31st Fatwa Committee National Council of Islamic Religious Affairs Malaysia, decided in the meeting held on 9th December 1992, ruled out that a company is compulsory to pay *zakāt* when it fulfils certain conditions as follow:

- i. The company is owned by Muslims;
- ii. The company is owned by independent Muslims;
- iii. Absolute ownership;
- iv. The amount of wealth reaches the minimum *zakatable* limit (*niṣāb*);
- v. Sufficient *ḥaul* which is a complete one lunar year or 354.3 days;
- vi. The *zakāt* rate on a company is 2.5%.

It is also decided that for companies whose shareholders consist of Muslims and non-Muslims, only shares owned by the Muslims are subject to *zakāt* based on the net income received. Nevertheless, the practice in Malaysia is that, there is an absence of law enforcement on Islamic banks to pay *zakāt* even though from the regulators itself, it is only depending on whether there is a law imposed to the company to pay *zakāt*, the company's article whether it consists of such provision, or the consensus among the shareholders of the company⁵. For the case of the Islamic banks in Malaysia, it may also depend on the decision or direction made by the management, *Sharī'ah* Committee as well as the board of directors as to whether they need to pay *zakāt* on the profit received.

2.2 The Importance of Zakāt in Islamic Social Finance

Zakāt is the third pillar of Islām where Allah (ﷻ) has made it obligatory to all Muslims to perform *zakāt* on their wealth whenever it fulfils certain conditions stated by the *Sharī'ah*. The importance of *zakāt* is evidenced in the *Qur'ān* when it was mentioned 58 times whereby by fraction, 32 of them mentioned in isolation and another

⁵ K. A. Samad, R. Said, M.H. Kamarulzaman, M. Mahshar and I.N.M. Nasir, "Exploring the *Zakah* Payment and Firm's Performance of Islamic Banks in Malaysia", *The 6th International Conference on Governance, Fraud, Ethics and Social Responsibility* (2015).

26 together with prayers⁶. Practically, it has a strong correlation with the fulfilment of the sustainable development goals (SDGs) whereby according to the data provided by the United Nation Development Programme, that the estimated amount of *zakāt* given by the Islamic Development Bank each year is between \$230 - \$560 billion globally to cover the shortage of fund in serving the needy all over the world. Not only focusing for the poor to have a better life, *zakāt* also plays an important role in reducing the debt burden since a debtor is one of the eight eligible recipients of *zakāt*⁷.

Zakāt is among the pertinent tools to alleviate poverty in the society. According to Ahmed, it is historically proven that in the time of Umar al-Khattab as well as Umar Abdul Aziz, *zakāt* distribution was conducted properly to enhance the standard of living until the *zakāt* recipient becomes the *zakāt* payer. There is at one time the *zakāt* at some regions cannot be distributed due to no recipient entitled to it during the time of Umar al Khattab and Umar Abdul Aziz. It is evidenced by the report from Amr bin Shuaib, when Muaz Ibn Jabal was a governor and he was sent to Yemen during the time of Abu Bakr as-Siddiq and Umar al Khattab. One year, Muaz brought back one third of the *ṣadaqah* collected from the people in Yemen as he failed to find anybody to receive it. The same happened during the reign of Umar Abdul Aziz when he responded to the Governor of Egypt asking on what to do with the proceed of *ṣadaqah* for he found no single poor person all over the country⁸.

Zakāt payers want to see the accountabilities of the *zakāt* collectors' institutions in managing their *zakāt* contribution. At minimum, sufficient disclosure is required especially for the Islamic banks' stakeholders, on how *zakāt* fund is managed and distributed. *Zakāt* can also be seen as a tool to reduce the rate of non-performing

⁶ M. A. Bakar and A. A. Ghani (2011), "Towards Achieving the Quality of Life in the Management of *Zakah* Distribution to the Rightful Recipients (The Poor and Needy)", *International Journal of Business and Social Science*, 2(4), 237 – 245.

⁷ U. Modeer, "Unlocking Islamic Social Finance to Help Communities Address Vulnerability and Inequality", Retrieved from https://www.undp.org/content/undp/en/home/newscentre/speeches/2018/Unlocking_Islamic_Social_Finance_to_Help_Communities_Address_Vulnerability_and_Inequality.html (2018, October 14).

⁸ H. Ahmed, "Role of *Zakah* and *Awqaf* in Poverty Alleviation", Jeddah, Occasional Paper, No. 8. (2004).

financing with specifically addressing the issue of the debtor who is in hardship and unable to settle his debt. *Zakāt* fund can be utilised to cover his outstanding debt under the *asnāf* of *al-ghārimīn*. Besides *zakāt* can benefit both the Muslims and non-Muslims in the society. If the Islamic Banks wants to deliver the Islamic values to non-Muslims, they can approach the new converters (*muallaf*) of Islām, whereby *zakāt* distribution can be used as capital to improve the economy of the converter's non-Muslims' family members⁹. Their research findings show that the cost of living between urban and rural must not be neglected in determining the benchmark of poor households due to the different phenomenon of poverty. *Zakāt* distribution will be more effective if the poverty lines between rural and urban areas are well identified. Therefore, the Islamic banks may be suggested to have a dedicated team to conduct on site survey on the poverty level at the targeted area to enhance the distribution of *zakāt* by the Islamic banks. Besides that, all Islamic banks with their very good infrastructure may explore different channels of *zakāt* collection and distribution like mobile applications, block chain and any other relevant channels to suit the demand of the younger generations.

