

The Impact of Socially Responsible Business Practices on the Profitability in Islamic Banking and the Significance to Conventional Banking

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with

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Executive Summary

In the aftermath of the financial crisis of 2008 there has been an increasing demand for responsible business practices in finance. This thesis provides an overview of approaches to implementing socially responsible business practices [SRBP] in finance. The emerging Islamic banking business model is used to illustrate the potential benefits of alternative mechanisms in finance. The challenges of Islamic banking and the embedded SRBP are identified and discussed.

In a qualitative review, the concept of profit-and-loss-sharing [PLS] is examined with reference to asymmetric information and risk and return considerations. This thesis shows that, despite the lower social benefit, debt-based financing is preferred over PLS contracts by most Islamic banks due to agency problems and monitoring cost.

In an empirical study, several negative portfolio screening methods are analyzed in order to measure their impact on profitability. The screening methods serve as proxy for SRBP as they do not only comply with Islamic law, but mostly also with socially responsible investments [SRI]. This thesis provides evidence that certain negative screening methodologies manage to outperform the unscreened benchmark, especially in periods of financial turmoil. Consequently, it is concluded that the respective screens contribute to the resilience of the Islamic banking industry due to their mandatory character. However, the results can be explained with the exclusion of conventional financial institutions and pro-cyclical firms, as a direct consequence of the limitation of financial leverage.

It is concluded that the restraint on certain industries and financial ratios through negative screening has a positive outcome in terms of financial as well as social performance. Nevertheless, it is suggested that the focus of SRBP should go beyond the scope of screening methodologies.