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Greenwashing in Islamic Finance? An Analysis of Islamic Private Banks' Non-Financial Reports and a Proposal for an Islamic Finance Reporting Initiative Standard

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Introduction

In the course of the current financial crisis, alternatives to the current economic system and its liability to crises have been widely discussed. In this context, Islamic banks have often been mentioned as possible role models, especially because it is sometimes argued that they got through the imponderabilities of the financial crisis more easily than conventional banks. More recently, scholars such as Haniffa and Hudaib, as well as Zaki, Sholihin and Barokah have additionally highlighted the role of Islamic banks as institutions that are based on and legitimated by ethical principles.[1] These scholars have asked about possible discrepancies between an "ideal ethical identity" and a "communicated ethical identity" of Islamic banks. In this study, we similarly ask to what extent Islamic private banks apply and disclose the specific characteristics of Islamic thought in their published annual reports. Unlike the studies mentioned above, however, we use content analyzed data to situate Islamic finance as a part of socially responsible finance.

Based on our findings, we discuss possible greenwashing effects, since normative considerations derived from Islamic thought is hardly ever highlighted in the annual reports of the banks we analyzed. In doing so, we come up with a number of practical implications that could strengthen the faith-based field of finance. Most importantly, we suggest the implementation of what we call an "Islamic finance reporting initiative," an initiative modeled after the Global Reporting Initiative (GRI) that would increase transparency and standardization in Islamic finance by incorporating normative issues deriving from Islamic thought.[2] Here, our starting point is the continuing criticism of Islamic finance as being "an inefficient, costly and cumbersome banking industry that is incapable of performing the functions of modern banking."[3] Against this background, we analyze whether the disclosed information of selected Islamic private banks meet the main constitutive criteria of *shari'ah*-compliant finance, as it is explained in the theoretical textbooks on Islamic thought and Islamic finance.

1 Roszaini Haniffa and Mohammad Hudaib, Exploring the ethical identity of Islamic banks via communication in annual reports, Journal of Business Ethics, 76(1), 2007, 97-116. Ahmad Zaki, Mahfud Sholihin and Zuni Barokah, The association of Islamic bank ethical identity and financial performance: evidence from Asia, Asian Journal of Business Ethics, December 2014, doi 10.1007/s13520-014-0034-7.

2 Since 2015, there is an Islamic Reporting Initiative (IRI) that aims to improve CSR standards for Islamic businesses. In this article, we could not take into account this recent development and similarities in wording and proposals for implication are purely coincidental.

3 Muhammad Saleem. Islamic Banking - A $300 Billion Deception: Observations and Arguments on Riba (interest Or Usury), Islamic Banking Practices, Venture Capital and Enlightenment. Xlibris Corp. 2005, 32.

We have defined 21 criteria indicating Islamic banks' commitment to the practical and normative foundations of economic behavior in Islam. Out of these 21 criteria, we have further defined four *conditio sine qua non* criteria that are considered to have a binding status in economy-related Islamic thought. Two of them are governance criteria, namely the existence of a *shari'ah board* und the application of *profit-and-loss sharing*. The other two criteria are normative criteria, namely the payment of *zakat* and the offering of *qard hassan*. Based on these four criteria, we formulated four research questions that have guided our analysis of the content of the annual reports of 18 selected Islamic private banks. The results of the 21-variables-coding show that just few Islamic private banks commit themselves comprehensively to the duties as imposed by the Islamic thought. The same shortcoming applies for the four *conditio sine qua non* criteria.

Based on our findings, we discuss whether the concept of greenwashing, as known from sustainability research on misleading and omitting communication, can be applied in the realm of Islamic finance. Elaborating on this, we present our conceptual contribution of a need of an Islamic finance reporting initiative. We suggest that, in addition to the regular annual reports, a voluntary additional report could be developed analogously to sustainability reports in the conventional banking industry. Just as in the sustainability reports, a list of key performance indicators (KPIs) could be created . The proposed Islamic finance reporting initiative could contribute to the standardization and transparency in the field of faith-based investing and therefore reduce critical claims that see Islamic finance as a simple marketing strategy. And, most importantly, it would help investors identify Islamic private banks that truly commit to the governance and normative criteria that represent the foundation of Islamic finance, as it is described in theory.

Previous research on the ethicality of Islamic finance

There has been a considerable amount of harsh criticism on the Islamic financial system.[4] As Aggarwal and Yousef state, "Islamic banks are niche providers of capital, and within that niche they do not operate much differently from conventional banks."[5] Yet, this type of criticism articulated by a number of scholars has hardly succeeded in becoming part of a broader discourse on Islamic finance. The absence of a broader discussion on whether Islamic finance is

[4] See, for example, Timur Kuran. Islam and Mammon: The economic predicaments of Islamism. Princeton University Press, 2004 and Mervyn K. Lewis and Latifa M. Algaoud. Islamic banking. Edward Elgar Publishing, Cheltenham, 2001.

[5] Rajesh K. Aggarwal and Tarik Yousef, Islamic banks and investment financing, Journal of money, credit and banking, 2000, 94.

structured too similarly to the conventional financial system and thus does not fulfill its actual purpose of supporting the socio-economic development of society, reveals many of the Islamic finance textbooks as being "deeply disappointing."[6] Few of these textbooks are empirical or interdisciplinary, even though these would be necessary to shed light on the complex and multidimensional phenomenon of Islamic finance.

Warde explains that „writings on Islamic finance tend to have an abstract, idealized character."[7] Few facts are offered, and numbers are tortured till they confess. Little attention is paid to the actual experience of Islamic finance." Having said that, Warde mentions that in addition to the sparsely studied facts and numbers on Islamic finance, the religious component to the factual experience with Islamic finance has to be kept in mind.[8] The focus on theoretical and idealized literature on Islamic finance and the relative ignorance toward empirical approaches and experiences becomes obvious when looking at the sheer number of books published on these particular topics. The vast majority of book deals with theory, while few are practically oriented.[9] The empirical studies show that Islamic banks can be criticized for the lack of profit-and-loss sharing (PLS) mechanisms, which are idealized in the theoretical literature, but rarely ever used in practice. Instead of PLS, Islamic banks frequently use of mark-up structures, which are formally considered to be *shari'ah*-compliant, but, according to many scholars, do not meet the criteria of risk sharing as expressed by the *shari'ah*.