2.3 Islamic Social Finance, Corporate Social Responsibility and Zakāt

Obaidullah and Muhamed¹⁰ state that Islamic social finance generally refers to capital investment in productive economic activities that can generate positive social or environmental solutions. They mention that the social economy plays two important roles in the economic system. Firstly, the roles as the third sectors whereby they provide source of fund to cater for the basic needs. Secondly, they empower and transform these groups into independent individuals who can participate in generating their own income. The main sources are coming from *zakāt*, *ṣadaqah*, *waqf*, *hibah* and others to be distributed in accordance with their own nature and terms and conditions. Therefore, they have come out with their own

⁹ M. Obaidullah and N.A. Muhamed, *Critical Readings in Islamic Social Finance*, (USIM Press: Universiti Sains Islam Malaysia, 2016).

¹⁰ Ibid.

definition and interpretation on Islamic social finance by concluding that it is referring to the utilisation of Islamic-based funds which are *zakāt*, *waqf* and *ṣadaqah* to be channelled to the productive *Shari'ah* compliant economic activities with the objective to help the poor and the needy to come out from the poverty cycle. According to the stakeholder theory, an organisation's management is expected to undertake activities deemed important by their stakeholders and to report on those activities back to the stakeholders¹¹. Hence, the theory suggests that CSR is important for organizations including Islamic banks in promoting Islamic social finance for the benefits of different stakeholders.

CSR is regarded as a voluntary corporate commitment to exceed the explicit and implicit obligations imposed on a company by society's expectations of conventional corporate behaviour¹². Falck and Heblich¹³ state that CSR consists of obligations covering both the legal framework and social conventions. In particular, for Islamic banks, the religious aspect of CSR includes the Islamic dimension of *zakāt* contributions. According to Hassan and Harahap¹⁴, based on the AAOIFI Financial Reporting and Governance Standard¹⁵, among the activities of CSR in the Islamic perspective which an Islamic bank is expected to disclose under CSR reporting standards are:

- i. Islamic ethical behaviour;
- ii. good governance, including efficient board of directors and *Shari'ah* Supervisory Board;
- iii. good customer relations;

¹¹ J. Guthrie, R. Petty and F. Ricceri, "The Voluntary Reporting of Intellectual Capital: Comparing Evidence from Hong Kong and Australia", *Journal of Intellectual Capital*, 7(2), (2006), 254-271.

¹² H.A.N. Al-Malkawi and S. Javaid, "Corporate Social Responsibility and Financial Performance in Saudi Arabia: Evidence from *Zakāt* Contribution", *Managerial Finance*, 44(6), (2018), 648-664.

¹³ O. Falck and S. Heblich, "Corporate Social Responsibility: Doing Well by Doing Good", *Business Horizons*, 50(3), (2007), 247-254.

¹⁴ A. Hassan and S.S. Harahap, "Exploring Corporate Social Responsibility Disclosure: The Case of Islamic Banks", *International Journal of Islamic and Middle Eastern Finance and Management*, 3(3), (2010), 203-227.

¹⁵ AAOIFI, Accounting, Auditing & Governance Standards for Islamic Financial Institutions, AAOIFI, Manama, (2005).

- iv. fair dealing with those in the supply chain;
- v. a focus on protecting staff, encouraging talent, ensuring diversity, keeping international labour standards, and providing safety and security in the workplace;
- vi. provision of *zakāt* (religious tax) and charity funds;
- vii. fostering strong links with the community through public service announcements, sponsorships, and so on; and
- viii. research, development, and training.

By looking at the AAOIFI disclosure requirement on CSR, the provisions of *zakāt* are among the important components of CSR.

This study focuses on *zakāt* on wealth which is closely related to the financial performance of Islamic banks whereby they are encouraged to pay *zakāt* on business that formed one of the types of *zakāt* on wealth. Even though, there is no clear direction, policy or enforcement for the corporate body or Islamic banks to pay *zakāt* on their business, in Malaysia, the majority of Islamic banks and development financial institution seems to make it compulsory for the institution to give a portion from their profit as *zakāt* albeit there is still perspective that paying *zakāt* is not important and there is nothing to do with companies' performance.

With the initiative spearheaded by the Central Bank of Malaysia, through the concept of value based intermediation, and the emergence of the Islamic social finance concept, the Islamic banks are encouraged not to only focus on profit maximisation but to also participate in offering responsible and social financing to serve the needy. The traditional Islamic and religious tools such as *zakāt*, *waqf* and *ṣadaqah* come into the picture to be incorporated and blended with the features and trends of Islamic banking products offered to meet the current needs of customers as one of the Islamic banking contributions towards the society.