Another concern is the Islamic banks' ethicality. We trust Islamic private banks do operate ethically. This ethical approach is however often not emphasized by transparency. As Pitluck points out, a third of all Islamic financial institutions operate without reporting financial data.[10] And even though there have been a lot of comparisons between Islamic and conventional banks, reporting standards have hardly ever been a subject to debate. One tellingly example is the special issue of the academic journal "International Journal of Islamic and Middle Eastern Finance" on the topic "Islamic Financial Institutions and the Global Financial Crisis 2008/09" published in 2010. Within the nine highly stimulating articles, the word "reporting" only occurs once. In their text on "[t]he global financial crisis

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6 Ibrahim Warde, Islamic Finance in the Global Economy, Edinburgh University Press, Edinburgh, 2000, 11.

7 Ibid., 21.

8 Cf. Bill Maurer. Pious property: Islamic mortgages in the United States, Russell Sage Foundation, 2006. Aaron Z. Pitluck, Islamic banking and finance: alternative or façade?. Edited by K. Knorr Cetina, and A. Preda. Oxford: Oxford University Press, 2012.

9 Exeptions are: Aggarwal and Yousef, 2000. Haniffa and Hudaib, 2007. Bill Maurer. Form versus substance: AAOIFI projects and Islamic fundamentals in the case of sukuk. Journal of Islamic Accounting and Business Research 1(1), 2010, 32-41.

10 Pitluck, Islamic banking and finance, 2012, 432 & 446.

and its implications for the Islamic financial industry", Smolo and Mirakhor note: "It is often argued that Islamic financial institutions are more transparent than their counterparts in the conventional system. Ironically, while information and data on conventional institutions, their structures and practices, are available to the public, information and data on Islamic financial institutions, their product structures and other related issues are difficult, in some cases impossible, to obtain."[11]

Our article aims at closing the gap of lacking research on reporting and disclosure activities in Islamic finance and shall give an overview on whether Islamic private banks meet their normative requirements as articulated in the Islamic finance literature. Furthermore, we use our results to emphasize the importance of a detailed reporting of non-financial activities. The most important preparatory work for our analysis has been provided by Haniffa and Hudaib.[12] In their study, Haniffa and Hudaib have examined seven Islamic banks that operate in the Arabic Gulf region and constructed what they call an "ethical identity Index" by analyzing the annual reports of these banks for a time period of three years. Their goal was to determine whether the *communicated* ethical identity of the selected banks matches the *ideal* ethical identity. The ethical identity index shows how many of the defined dimensions of the ideal ethical identity of the banks in the sample are being met. The authors identify five features of Islamic banks: (1) the underlying values and philosophy; (2) the provision of interest-free products and services, (3) the restriction to contracts that are acceptable from an Islamic point of view, (4) the focus on economic development and social goals and (5) the "subjection" to the additional examination by the *shari'ah* board. Within these categories, the author defined 78 factors that display an "ideal" ethical identity of Islamic Banks. The authors show that the actual communication of the banks with regard to the selected factors lies between 16 and 65 percent in the three years average. As the authors argue, this finding points to a big difference between the communicated and the ideal ethical identity of Islamic banks.

Analyzing their results, the authors confine themselves to the fact that there should be more communication in Islamic finance and that Islamic banks should account for their activities not only as a financial, but also as a religious institution. However, Haniffa and Hudaib do not dare to generalize the results of their study to the actual ethical identity of the Islamic banks. Moreover, they do not engage in a debate on the implications of the lack of communication in the

[11] Edib Smolo and Abbas Mirakhor, The global financial crisis and its implications for the Islamic financial industry, International Journal of Islamic and Middle Eastern Finance and Management, 3(4), 2010, 380.

[12] Haniffa and Hudaib, 2007.

Islamic financial sector in general. Another limitation of the study is that among the 78 factors selected, there is no consideration of profit-and-loss sharing, which we consider to be a decisive characteristic of Islamic finance.

Drawing on the results of Haniffa and Hudaib, Zaki, Sholihin and Barokah have studied Islamic banks in terms of the disclosure of an ethical identity and tested which categories of disclosure impact the financial performance of Islamic banks in what way.[13] They come to the conclusion that the disclosure of information about the normative mission of the banks is associated with negative financial performance, while the disclosure of products, services and commitment toward employees is positively associated with financial performance.

Apart from the two studies on the ethical identity of Islamic banks, the recently published studies of Farook, Hassan and Lanis, Choudhury and Alam, and Sairally are to be mentioned.[14] All of them deal with the importance of corporate governance and corporate social responsibility in Islamic finance. Choudhury and Alam discuss whether Islamic and non-Islamic attitudes toward corporate governance can be brought together at all. Farook, Hassan and Lanis, as well as Sairally chose to use an empirical approach. Evaluating questionnaires filled in by representatives of 46 Islamic financial institutions, Sairally tries to find out whether Islamic financial institutions meet their ethical obligations. Farook, Hassan and Lanis analyze Islamic banks' annual reports concerning social obligations. Both studies are of great value and therefore form part of the basis of our own study. However, neither Farook, Hassan and Lanis, nor Sairally lay such a heavy weight on the public and transparent reporting and its link to a general legitimacy of Islamic banks as we do. In Sairally´s study, the published reports only serve as means for secondary data. Farook, Hassan and Lanis determine a backlog demand of Islamic banks in reporting, but do not link this proposition to the question of possible greenwashing or to an adaptation of reporting guidelines such as the Global Reporting Initiative. To establish the link between reporting practices and greenwashing, we refer to the concept of greenwashing, as it was first introduced by Jay Westerveld.[15] The Oxford English Dictionary defines greenwashing as "disinformation disseminated by an organization so as to present an environmentally responsible public image." In addition to that, we rely on the distinction between attribute-focused and process-focused greenwashing, as made

[13] Zaki, Sholihin, and Barokah, 2014.

[14] Sayd M. Farook, Kabir Hassan, and Roman Lanis, Determinants of corporate social responsibility disclosure: The case of Islamic banks, Journal of Islamic Accounting and Business Research, 2(2), 2011, 114-141. Beebee Salma Sairally, Evaluating the corporate social performance of Islamic financial institutions: an empirical study, International Journal of Islamic and Middle Eastern Finance and Management, 6(3), 2013, 238-260.

[15] See Jason Pearson, Are we doing the right thing? Leadership and prioritisation for public benefit, The Journal of Corporate Citizenship, 37, 2010, 37-41.

by Linder.[16] In our study, we look at attribute-based greenwashing , as we analyze the commitment of Islamic banks toward the normative foundations of Islamic finance (for a detailed discussion of the concept of greenwashing, see concluding section).

Islamic finance as socially responsible investing

This study focuses on the field of socially responsible investing (SRI), which is to be distinguished from the classical approach of conventional finance according to the principle of absolute return. socially responsible investing originally grew out of the wish of religious groups to invest in accordance to their normative beliefs. Here, the founding initiative was the Religious Society of Friends of 1758 that established investment rules prohibiting slave trade in northern America.[17] Nowadays, socially responsible investing is a concept that has become mostly secular and is applied as an investment strategy in a variety of different settings. Socially responsible investing is defined as an investment style in which ethical, social and ecological aspects of investments are considered to be as important as financial performance.[18] Investors and institutions that apply socially responsible investing do not solely operate on the premise to maximize profits, but consider the harmonization between social and ecological values and economic profits to be the foundation of their work. As Weber and Remer note, this approach "aims to have a positive impact on people, the environment and culture by means of banking."[19]

As a subcategory, socially responsible investing contains religion-based investing, i.e. a way of investing where the normative basis is drawn from a religious code of ethics.[20] Especially among the three monotheistic religions – namely Judaism, Christianity, and Islam – there has always been great interest in

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[16] M. Linder. The Two Mayor Types of ‚Greenwash' definitions, the Problematic Implications of Indistinctness and a Set of Likely Inconsistencies, Center for Business Innovation Working Paper Series, 18 2010.

[17] Robert Howell. Globalization and the good corporation: Whither socially responsible investment?, Human Systems Management 27, 3, 2008, 243-253.

[18] Celia De Anca. Investing with values: ethical investment versus Islamic investment, Islamic Banking and Finance in the European Union, Edward Elgar Publishing, Cheltenham and Northhampton 2010, 128.

[19] Olaf Weber and Sven Remer, Social Banks and the Future of Sustainable Finance, Routledge, London, 2012, 2.

[20] Céline Louche, Daniel Arenas, and Katinka C. Van Cranenburgh, From preaching to investing: Attitudes of religious organisations towards responsible investment, Journal of business ethics, 110(3), 2012, 301-320.

combining financial activities with religious norms. Current figures show that there are Christian investments of 17 billion US dollar in assets in about 50 religion-based funds.[21] Apart from these specific funds, Christian organizations such as the American Family Association advise members on how the invest in accordance to religion-based norms. Interestingly, however, today's most developed field of religion-based investing is Islamic finance. Islamic finance is often presented as a fully distinct market system, contrasting the conventional[22] financial system. On a broader level, the ethical goals of Islamic finance are considered to be as important as the maximization of financial profits. Namely, Islamic finance focuses on the social and economic welfare of the (Islamic) community.[23] The core principles of Islamic finance are derived from the *shari'ah*, the Islamic legal code. The *shari'ah* is not a codified law, but a mixed code of conduct coming from different religious sources. The *qur'an* and the *sunnah* (collected stories about the life of the Islamic prophet Muhammad) are classified as primary sources. They contain instructions on how Muslims should deal with financial matters and how the Islamic prophet Muhammad himself dealt with financial matters during his lifetime. As secondary sources, *ijma'* (consent of Islamic scholars) and *ijtihad* (individual thinking and reflection) are part of the foundation of the *shari'ah*. If a question about the Islam-compliance of a particular behavior cannot be answered by the consultation of one of the primary sources (or if the sources bear conflicting results), the secondary sources are usually included into the jurisdiction.[24]

In terms of modern banking and finance, the *shari'ah* can of course only give an overall guidance. Based on the writings of Islamic scholars of the twentieth century, as well as based on the opinions of Islamic scholars with a deep knowledge in Islamic jurisdiction and economics, four prohibitory guidelines have been developed for current Islamic finance: First, Islamic financial market participants are not allowed to deal with interest (prohibition of *riba*). Second, speculative activities are allowed only if all parties involved are exposed to the very same risk to either win or lose from a particular investment. Third, economic transactions or investments must not be gambling-like. Here, especially zero-sum games (in which one parties only wins if another party loses) are prohibited. Fourth, there is a ban to invest in a number of business sectors that are classified

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21 William B. Werther and David B. Chandler. Strategic Corporate Social Responsibility. Stakeholders in a Global Environment, Sage, New York, 2011, 365.

22 The term "conventional" is used in this study for all financial institutions that do not operate according to the religious and legal demands of Islamic finance.

23 Frank E. Vogel and Samuel L. Hayes, Islamic Law and Finance. Religion, Risk, and Return, Kluwer Law International, Den Haag, 1998. Haniffa and Hudaib, 2007, 98.

24 Stefan Leins, Zur Ethik des islamischen Finanzmarktes, Zeitschrift für Wirtschafts- und Unternehmensethik, 11(1), 2010, 66.

as not being compliant to Islam. Namely, this is the alcohol sector, pork production, adult entertainment as well as the defense industry.[25]

The controversy over form versus substance

In an article published in 2010, anthropologist Bill Maurer discusses the difference between the formal application of *shari'ah* rules on financial transactions and the consideration of normative religious criteria for the structure of an Islamic economy. According to Maurer, one can find both positions in the debate on Islamic finance. Discussing the example of the change of the criteria for the *sukuk*-structuring in 2009, Maurer argues that the formalist position – which is the view that Islamic finance can be constructed as a technical procedure regardless of its normative aspects – gained the upper hand in practice since the beginning of the 1990s.[26] He considers the dominance of the formalistic position to be primarily caused by the rise of the interregional regulatory agency AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). The organization that was initiated in 1991 had established a practice that encourages a juridical interpretation of what is considered to be *shari'ah*-compliant in a financial market context instead of stressing a normative approach to define *shari'ah* compliance in an economic context. Referring to a financial market report of the rating agency Moody's that was published under the title "The future of *sukuk*: substance over form? Understanding Islamic securitization, asset-backed and AAOIFI principles,"[27] Maurer characterizes this development as a result of a *form-versus-substance* debate among the practitioners of Islamic finance.

Evidently, these different positions concerning the application of Islamic finance have rarely been discussed in the specialized literature. Even though the massive increase of mark up-products (*murabahah*) that share similar characteristics to interest-based products reinforce the dominance of the formalistic position, much of the Islamic finance literature still highlights the substance-based aspects of the field. In order to understand the biases between theory and practice, it is therefore worth to take a quick look at the history of thought that served as basis for the establishment of an Islamic financial market.