2.4 Corporate Social Responsibilities and Financial Performances

CSR according to agency and stakeholders, exerts a positive effect on financial performance. The proactive CSR initiatives have positive influence on financial performance through the creation of intangible assets such as good reputation, trust, and commitment which drive

the long-term success of the business (see for examples; Jones¹⁶; Jones and Wicks¹⁷). The positive relationship shows that CSR enhances competitiveness of a firm. Not only that, from an innovation perspective, CSR reduces firm costs, creates value for shareholders, and crafts internal capabilities¹⁸ and hence provides competitive advantage to a firm. Thus, by investing in superior social responsibility, Islamic banks can build up their reputation and engagement with their customers and societies and motivate their employees to boost the firm's financial performances. In the perspective of Islām, Allah (s.w.t) has promised to those who contribute their wealth in the cause of Allah (ﷺ) He will grant rewards.

According to Maqbool and Zameer¹⁹, previous studies on the relationship between CSR and financial performance have shown mixed results. Margolis and Walsh²⁰ observe the study that focuses on the relationship between CSR and financial performance, found that approximately 50% of the studies found positive relationship between CSR and financial performance, while 25% with no relationship, 20 percent had mixed results and 5% with a negative relationship.

Maqbool and Zameer²¹ examine the relationship between CSR and financial performance. The CSR is measured by computing CSR index based on CSR information from the annual report. The sample of the study includes 28 Indian commercial banks listed in Bombay stock exchange for the period of 10 years which are from 2007 to

¹⁶ T.M. Jones, "Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics", *Academy of Management Review*, 20(2), (1995), 404-37.

¹⁷ T.M. Jones, and A.C. Wicks, "Convergent Stakeholder Theory", *Academy of Management Review*, 24(2) (1999), 206-221.

¹⁸ L.E. Preston and D.P. O'bannon, "The Corporate Social-Financial Performance Relationship: A Typology and Analysis", *Business Society*, 36(4), (1997), 419-429.

¹⁹ S. Maqbool and M.N. Zameer, "Corporate Social Responsibility and Financial Performance: An Empirical Analysis of Indian Banks", *Future Business Journal*, 4(1), (2018), 84-93.

²⁰ J.D. Margolis and J.P. Walsh, *People and Profits? The Search for a Link between a Company's Social and Financial Performance*, Lawrence Erlbaum Associates, Mahwah, NJ (2001).

²¹ S. Maqbool and M.N. Zameer, *Future Business Journal*, 4(1), (2018), 84-93, op. cit.

2016. The results show that CSR has positive impact of financial performance of Indian banks. Kim and Kim²² examine the impact of CSR on value of shareholders in tourism industry. The study used ESG rating from 1991 to 2008. The study found that CSR enhances shareholder value by increasing firm performance (Tobin's Q).

Al-Malkawi and Javaid²³ investigate the impact of CSR on financial performance using *zakāt* as the measure of CSR. The study examines a sample of 107 non-financial firms listed on the Saudi Arabia stock market from 2004 to 2013. The study adopted a Generalized Method of Moments framework and also panel data techniques to explain the relationships between CSR and financial performances. The findings show that there is a strong positive relationship between CSR on financial performance and explain that the contribution of *zakāt* by the companies have positive effects to both firm's profitability and value to the society as a whole. Rahman and Haron²⁴ in their study on 11 Indonesian banks for the period from 2012 to 2016 conclude that the increasing amount of CSR and *zakāt* is very important in achieving the *Maqāṣid al-Sharī'ah* and enhancing human life and dignity. Their study also discussed how far Islamic banks in Indonesia has contributed to the society through *zakāt* payment and proposed several improvements to the existing accounting standard for uniformity on *zakāt* rate of Islamic banks and the calculation and recognition mechanism on *zakāt* for Islamic banks in Indonesia.

However, after several decades of research on CSR subjects, it is still unclear whether shareholders gain or lose from CSR. For example, Kenneth and Hage²⁵ study 82 business firms to understand the effect of community services goals with various organizational

²² M. Kim and Y. Kim, "Corporate Social Responsibility and Shareholder Value of Restaurant Firms", *International Journal of Hospitality, Management*, 40(1), (2014), 120–129.

²³ H.A.N. Al-Malkawi and S. Javaid, *Managerial Finance*, 44(6), (2018), 648-664, op. cit.

²⁴ A.S. Rahman and R. Haron, "The Effect of Corporate Governance on Islamic Banking Performance: A *Maqāṣid Sharī'ah* Index Approach on Indonesian Islamic Banks", *Journal of Islamic Finance* (Special Issue) (2019), 1-18.