According to Saeed, the early development of the concept of an Islamic economic system can be ascribed to a number of Islamic thinkers of the twentieth

[25] Some Islamic scholars also prohibit investments in Western entertainment and media companies, as they accuse them to support propaganda against the Muslim community.
[26] Maurer, 2010, 33-34
[27] Khalid Howladar, The Future of Sukuk: Substance over Form? Understanding Islamic securitisation, Asset-Backed and AAOIFI principles, Moody's Investors Service, 2009, 1-13.

century.[28] These masterminds – above all Sayyid Qutb, one of the founders of the Egyptian Muslim Brotherhood and Muhammad Baqir as-Sadr, an Iraqi religious scholar and economic theorist – were mainly interested in the establishment of an Islamic economic system as an autonomous economic system.[29] According to as-Sadr, this economic system should have represented an alternative to Western capitalism as well as to Marxist-socialist principles. Qutb, too, was primarily interested in an Islamic alternative to the economic schools of thought dominated by the West.[30]

Especially as-Sadr's attempts of formulating an Islamic economy with a normative religious aspiration can be found in early texts on Islamic finance. However, they vanished over time in the specialized literature. Instead of taking up the idea of an Islamic political economy, the current literature presents Islamic finance as part of the global capitalist system, in which *shari'ah* compliance amounts to a formal procedure during the structuring and circulation of financial products. Normative religious components are still mentioned and used in the description of products and the marketing of banks, especially when these descriptions aim at claiming a superiority of the Islamic approach toward economic action.[31] But ideational thoughts of an Islam-based economic system referring to the application of religious principles in order to promote social justice, as it is described by as-Sadr and Qutb, seem to play a minor role in the practical application of Islamic finance today.

Based on this diverge between theory and practice, our study examines whether Islamic private banks fulfill the demands of an Islam-based economic processing today as imposed by the *shari'ah*, or whether they engage in greenwashing. Hence the overall research objective of this study can be formulated as follows: *Are Islamic private banks listed in the Bloomberg list of Islamic banks committed to the governance and normative ideal of Islamic finance as it is described in the theoretical literature, or do they engage in greenwashing, as it is argued by critiques?*

We address this research objective by deriving 21 criteria from the literature. Based on these 21 criteria, we identify four criteria as *conditio sine qua non* (see next chapter). Based on the four criteria as described in the next sections

[28] Abdullah Saeed, Islamic banking and interest: A study of the prohibition of riba and its contemporary interpretation, Leiden, Brill, 1996, 5-16.

[29] Cf. Kabuye Uthman Sulaiman. Distributive Justice: A Comparative Analysis of The Views of Sayyid Qutb, Muhammad Baqir al-Sadr, John Rawls and Robert Nozick, Lambert Academic Publishing, Saarbrücken, 2009.

[30] Sabine Damir-Geilsdorf, Herrschaft und Gesellschaft: der islamistische Wegbereiter Sayyid Quṭb und seine Rezeption, Ergon, 2003.

[31] Cf. Saleem, Islamic Banking-A $300 Billion Deception, 2006, 8.

we identify four research questions. The first two examine the fulfillment of formal governance-related demands, the third and fourth test the fulfillment of religion-based normative demands.

Governance-based Islamic finance criteria

We have identified 21 different criteria that shall measure the rigidity of Islamic private banks when it comes to applying the formal and normative rules of Islamic finance (see appendix 1). Regarding governance, two of them appear to be especially important to us. The first one is the declaration of the existence of an independent *shari'ah* board. The second one is the use of so-called profit-and-loss sharing mechanisms – a sort of business partnership that is a central part of the idea of Islamic finance. Following from this, we define our first two research questions (1.1 and 1.2) according to these criteria.

The AAOIFI advises Islamic banks to create their own *shari'ah* board, which examines the structure of their own products and financial transactions. Even though the Islamic religion allows every Muslim to decide himself or herself whether something is Islamic (*halal*) or not Islamic (*haram*), it is common practice that *fatwa*-decisions are taken by a small number of scholars with a high reputation within the Islamic community. In the context of the Islamic financial market it is also common that banks give at least one chair of the *shari'ah* board to a scholar who is also a member of the legislative AAOIFI-*shari'ah* board (for an illuminating analysis of the concentration of power in favor of the *shari'ah* scholars and of the process of the *halal*-certification, see Hayat, Den Butter and Kock 2013).

Following this procedure, Islamic banks can strengthen their credibility among Islamic costumers and at the same time minimize the risk of being criticized by the AAOIFI concerning particular products. The compliance with the AAOIFI-standards – among which is the maintenance of a permanent bank internal *shari'ah* board – is a requirement for the acquisition of an Islamic banking license in Bahrain, Dubai, Jordan, Lebanon, Qatar, Sudan and Syria (AAOIFI Online 2013). Regardless of such governmental regulations we consider the existence of an independent *shari'ah* board that is not involved in the operative business of the bank as a central criterion of an adequate Islamic banking governance. Research question 1.1 therefore focuses on this particular issue.

RQ 1.1: Do Islamic private banks declare an independent shari'ah board in their annual report?

In addition to the *shari'ah* board, the business principle of profit-and-loss sharing is characterized as a central principle of *shari'ah*-compliant banking in the Islamic finance literature. Muhammad Nejatullah Siddiqi, a central figure in the development of Islamic finance, for example, writes in the introduction of his book: "In view of the prohibition of interest in Islam, modern writers on Islamic economics are unanimous that any reorganization of banking will have to be done on the basis of *shirkah* (partnership) and *mu[da]rabah* (profit-sharing)."[32] Profit-and-loss sharing is of crucial importance, because it stresses the fact that all business partners should bear a risk of loss. This goes in line with the aspiration of Islamic finance to be a profit-based (rather than interest-based) economic system. *Mudaraba* and *musharaka* – the two profit-and-loss sharing mechanisms of Islamic finance – are described as the heart of the Islamic financial economy. One reason for that is its religious legitimacy: *musharaka*, for example, is directly mentioned in the *qur'anic* verses 4/12 and 28/24. Further, they are used to describe Islamic banking as fair banking due to the sharing of profits and risks.[33] Despite the stylizing of profit-and-loss mechanisms as the heart of Islamic finance, Vogel and Hayes note that the formalistic style of the mark up-transaction was already popular among providers of Islamic financial operations at the end of the 1990s.[34] Reasons for that are surely that mark-up financing, in which the mark up to be paid is usually similar to the exact amount an interest rate, allows for a conventional economic calculation of risk. Here, it also needs to be mentioned that stricter global regulations of the risk management of banks (especially under the regulations Basel II and III) have made the application of the rather risky profit-and-loss sharing operations more difficult. Especially because of the increasing difficulties to make profit-and-loss sharing, we argue that Islamic private banks that still offer and declare profit-and-loss sharing are more likely to fulfill their religious requirements. Research question 1.2 therefore aims at the examination of these operations and their declaration.

RQ 1.2: Do Islamic private banks declare to offer profit-and-loss sharing in their annual report?

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32 Muhammad Nejatullah Siddiqi, Partnership and Profit-Sharing in Islamic Law, Islamic Foundation, Leicester, 1985, 9 (italics in original).