²⁵ K. Kenneth and J. Hage, "Strategy, Social Responsibility and Implementation." *Journal of Business Ethics*, 9(1), (1990), 11–19.

characteristics including performance. The study found that community services goals were not significantly correlated with profit goals. Cordeiro and Sarkis²⁶ examine a sample of 523 US firms and found that there is a negative correlation between environment activism and earnings per share. The negative relationship may indicate that companies engaging in the CSR activities incur a competitive weakness because they incur costs which should have been borne by other institutions or governments. Samad et al.²⁷ examine the relationship between *zakāt* payment and Islamic bank's financial performance from 2010 to 2014. The study found there is a negative relationship between *zakāt* payment and bank's performance and it is also found that bank's size has a positive relationship with *zakāt* payable.

3.0 Data and Methodology

3.1 Data and Sample of the Study

This study analyzes 15 Islamic banks for the period of 8 years between 2011 and 2018 (104 total observations) with firm data extracted from the Fitch Connect and annual reports of the respective Islamic banks. The sample of Islamic banks in this study are Affin Islamic Bank, Al Rajhi Banking & Investment Corporation (Malaysia), Alliance Islamic Bank, AmBank Islamic, Bank Islam Malaysia, Bank Muamalat Malaysia, CIMB Islamic Bank, HSBC Amanah Malaysia, Hong Leong Islamic Bank, Kuwait Finance House (Malaysia), Maybank Islamic, OCBC Al-Amin Bank, Public Islamic Bank, RHB Islamic Bank and Standard Chartered Saadiq. The panel data is unbalanced due to the different years of establishment of the individual bank. One Islamic bank which is MBSB Bank is excluded from the sample following merger with another bank during the study period.

²⁶ J.J. Cordeiro and J. Sarkis, "Environmental Proactivism and Firm Performance: Evidence from Security Analyst Earnings Forecasts", *Business Strategy and the Environment*, 6(2) (1997), 104–114.

²⁷ K. A. Samad, R. Said, M.H. Kamarulzaman, M. Mahshar and I.N.M. Nasir, The 6th International Conference on Governance, Fraud, Ethics and Social Responsibility (2015).

3.2 *Financial Performance Indicators, Control Variables and Zakāt indicator*

Numerous studies on financial performance (see for examples; ^{28,29,30}) employed return on asset (ROA) and return on equity (ROE) to show the profitability of the firms. In general, ROA and ROE measure how far the firms manage their asset and equity efficiently to increase their profit. However, this study includes another profitability measurement which is operating profit over risk weighted average asset to specifically look at the relationship of CSR directly on the operating profit of Islamic banks.

For control variables, common bank specific factors used are (1) capitalization; (2) coverage; (3) liquidity; and (4) size of the Islamic banks. Islamic bank capitalization is an important control variable in explaining the financial performance. However, previous studies have shown mixed results as lower capital ratios would suggest a relatively high risk position and expect negative coefficient with financial performance but higher level of equity would lower the cost of capital hence improve financial performance. For coverage ratio, in general, it assesses the firm's cash flow generation relative to its debt services requirements. In particular, for Islamic bank, it measures the ability to absorb the potential losses from its earning assets. Liquidity ratio is to measure their ongoing ability to meet the bank short-term obligations. For size of the Islamic bank, even though bigger size may have demonstrated in explaining the ability of a bank to perform well, again the impact on the financial performance has been ambiguous.

As far as CSR is concerned, this study uses *zakāt* as the proxy for CSR. Previous study (see for example; ³¹) argues that the concept

²⁸ R. Rosman, N.A. Wahab and Z. Zainol, "Efficiency of Islamic banks during the Financial Crisis: An Analysis of Middle Eastern and Asian countries", *Pacific-Basin Finance Journal*, 28(2014), 76–90.

²⁹ A. F. R. Bayuny and R. Haron, "Determinants of Efficiency of Islamic Banks: Indonesian Evidence", *Journal of Islamic Finance*, 6(1), (2017), 1-15.

³⁰ N.M. Nomran, R. Haron and R. Hassan, "Sharī'ah Supervisory Board Characteristics Effects on Islamic Banks' Performance: Evidence from Malaysia", *International Journal of Bank Marketing*, 36(2), (2018), 290-304.

³¹ H.A.N. Al-Malkawi and S. Javid, *Managerial Finance*, 44(6), (2018), 648-664, op. cit.

of CSR is corporate obligation towards the society which is similar to *zakāt* which is obligation towards the society according to *Sharī'ah*. Furthermore, *zakāt* is not restricted to only an individual responsibility but it can be extended as the responsibility of an institutions depending on the jurisdictions. Particularly in Malaysia, the majority of Islamic banks as institutions are paying *zakāt* as the obligation towards the society. Furthermore, *zakāt* is an important part of disclosure requirement based on the AAOIFI Financial Reporting and Governance Standard (1998, 2005) showing that *zakāt* is an important element of CSR.

3.3 Methodology

This study employs three performance models of Islamic banks according to the different performance measurement (Return on Asset – ROA; Return on Equity – ROE; Operating Profit – OP).

ROA, ROE and OP are measured according to $\frac{Net\ Profit}{Total\ Aset}$,

$\frac{Net\ Profit}{Total\ Shareholders\ Equities}$ and $\frac{Operating\ Profit}{Risk\ Weighted\ Asset}$. A static panel data

approach is employed to estimate the parameters of interest and estimate the performance of Islamic banks with a set of bank level determinants. To examine the determinants of IB performance, the function is specified as:

$$PER_{it} = \alpha + \beta_1 CSR_{it} + \beta_2 CAP_{it} + \beta_3 COV_{it} + \beta_4 LIQ_{it} + \beta_5 SIZE_{it} + \varepsilon_{it} \quad (1)$$

where the dependent variable, PER_{it} , represents the performance of Islamic banks i at time t , which is defined as ROA, ROE and OP. CSR represents Corporate Social Responsibility, which is the focused independent variable in this study, while the remaining independent variables are the controlled variables, being CAP (Capitalization), COV (Coverage), LIQ (Liquidity) and SIZE (Bank Size). The following Table I details the definitions of each variable in this study.

Table 1: Definition of Variables

Dependent Variable		Measurement
Performance	ROA (Model 1)	$\frac{\text{Net Profit}}{\text{Total Aset}}$
	ROE (Model2)	$\frac{\text{Net Profit}}{\text{Total Shareholders Equities}}$
	OP (Model 3)	$\frac{\text{Operating Profit}}{\text{Risk Weighted Asset}}$
Independent Variable		Measurement
CSR	Corporate Social Responsibility	$\frac{\text{Zakāt}}{\text{Total Aset}}$
Controlled Variable		Measurement
CAP	Capitalization	$\frac{\text{Equity}}{\text{Total Aset}}$
COV	Coverage	$\frac{\text{Financial Income}}{\text{Average Earning Asset}}$
LIQ	Liquidity	$\frac{\text{Financing}}{\text{Customers Deposits}}$
SIZE	Bank Size	Ln Total Asset

Based on equation (1), if individual Islamic bank effects do not exist and all other assumptions are satisfied, ordinary least square (OLS) is sufficient as model estimation as it produces efficient and consistent parameters estimates. However, in the presence of individual bank effects, heterogeneity may influence OLS assumptions and the violation of assumptions renders OLS to be biased. Hence the OLS estimator is no longer the best linear unbiased estimator (BLUE). The

panel data models such as fixed effects model (FEM) and random effects model (REM) provide better way to deal with these problems. The FEM is estimated based on within effect estimation method and is expressed as follow.

$$Y_{it} = (\alpha + u_j + \lambda_t) + \beta_1 X_{1it} + \beta_2 X_{2it} + \dots \dots \dots + \beta_k X_{kit} + \varepsilon_{it} \quad (2)$$

where u_j and λ_t denotes the individual and time effects respectively, together they represent that each bank is having different intercepts.

REM, unlike the FEM, the intercepts and slope of regresses are the same across individual bank. The REM can be written as follow.

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \dots \dots \dots + \beta_k X_{kit} + \varepsilon_{it} \quad (3)$$

where $\varepsilon_{it} = u_j + \lambda_t + v_{it}$; u_j and λ_t denotes the individual and time effects respectively.

Through several model specification tests, the robust model that is the most appropriate for this study is identified among the three panel data models i.e. pooled OLS, FEM and REM. Accordingly, this study employed all the three tests, namely the Chow Test, Breusch and Pagan Lagrangian Multiplier Test (BP-LM) and Hausman Test in selecting the most appropriate model for this study.

Diagnosis checks are performed to ensure the basic OLS assumptions related to heteroscedasticity, autocorrelation and multicollinearity are not violated. If heteroscedasticity and autocorrelation problem arises, following Hoechle³², a robust standard error will be applied as a corrective measure to the problem. After performing the robust standard error, the standard error estimates in this study are hence robust to disturbances being heterocedastic and autocorrelated. As for multicollinearity, we performed the variance inflation factor (VIF) to check for possible

³² D. Hoechle, "Robust Standard Errors for Panel Regressions with Cross-Sectional Dependence", *Stata Journal*, 7(3), (2007), 1-31.

multicollinearity between variables. Each variable should have a VIF of less than 10 to avoid multicollinearity problem.