33 Leins, 2010, 71-72.

34 Vogel and Hayes, 1998, 238-240.

Norm-based Islamic finance criteria

In addition to the two research questions introduced, which examine the normative religious requirement of Islamic private banks from a governance perspective, we phrase two questions that aim to explore the normative activities of Islamic private banks. First, we check whether the examined Islamic private banks declare the payment of *zakat*, i.e. Islamic alms. Second, we check whether the examined private banks offer *qard hassan*, which are loans that are interest-free and free of charge, for people in need.

Zakat is a religious tax in favor of the poor and has an important meaning in Islam, as it marks one of the “five pillars” of Islam. Its prominent role in the *qur’an* and in religious practice turns *zakat* into an Islamic obligation and is often considered to be a universal remedy against poverty and for economic justice by the Islamic community.[35] The payment of *zakat* is often believed to function as a purification of the acquired fortune and is should amount to about 2.5 percent of the owned capital annually. The fact that *zakat* is not just a volontary charitable donation is also shown by the division of Islamic donations into *zakat*, *sadaqat* and *khayr*. Schäublin defines *zakat* as “mandatory almsgiving”, *sadaqat* as “voluntary almsgiving” and *khayr* as “charity”.[36] In literary discourse on Islamic finance, there is consent that the payment of *zakat* by banks and costumers (as separate entities) is obligatory and should be explicitly made transparent. Against this background, question 2.1 raises the question whether the examined banks pay and declare *zakat*. In doing so, we stress our conviction that Islamic banks that pay *zakat* are more likely to fulfill the normative religious requirements.

RQ 2.1: Do Islamic private banks declare the payment of zakat in their annual reports?

Another type of philanthropic contribution that is deduced from the normative claim of Islamic economics is *qard hassan*. *Qard hassan* equates a free-of-charge loan that is supposed to support the economic and social development of the Islamic community without prioritizing the financial interests of an Islamic bank. As highlighted in theory, *qard hassan* should be made available to less privileged groups that have to finance unique or unexpected expenses like medical bills,

35 Cf. Jonathan Benthall, Financial worship: the Quranic injunction to almsgiving, Journal of the Royal Anthropological Institute, 1999, 27-42.

36 Emanuel Schäublin, The West Bank Zakat Committees (1977-2009) in the Local Context. Center on Conflict, Development and Peace-building Working Paper, Graduate Institute, Geneva, 2006, 21-22.

weddings or funerals.[37] In practice, *qard hassan* is also often used as a technique to administer checking accounts. This, however, is characterized as formal *qard hassan* that is not considered as normative religious activity.[38] *Qard hassan*, as a free-of-charge loan, is not a profitable business method for Islamic private banks, but only aims at helping the Islamic community socially. Hence, it is an important indicator of how rigid the religious normative claim of an Islamic private bank is. We there formulate research question 2.2 as follows:

RQ 2.2: Do Islamic private banks declare practicing qard hassan in their annual report?

Research Design

In order to examine the commitment of Islamic private banks toward the duties as depicted in textbooks, we have developed a codebook of 21 constitutive items for Islamic finance according to our literature review (see appendix for the 21 criteria and basic literature). As there is no reference sheet for a codified Islamic finance, we decided for consensus sessions to develop the 21 items.

We used the literature discussed in the previous sections, and discussed among the three authors which criteria could be considered constitutional. For the four condition-sine-qua-non criteria, we additionally relied on the distinction of governance and norm based criteria to be incorporated.

Using this codebook, we can check whether the published information by Islamic private banks reflects the theoretical claim of Islamic finance. As mentioned above, we also developed four *sine qua-non* criteria. Relying on the literature on Islamic finance, we assume that an Islamic private bank that does not apply these four criteria does not practice Islamic finance as it is described in the theoretical literature, but a reduced version that could potentially be labeled as greenwashing. In more detail, our research design thus looks as follows:

In order to answer our overall research objective and more specifically our four research questions, we chose a sample of Islamic private banks. Their annual reports serve as unit of analysis. The selection of banks was taken from the

[37] Haniffa and Hudaib, 2007, 101.

[38] Michael Gassner and Philipp Wackerbeck, Islamic finance: islam-gerechte Finanzanlagen und Finanzierungen, Bank-Verlag Medien, 2010, 62-64.

Bloomberg list for Islamic banks.[39] The full list consists of 42 banks. However, since Bloomberg lists a very heterodox sum of institutes, the following selection criteria were applied:

1. The banks had to be labeled as *shari'ah*-compliant. This commitment had to be explicitly mentioned in the annual report. The banks that could be regarded as being inspired by Islamic finance but did not officially declare to be compliant to the *shari'ah* were therefore excluded.

2. Banks that just maintain a so-called *Islamic window* were also excluded because Islamic windows of conventional banks are particular service centers whose activities are not necessarily reflected in the overall commitment or the culture of the bank. As a consequence, their commitment to religion-based norms in normally not mentioned in the banks' annual reports.

3. We chose to only select private banks. Islamic investment banks, Islamic sovereign wealth funds, or other providers of Islamic financial services were excluded. We took this decision because private banks are accessible to the public and thus face different disclosure expectations than institutions such as sovereign wealth funds or investment banks.

4. We only selected bank that published an annual report in 2011 that was available on their website in English. Just one bank in the original sample, namely Syria International Islamic Bank, offered its annual report only in Arabic.

The sample was created between the 25th of June and the 6th of July, 2012. After the application of our filter criteria, a sample of 18 Islamic private banks with a total market capitalization of USD bn 58,5 emerged (see Table 1).

[39] Retrieved from Bloomberg on 20 June 2012.

Table 1: Selected Islamic private banks

No	Institution	Country	Market Cap. (in $m)
1	Al Rajhi Bank	Saudi Arabia	29700
2	Kuwait Finance House	Kuwait	7270
3	Alinma Bank	Saudi Arabia	5060
4	Qatar Islamic Bank	Qatar	4970
5	Boubayan Bank K.S.C.	Kuwait	3880
6	Qatar International Islamic	Qatar	2040
7	Bank Al-Jazira	Saudi Arabia	1860
8	BIMB Holdings BHD	Malaysia	1110
9	Islami Bank Bagladesh LTD	Bangladesh	616.63
10	Jordan Islamic Bank	Jordan	436.24
11	Ithmaar Bank BSC	Bahrain	378.55
12	Meezan Bank LTD	Pakistan	280.21
13	Bahrain Islamic Bank	Bahrain	236.78
14	Faisal Islamic Bank of Egypt	Egypt	228.25
15	Al-Salam Bank	Bahrain	158.84
16	Al Baraka Bank Egypt E.S.C.	Egypt	118.95
17	Khaleeji Commercial Bank	Bahrain	104.09
18	Bankislami Pakistan LTD	Pakistan	52.24
	Sum		**58500.78**

The sample offers a homogenous field of Islamic private banks and therefore improves the comparability of the institutions. We consider this homogeneity of the sample as methodologically important, as otherwise institutions of different nature would have caused a sample bias in their disclosure policy. This, in return, imposes limitations of the research that are discussed in detail at the end of the article. Still, the phenomenon of Islamic finance according to the Bloomberg list and the sample selection is so broad that a multivariable, statistical analysis cannot be conducted, which is why the following part of the study consists of a benchmark development based on descriptive statistics.