4.0 Analysis and findings

4.1 Descriptive Statistics

Table II summarizes the descriptive statistics of all variables in this study. Islamic banks recorded average performance of 0.72%, 10.34% and 1.64% for ROA, ROE and OP respectively. Negative performance however was recorded at minus 0.36%, 2.18% and 7.61% for ROA, ROE and OP respectively. Overall, most of Islamic banks recorded positive performance throughout the period under study with high performance variation between banks as recorded by the standard deviation. In term of CSR, Islamic banks paid an average of 0.0071% *zakāt* from total asset with the highest of 0.069% while some Islamic banks paid no *zakāt* at all such as Al Rajhi Banking & Investment Corporation (Malaysia), HSBC Amanah Malaysia, Kuwait Finance House (Malaysia) and Standard Chartered Saadiq. Most of these Islamic banks do not pay *zakāt* throughout the period under study. Nevertheless, Islamic banks such as Affin Islamic Bank, Bank Islam, Bank Muamalat Malaysia and Maybank Islamic recorded higher payment of *zakāt* to total asset during the period. Possible reason for some Islamic banks not paying *zakāt* is that *zakāt* is to be collected only from persons professing the religion of Islām not from companies and this includes Islamic banks³³ and *Shari'ah* Supervisory Board (SSB) has also confirmed that IB is not liable to pay *zakāt*³⁴. In relation to this, Sarea and Hanefah³⁵ revealed that AAOIFI has no authority to impose its standards to be adopted by Islamic Banks, its standards therefore remain voluntary in some countries such as Malaysia. Bank Negara Malaysia has no

³³ Z. Hasan, "Does Islamic Financial Institutions Need to Pay Zakāt?" (2008), Retrieved from, <http://www.zulkiflihasan.com/wp-content/uploads/2008/05/Does-Islamic-Bank-Need-to-Pay-Zakah.pdf>

³⁴ K. A. Samad and R. Said, "Zakāt Disclosure by Malaysian Islamic Banks", *International Business Management*, 10(1), (2016), 4737-4742.

³⁵ M. A. Sarea and M.M. Hanefah, "The Need of Accounting Standards for Islamic Financial Institutions: Evidence from AAOIFI", *Journal of Islamic Accounting and Business Research*, 4(1), (2013), 64-76.

objection to the adoption of the AAOIFI standards but not in contradiction to the national requirements. Basically, there are no specific requirements for the financial statements to show movement of *zakāt* as required by the AAOIFI *Zakāt* FAS 9 standard in Malaysia. Further, former Chief Justice, Tun Abdul Hamid Mohamad who is also an ex-member of the *Sharī'ah* Advisory Council of the Bank Negara Malaysia made a significant statement that Fatwa Committees fail to make a distinction between a Muslim human being and a company when they apply the obligation to pay *zakāt* to companies. The current practice of some Islamic banks do not pay *zakāt* signifies that in some Islamic banks, the shareholders are paying *zakāt* themselves while in some, the shareholders pay their own *zakāt* and authorise Islamic banks to pay 2.5 or 2.577 per cent with respect to the “Retained Earnings” and “Reserves” held by the Islamic banks. The statement by Tun Abdul Hamid hence seems to support the practice of some Islamic banks not paying *zakāt* at all although the profit generated annually may amount to billions of ringgit³⁶. Abbas et al.³⁷ in their study on *zakāt* payment by Islamic banks in Malaysia further confirmed the lower *zakāt* payment by Islamic banks based on a sample of 16 Islamic banks for the period from 2013 until 2017. The study records that, even if the Islamic banks pay *zakāt*, the payment is significantly lower compared to the *zakāt* computation method recommended by the authorities, such as JAKIM³⁸ (the *urfīyyah* method or also known as the adjusted growth capital method and the *shar'īyyah* method or adjusted working capital method).

³⁶ Z. Hasan, “Does Islamic Financial Institutions Need to Pay Zakāt?” (2008), Retrieved from, <http://www.zulkiflihasan.com/wp-content/uploads/2008/05/Does-Islamic-Bank-Need-to-Pay-Zakah.pdf>

³⁷ S.Z.M. Abbas, S. Sulaiman and N. A. Bakar, “A Review on Zakāt Payments by Islamic Banks in Malaysia”, *International Journal of Zakāt* (Special Issue on Zakāt Conference 2018), 71-82.

³⁸ In 2001, the Department of Islamic Development Malaysia (JAKIM) has published a book entitled “Panduan *Zakāt* di Malaysia”. According to this book, there are two highly recommended methods of business *zakāt* to be applied. The first method is *urfīyyah*. This method is also known as the adjusted growth capital which considers the equity of ownership in a particular company and other financial sources. The second method is the *syariyyah* method. This method is also called the adjusted working capital.

Table II: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	104	0.7157	0.3254	-0.3600	1.4000
ROE	104	10.3402	5.1805	-2.1800	20.9200
OP	114	1.6386	1.2307	-7.6100	4.2100
CSR	114	0.0071	0.0122	0.0000	0.0696
Capitalization	114	7.7781	2.6259	4.3200	18.0500
Coverage	104	5.4817	0.8175	3.2300	9.7900
Liquidity	114	100.4387	31.8131	51.5000	219.2900
Bank Size	114	16.9372	0.8751	15.5600	19.2326

Notes: ROA (Return on Total Asset); ROE (Return on Shareholders Equities); OP (Operating Profit); CSR (Corporate Social Responsibility)