We mentioned that in order to answer our four research questions, the annual reports were chosen as data sources. Annual reports are considered to be one of the most important communication channels of banks toward the public, customers and shareholders. An additional reason to choose annual reports as data source for our analysis was the fact that are that they are accessible to the public and therefore have a large distribution. The limitations associated to this approach will also be discussed in detail at the end of this article.

In order to address our research objective, we conducted a quantitative content analysis following the methodological approach of Früh (2007). We developed a coding sheet that consists of 21 criteria that, in our view, mark a rigorous approach toward Islamic finance. We have discussed the criteria in two consensus sessions, considered the selection of *conditio sine qua non* criteria and finally determined the four criteria mentioned above. Decisive for the selection of the criteria was that they are constitutive for Islamic thought and thus also for Islamic finance as a market practice. The list of criteria consequently represents an ideal Islamic financial mode in order to ensure the comparability with banks in different national legislations. For the structuring of the 21 criteria six fields were determined on the basis of coded literature. These fields were (1) the *shari'ah* compliance of the operations of Islamic banks, (2) the certification of these operations by a *shari'ah* board, (3) profit-and-loss sharing as the most important financing model, (4) the promotion of economic development in the society, (5) the payment of *zakat* and other donations to charitable organizations, as well as (6) the engagement for social development in the society (*qard hassan*). All of the 21 criteria can be found in the appendix. The criteria have been evaluated as either "fulfilled" or "not fulfilled" for each bank and filled in as a binary code in the respective list of criteria (1 for "fulfilled" and 0 for "not fulfilled").

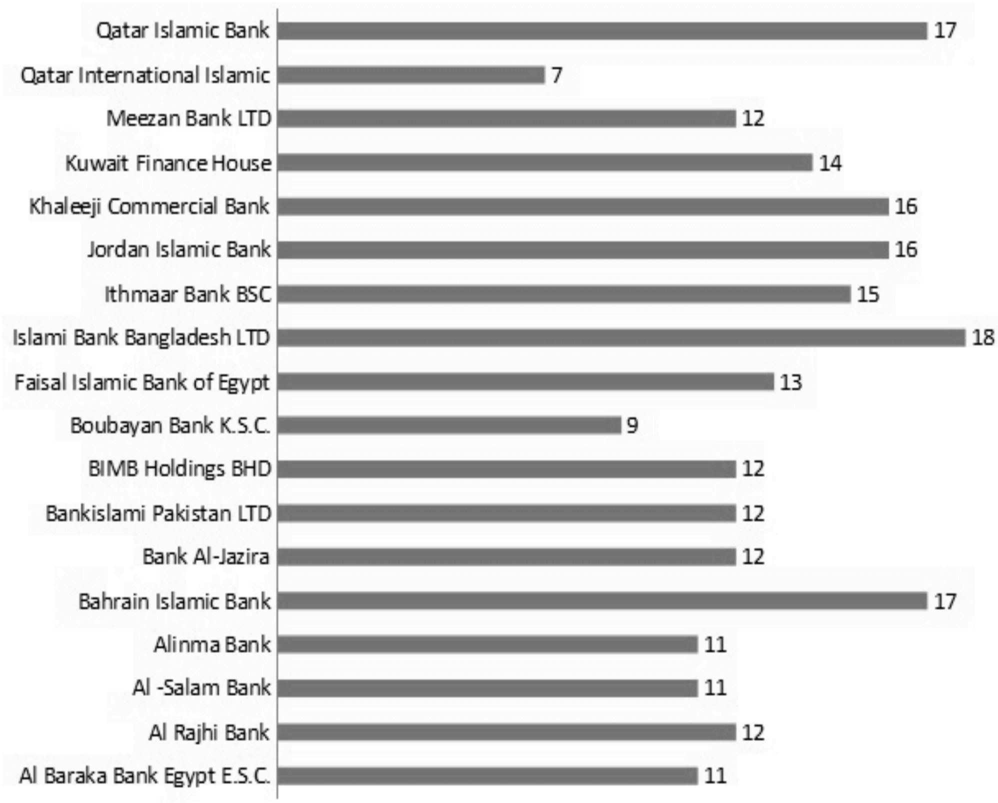
Results and discussion

In what follows, we present the results of our analysis in three steps. First, we put forward the performance of the banks represented in our sample by showing to what degree they fulfill the 21 constitutive criteria. Second, we present the results of our four research questions that we tested on the basis of our four *conditio sine qua non* criteria. Third, we discuss the overall results summarized as a frequency analysis of the banks. Building upon these three steps, and based on our sample, we will then determine a best-in-class profile.

The conducted study confirms the results of the study by Haniffa and Hudaib, which we discussed in our introduction: Islamic banks primarily focus on mark-up transactions, while the forms of transactions idealized in theory are rarely ever applied. This is true for profit-and-loss sharing, *qard hassan* and microloans, but also, even if only to a minor extent, to *zakat* and other charitable donations. The degree of the performance of the banks can be understood as the degree of their effort to fulfill Islamic finance criteria as they are put forward in theory. The banks that fulfill many criteria are particularly striving for a complete implementation of religion-based norms, while the ones with poor performance lack to offer an Islamic way of banking as it is described in theory.

Figure 1 shows the frequency of fulfilled criteria of our sample:

Figure 1: Performance of all selected Islamic private banks on all 21 criteria



The three top performers among the selected Islamic private banks that can be used for the determination of the best-in-class cases are *Islamic Bank Bangladesh* (18/21), *Bahrain Islamic Bank* and *Qatar Islamic Bank* (both 17/21). The banks that adhere to less of the criteria seem to be subject to less strict rules even though they run under the label of Islamic finance (for a detailed discussion of this particular point, see research implications). Generally speaking, the degree of performance shows a rather wide range of commitment regarding the communication of Islam-based banking rules. Also, the frequency of the overall criteria indicates that there is a considerable variance regarding the commitment to implement the broad range of religious standards as imposed by the *shari'ah*. Reflecting on these results, readers should keep in mind that there is no strict consent on universally valid factors that determine *shari'ah* compliance. Therefore, the banks' performances should be understood as a relative measurement. We are not in a position to determine what is considered to be Islamic and what is not, so our analysis only shows which banks show what commitment in reporting on the criteria set up in theoretical books on Islamic finance.