4.2 *The Impact of CSR on Financial Performance*

In order to explain the impact of CSR on financial performance and analyse the other determinants of the financial performances as depicted in Table III, there are three (3) regression models. The common determinants are bank specific factors (namely, capitalization, coverage, liquidity and size) and the specific factor for this study is the CSR which is proxied by *zakāt* over total assets. Table III summarizes the results of Model 1, 2 and 3. Firstly, the results showed that CSR has positive significant impact on operating profit of Islamic banks. This shows that CSR through *zakāt* payment may support the stakeholder theory where Islamic banks that focus on social obligation will improve their financial performance. The stakeholder theory states that for the organization to perform well, managers need to pay attention to wide array of stakeholders and have obligations to extend beyond shareholders. This is well supported by Al-Malkawi and Javaid³⁹ who argue that *zakāt* contribution by the companies have positive effects to both firm's profitability and value to the society as a whole. However, there is no evidence that CSR can provide significant impacts on ROA and ROE. This may be due to the other element of costs such as *zakāt* and

³⁹ H.A.N. Al-Malkawi and S. Javaid, *Managerial Finance*, 44(6), (2018), 648-664, op. cit.

tax expenses in determining the net profit not being reflected to explain the impact of CSR.

By looking at the other determinants, for Model 1, it shows that both capitalization and coverage have positive significant effect on ROA while only coverage has positive significant effect on ROE by referring Model 2. This may be due to the elements of financial leverage that distinguish between ROA and ROE. By referring to Model 3, surprisingly shows that liquidity has significant negative effect on operating profit of Islamic banks. Hence, the higher the amount of financing over total deposits may not necessary influence the operating profit of Islamic banks.

Table III: Panel Regression Results

	Model 1 ROA	Model 2 ROE	Model 3 OP	VIF
Constant	-0.3725 [-0.19]	10.4974 [0.38]	-7.2730 [-1.31]	
CSR	1.4019 [0.32]	26.9162 0.4700	18.1456** [2.10]	1.18
<i>Controlled Variables</i>				
Capitalization	0.0568** [2.06]	-0.2622 [-0.70]	0.0982 [1.40]	1.36
Coverage	0.1228*** [3.26]	2.0276*** [3.85]	0.1792 [1.29]	1.32
Liquidity	-0.0023 [-1.42]	-0.0051 [-0.27]	-0.0073** [-2.40]	1.19
Size	0.0115 [0.10]	-0.5247 [-0.36]	0.4616 [1.49]	1.68
R-sq (within)	0.2682	0.2903	0.2369	
F-statistic	4.63***	7.61***	10.95***	
Observations	104	104	104	

Notes: The *t*-statistics in parentheses are the *t*-values robust standard errors adjusted for heteroscedasticity and autocorrelation; ***, ** denotes significant at 0.01 and 0.05 levels respectively. Multicollinearity test in the dataset is performed and no multicollinearity problem is found in the data since the variance inflation factor (VIF) of variables are less than 10 for ROA as the dependent variable, reported above. Similarly, VIF are less than 10 on variables when regress with ROE and OP.

5.0 Conclusion and Recommendations

In conclusion, this study explains the conceptual view on the components of Islamic social finance that can be captured by Islamic banks activities on their CSR. The significant values of Islamic social finance have been elaborated especially on the impact to the society in supporting the objective of Islamic banks as value-based intermediation. The study further discusses on the important element of CSR which is *zakāt* contributions especially for Islamic banks that are expected to perform well in both financial performance and also be socially responsible. This study provides empirical evidence on the relationship between CSR and financial performance. These findings reflect the need for Islamic banks to focus on CSR especially on *zakāt* contributions to improve the Islamic bank's financial performance. It is also expected that CSR can build their reputation and expectation from various stakeholders. In the Islamic perspective, those who contribute their wealth in the cause of Allah (s.w.t) will obtain rewards in this world and hereafter. Furthermore, CSR that involves engagement with the communities will motivate their employees to improve Islamic bank's performance and will have positive supports from their customers especially who are conscious with improving society well-being. The role of *zakāt* in Islamic social finance will both reduce the debt burden of the recipient and also will help in poverty reduction in the society. Hence, this study contributes theoretically by explaining the components of Islamic social finance and provides important empirical evidence for policy implications. Finally, the management of Islamic banks may find the importance of engaging with Islamic social finance for the benefit of their shareholders and stakeholders at large.