The four *conditio sine qua non* criteria that were derived from the literature are: (1) the existence of *shari'ah* board, (2) the use of profit-and-loss sharing, (3) the payment of *zakat* and (4) the offering of *qard hassan*. We have argued that the addressing of these elementary criteria allows for a valuation regarding the rigorous implementation of the constitutive criteria. As mentioned above and as recommended by the AAOIFI, Islamic banks should have a *shari'ah* board which at least one renowned religious scholar is part of. Out of the 18 examined Islamic private banks, only 12 banks actively declare an independent *shari'ah* board as a means of governance-based Islamic finance criteria. With regard to the equally important profit-and-loss sharing criterion, our data indicates that only 16 banks declare to actively apply profit-and-loss sharing mechanisms. Hence, these two *conditio sine qua non* criteria are represented with 66,7 percent (declaration of existence of *shari'ah* board) and 88,9 percent (declaration of the use of profit-and-loss sharing mechanisms).

Let us now consider the norm-based Islamic finance criteria. As for the payment of *zakat*, we found that 13 banks and therefore 72,2 percent of the examined Islamic private banks report a participation in this mandatory religious tax for the poor. As for *qard hassan*, a free-of-charge loan for social purposes, we could find such an offering only in four of the examined Islamic private banks, which represents 22 percent of the sample.

As we considered these criteria to be conditio sine qua non criteria, our originial benchmark is only achieved by one single bank. Figure 2 shows the performance of the 18 banks we evaluated with regard to the four conditio sine qua non criteria.

Figure 2: Frequency Conditio Sine Qua Non Criteria

Bank/Criteria	***shari'ah board***	***PLS***	***zakat***	***qard hassan***
Al Baraka Bank Egypt E.S.C.		x	x	
Al Rajhi Bank	x	x	x	
Al -Salam Bank		x		x
Alinma Bank	x	x	x	
Bahrain Islamic Bank	x	x	x	x
Bank Al-Jazira	x	x	x	
Bankislami Pakistan LTD	x	x	x	
BIMB Holdings BHD		x	x	
Boubayan Bank K.S.C.	x		x	
Faisal Islamic Bank of Egypt		x	x	
Islami Bank Bangladesh LTD	x	x	x	
Ithmaar Bank BSC	x	x		x
Jordan Islamic Bank	x	x		x
Khaleeji Commercial Bank	x	x	x	
Kuwait Finance House			x	
Meezan Bank LTD	x	x		
Qatar International Islamic		x		
Qatar Islamic Bank	x	x	x	

Regarding our research questions that were based on the *conditio sine qua non* criteria, we have found that the commitment to the most important duties is rather low, when compared to the claims made in Islamic finance textbooks. In our sample, two banks only meet the most general criterion of the existence and declaration of an independent *shari'ah* board, while meeting no other *conditio sine qua non* criterion. Moreover, six of the banks only meet two out of the four *conditio sine qua non* criteria. Given this rather large gaps between theory and practice, allegations of greenwashing in the field of Islamic finance have to be taken seriously.

While the banks with a relatively lower commitment seem to benefit from the label Islamic finance as a marketing strategy, these banks only partially deal with the fact that some of the requirements of the *shari'ah*, as it is explained in textbooks, are risky and expensive to implement. As a consequence, they are hardly ever put into practice or at least do not show up in the annual reports of these banks. In the end, investors and customers will never know whether this lack of information is caused by a bank's relatively low commitment to the governance-based and norm-based rules of Islamic finance, or whether it is caused by a lack of transparency and reporting standards. Based on this, we suggest a standardization of reporting similar to the Global Reporting Initiative, which, in our view, would increase the comparability for Islamic investors and customers and help Islamic private bank to not be suspected of possible greenwashing.

Promoting Transparency and Standardization

As our findings show, the gap between the claim of Islamic finance as found in textbooks and the communicated practice as found in the annual reports put Islamic finance in danger of being perceived as a market practice exposed to greenwashing. From our sample of 18 Islamic private banks, no bank fulfills all 21 constitutive criteria for Islamic finance mentioned in Islamic finance textbooks. The laxity in implementing Islamic banking requirements as mentioned in textbooks becomes even more obvious if we look at the fulfillment of the four *conditio sine qua non* criteria. There is only one bank that meets all four *conditio sine qua non* criteria we have set up for our study: Bahrain Islamic Bank.

Looking at the fulfillment of the 21 constitutive criteria, our best-in-class ranking looks at follows: The top banks are Islamic Bank Bangladesh LTD (meeting 18 of 21 criteria), Bahrain Islamic Bank and Qatar Islamic Bank (both meeting 17 of 21 criteria), as well as Jordan Islamic Bank and Khaleeji Commercial Bank (both meeting 16 of 21 criteria). If we consider both the overall score and the *conditio sine qua non* criteria, Bahrain Islamic Bank ranks best. Assuming that the banks that are not listed in this positive-benchmarking evaluation can benefit from *freeriding* (i.e. using the designation Islamic bank without necessarily imposing its rigorous rules), we suggest the introduction of transparency and standardization measures as it had been established for corporate social responsibility and sustainability reporting through the Global Reporting Initiative.

If we look at the results of the content analysis, questions arise about the disclosure practice of Islamic private banks. Clearly, the results point to the fact that there is a lot of potential to develop Islamic finance-related reporting standards and we are interested in contributing to this endeavor by sharing our insights gained from this study.

The sample selection of the full Bloomberg list of 42 Islamic financial institutions has resulted in the exclusion of 24 banks. This has been caused by the fact that we could only consider banks that published an annual report, rather than just provide a consolidated financial statement. The lack of an information policy of banks that do not offer an annual report, but just publish a balance of accounts without any comment on it is not only problematic for the respective banks but also for the whole sector the banks operate in. As for 11 of the 42 listed banks, this was the case. As we have shown, even among the Islamic private banks that do publish annual reports, the published information on governance-based und norm-based Islamic finance rules has many times been fragmentary. This lack of transparency is problematic because it allows single institutions to benefit from the designation and the image of Islamic finance without being forced to implement its rules. In doing so, they create a distortion of the market, since the more rigorous Islamic private banks cannot seize similar business opportunities because of self-imposed restrictions and therefore possibly cannot achieve the same profits and returns as possible greenwashers.

In the debate on corporate social responsibility, the term greenwashing is used when pointing to such dissemination of strategic misinformation.[40] When talking about greenwashing, scholars such as Gillespie or Vos use the concept as it is defined in the Oxford Dictionary (see introduction).[41] Other scholars, such as Delmas and Burbano refer to the definition of Greenpeace that describes greenwashing as an "act of misleading consumers regarding the environmental practices of a company or the environmental benefits of a product or service."[42] As we use the concept of greenwashing in a context of religion-based investing, this definition need to be adjusted. Hence, we define *greenwashing in Islamic finance as an act of misleading consumers or stakeholders in general regarding the religious norms of a company or the lack of information published on how religious duties are implemented.*

We mentioned that greenwashing in Islamic finance has critical consequences on an operative level, as banks can become free riders by practicing it. As Jensen and Seele argue, such activity should be labeled as "ethical free riding."[43] As we did not examine *de facto* actions of Islamic private banks, but the disclosure practices, we cannot label any of the banks under study as actual greenwashers or ethical free riders. In order to so, there should be at least a standardized way of reporting Islamic financial practices, which we then could

[40] William S. Laufer, Social accountability and corporate greenwashing, Journal of business ethics, 43(3), 2003, 253-261. Peter Seele, Blue is the new green. Colors of the earth in corporate PR and advertisement to communicate ethical commitment and responsibility, CRR working papers, 1(3), 2007. Peter Seele and Lucia Gatti, Greenwashing Revisited: In Search for a Typology and Accusation-based Definition Incorporating Legitimacy Strategies, Business Strategy and the Environment, 2015, 1-16.

[41] Ed Gillespie, Stemming the tide of greenwash': How an ostensibly greener' market could pose challenges for environmentally sustainable consumerism, Consumer Policy Review, 18(3), 2008, 79. Jakob Vos, Actions speak louder than words: Greenwashing in corporate America, Notre Dame Journal of Law, Ethics & Public Policy 23, 2009, 673–697.

[42] Magali A. Delmas and Vanessa Cuerel Burbano, The drivers of greenwashing, California Management Review, 54(1), 2011, 64-87.

[43] Ole Alexander Jensen and Peter Seele, An analysis of sovereign wealth and pension funds' ethical investment guidelines and their commitment thereto, Journal of Sustainable Finance & Investment, 3(3), 2013, 264-282.

have tested against the actual reporting done by Islamic banks. We therefore advocate a standardization of Islamic finance reporting practices. Considering the ongoing critique, this would allow Islamic finance to become immune against allegations that the sector is based on false premises. Moreover, a standardized non-financial reporting of Islamic private banks would provide reliable information to investors and customers and thus enhance transparency within this business sector. Ironically, Islamic scholars usually tend to stress the importance of transparency in Islamic finance. In order to achieve that, however, a standardization of non-financial reporting practices is a necessity.

A standardization of non-financial reporting practices for Islamic financial institutions could benefit from looking at the United Nations' Global Compact that has helped to introduce first non-financial reporting standards in conventional banking. Along those lines, the Global Reporting Initiative can be taken as an example for the suggested non-financial Islamic finance reporting. The Global Reporting Initiative determines key performance indicators that focus on environmental and social issues. An Islamic finance reporting initiative could define similar performance indicators linked to religion-based norms. Such key performance indicators could be developed by an Islamic finance-board of *shari'ah* boards, cooperating with experts on non-financial reporting from the conventional banking sector. Here, the coding sheet that we used could give some orientation (see appendix).

Limitations and Future Research

Islamic finance, as a business sector, is still small when compared to conventional finance. One should not be misleaded by the public attention it has generated due to its cultural characteristics and its leading role it the development of financial practices that integrate ethical norms. As our sample shows, the overall number of Islamic private banks is limited. And as we have shown, the reporting standards of Islamic private banks are generally below the level of conventional banking.

Moreover, the coding of the sample according to the literature-based criteria has shown that the disclosure of information is restrained. Based on this, an essential limitation of our study is the size of the sample, which allowed us to only engage in descriptive statistics for our analysis. Another limitation derived from the coding: essential criteria for Islamic finance like profit-and-loss sharing transactions and the general rules of the *shari'ah* on *riba*, *gharar*, *maysir* and investments labeled as *haram* could only be summarized and taken into the list of criteria to a minor extent. The desired detailed elaboration of these particularly important criteria had to be postponed because of the lack of verifiability. Another factor of our study's limitations has been the lack of economic guidelines on how to operationalize some of the transactions preferred by Islamic scholars. With respect to profit-and-loss sharing in particular, there are hardly any regulations or instructions that could serve as criteria. This is particularly problematic when taking into consideration the role of profit-and-loss sharing contracts in theoretical textbook. Referring to all of these issues, the establishment of an Islamic finance reporting initiative would help not only to professionalize standardization, but also shed light on untapped opportunities within the Islamic financial sector.

We have already pointed out that our analysis is based on annual reports that were published in English. We are aware that this limitation includes the risk that Islamic private banks provide further information in other documents that we did not consider. However, the sample selection plays an important role here, since only private banks have been chosen from the Bloomberg list in order to provide a homogeneous sample and to prevent sample bias. In contrast to closed funds or sovereign wealth funds, these private banks are accessible to private clients from all over the world. Hence, it should be assumed that these Islamic private bank are interested in publishing data accessible in different languages.

Future research on the standardization of Islamic finance reporting practices could be conducted on either a conceptual or an empirical level: On a conceptual level, the development of guidelines similar to the Global Reporting Initiative would help to increase transparency and advance standardization. Also, the definition of Islamic finance-specific key performance indicators could help Islamic finance to gain attraction. On an empirical level, the size of the sample could be broadened. Here, it would be possible to examine not only Islamic private banks but Islamic financial institutions in general.

Appendix

21 constitutive criteria for Islamic finance, with four *conditio sine qua non* criteria (5, 10, 16, 18)

Item	
1	Activities declared as *shari'ah*-compliant
2	Commitment of belonging to the (Muslim) community declared
3	In-house shari'ah board
4	Education of *shari'ah* board members following Islamic law and experience in the financial sector
5	Independence of *shari'ah* board declared
6	All products and processes are certified by *shari'ah* board
7	Declaration of *shari'ah* board that all profits are ‚just' (aka compliant)
8	Declaration of engagement in non-compliant business activities
9	Share of mark-up financial products is smaller than share of PLS contracts
10	Profit-and-loss products used
11	Promotion of start-ups and small enterprises with PLS
12	Microloans
13	Advanced education for employees offered
14	Donations for charity: Quanity and purpose declared
15	Zakat: Liability for payment of *zakat* is fixed with regard to shares
16	Payment of *zakat*: payments done
17	Payment of *zakat*: Calculation, source and distribution published
18	qard hassan used
19	Done social projects: education and/or job creation
20	Done social projects: health and or sport
21	Done social projects: business promotion of women