TRANSLITERATION TABLE

CONSONANTS

Ar=Arabic, Pr=Persian, OT=Ottoman Turkish, Ur=Urdu

Ar	Pr	OT	UR	Ar	Pr	OT	UR	Ar	Pr	OT	UR	
ء	ب	پ	پ	ز	ز	ز	ز	گ	—	g	g	g
ب	ب	ب	ب	ژ	—	—	ř	ل	l	l	l	l
پ	پ	پ	پ	ژ	—	zh	j	م	m	m	m	m
ت	ت	ت	ت	س	s	s	s	ن	n	n	n	n
ث	—	—	ṭ	ش	sh	sh	ş	ه	h	h	h ¹	h ¹
ث	th	th	th	ص	ş	ş	ş	و	w	v/u	v	v/u
ج	j	j	c	ض	ḍ	ḍ	ž	ی	y	y	y	y
چ	—	ch	çh	ط	ṭ	ṭ	ṭ	ة	-ah	—	—	-a ²
ح	ḥ	ḥ	ḥ	ظ	ẓ	ẓ	ẓ	ال	al ³	—	—	—
خ	kh	kh	kh	ع	‘	‘	‘	—	—	—	—	—
د	d	d	d	غ	gh	gh	ğh	—	—	—	—	—
ڈ	—	—	d	ف	f	f	f	—	—	—	—	—
ذ	dh	dh	dh	ق	q	q	k	—	—	—	—	—
ر	r	r	r	ك	k	k/g	k/ñ	—	—	—	—	—

¹ – when not final
² – at in construct state
³ – (article) al - or l-

VOWELS

	Arabic and Persian	Urdu	Ottoman Turkish
Long	ا	ā	ā
	آ	Ā	—
	و	ū	ū
	ي	ī	ī
Doubled	ي	īyy (final form ī)	īyy (final form ī)
	و	uww (final form ū)	uvv
	و	uvv (for Persian)	uvv
Diphthongs	و	au or aw	ev
	ی	ai or ay	ey
Short	ا	a	a or e
	ا	u	u or ū
	ا	i	o or ö
	ا	i	i

URDU ASPIRATED SOUNDS

For aspirated sounds not used in Arabic, Persian, and Turkish add h after the letter and underline both the letters e.g. چ jh گ gh

For Ottoman Turkish, modern Turkish orthography may be used.

AL-SHAJARAH

Special Issue

Contents

THE IMPACT OF <i>ZAKĀT</i> CONTRIBUTION ON THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN MALAYSIA <i>Romzie Rosman, Razali Haron, Nurul Balqis Mohamed Othman</i>	1
A CONCEPTUAL FRAMEWORK FOR THE IMPACT OF FINANCIAL CRIME TOWARDS THE FINANCIAL PERFORMANCE OF ISLAMIC FINANCIAL INSTITUTIONS <i>Nur Harena Redzuan, Nur Hasnida Abd Rahman, Adam Abdullah</i>	23
ISLAMIC SOCIAL FINANCE AND THE IMPERATIVE FOR SOCIAL IMPACT MEASUREMENT <i>Syed Marwan Mujahid Syed Azman, Engku Rabiah Adawiah Engku Ali</i>	43
LEADING TOWARDS IMPACTFUL ISLAMIC SOCIAL FINANCE: MALAYSIAN EXPERIENCE WITH THE VALUE-BASED INTERMEDIATION APPROACH <i>Nur Farhah Mahadi, Nor Razinah Mohd Zain, Engku Rabiah Adawiah Engku Ali</i>	69
THE POTENTIAL IN REVIVING <i>WAQF</i> THROUGH CROWDFUNDING TECHNOLOGY: THE CASE STUDY OF THAILAND <i>Nor Razinah Mohd Zain, Nur Farhah Mahadi, Azman Mohd Noor</i>	89
ARE THE NEW CRYPTO-CURRENCIES QUALIFIED TO BE INCLUDED IN THE STOCK OF HIGH QUALITY LIQUID ASSETS? A CASE STUDY OF BITCOIN CURRENCY <i>Anwar Hasan Abdullah Othman, Adam Abdullah, Razali Haron</i>	107
THE IMPACT OF <i>ZAKĀT</i> DISTRIBUTION ON SOCIAL WELFARE: A CASE STUDY OF SELANGOR <i>ZAKĀT</i> AGENCIES, MALAYSIA <i>Ashurov Sharofiddin, Anwar Hasan Abdullah Othman, Syed Musa Syed Jaafar Alhabshi</i>	147
P2P ISLAMIC FINTECH INVESTMENT INNOVATION. A PROPOSAL OF <i>MUSHĀRAKAH</i> SMART CONTRACT MODEL FOR SMES FINANCING AND SOCIAL DEVELOPMENT <i>Auwal Adam Sa'ad, Khaliq Ahmad, Abdulmajid Obaid Hasan Saleh</i>	169
THE ROLE OF ISLAMIC SOCIAL FINANCE IN ACHIEVING SDG NUMBER 2: END HUNGER, ACHIEVE FOOD SECURITY AND IMPROVED NUTRITION AND PROMOTE SUSTAINABLE AGRICULTURE <i>Muhamad Abduh</i>	185
THE UNDESIRABLE ISSUES IN THE INSURANCE PRACTICES CAN BE RESOLVED BY INTRODUCING <i>TAKĀFUL</i> IN INDIA: THE VIEWS OF ISLAMIC FINANCE EXPERTS <i>Syed Ahmed Salman, Adnan Yusoff, Meraj Tahniyath</i>	207
NOTES ON CONTRIBUTORS	229

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