Corporate Social Responsibility Ethical Index and the Financial Performance in the Egyptian Banking Sector

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Abstract:

The objective of the study is to investigate the relationship between corporate social responsibility ethical index adopted in financial institutions and their financial performance. The sample of the study is the financial institutions listed on Egypt stock exchange in the period from 2007-2014. The data are collected from annual reports issued by banks and central bank of Egypt. In order to determine the attributes of banking ethical index six factors are suggested: transparency, reliability, honesty, compliance, guarantees social responsiveness. A questionnaire was developed and distributed to the sampled banks with a kind of high response rate (85%). The results show that 50 % of the Egyptian banks adopted about 55% of ethical bank policies while the other half adopted only about 11 % of ethical activities. The study uses the complete case regression analysis to model the relationship between the high ethical banking index as a censored variable and financial performance. The results indicated that high ethical index banks reported a positive significant impact on banks financial performance.

Key words: CSR, Ethical Banking Index, Financial performance

Purpose:

The study aims to develop an ethical banking index (EBI) to distinguish banks that adopt social responsible activities and to explore the impacts of engagement in social responsible projects on bank financial performance.

Design/Methodology/Approach:

The study has conducted Survey research to identify factors of relevance. that represents the banking ethical index. And the complete case regression analysis was used to model the relationship between EBI and bank financial performance.

Findings:

The analysis indicates that high ethical practices have a positive impact on financial performance through transparency, honesty and reliability that are obvious apparent in reduction of unfair practices and increased productivity.

Practical implications:

Investors, customers and bank management are entitled to make use of the results of the study.

Originality:

The study indicates how ethical practices affect financial performance of banks. This area did not receive due attention in the accounting literature. The current study represents a contribution in this field.

Limitations:

a) The research is limited to the banking sector with the exclusion of other financial institutions.

b) Questionnaires were distributed to banks and responses were received with a 85 % response rate.

1. Problem statement:

Ethical banking is the business model that responds to the sustainable economy approaches represented in corporate social responsibility (CSR). And sometimes is called sustainable banking, clean banking (Robert Brian O'mahony, 2014).

Ethical behaviour has a considerable attention and importance especially in banking sector. Ethical banking refers to banks that have most interest in financing sustainable projects that combines social, environmental standards along with the economic benefits.

The financial crisis that exploded in 2008 gave an increasing attention towards the absence of ethical banking behavior, and urged the governments to undertake a role in the regulation of financial institutions (Belas, J.2012).

Egypt has begun an extensive economic reform and structural adjustment program (ERSAP) from 1991 to liberalize bank activities and to give private sector a wider contribution in the

Egyptian banking sector. Accordingly; the central bank of Egypt has opposed the international governance rules on the Egyptian banking sector in 2011. It includes effective information systems, proper competency criteria for the bank's officials and managers, and clear governance rules. (Nasr, 2012)

Despite the main objective of a bank is to maximize profit. It is hardly required to do so in an ethical way and to fulfill social obligations. As Ethical coordination remains a mandate, and corporate social responsibility becomes an integrating, part into bank in everyday activities and it must be incorporated into the organizational culture. It is expected that embracing social obligations will inherently increase long-term profit through working with a CSR perspective.

In the highly competitive environment and regarding the incoming regulations for firms, it is highly important to examine the relationship between ethical banking index based on CSR and financial performance for Egyptian banks. As financial institutions work with policymakers in the private sector to restore growth and build public good will.

The demand of customers seeking for a new sustainable business model that guarantees a financial return consistent to the principles of social responsibility and commitment environment has motivated the introduction of ethical banking index.

The relation between EBI and financial performance is not so clear in previous studies. Therefore, the purpose of the current study is to develop an ethical banking index (EBI) and to explore whether there is an association between the adoption of highly ethical banking index and bank financial performance.

In addition, the study attempts to address the impacts of January revolution 2011, which caused many troubles to the Egyptian economy not the less is the increase of national debts, rate of unemployment and slowing down the macroeconomic growth. Therefore, expectations from banking sector are fast growing to undertake not only the financial part but also to consider the social, human and environmental responsibilities, which extend beyond the economic benefits (Nasr, Sahar, 2012).

2. An overview of Corporate Social Responsibility (CSR):

2.1 Definition of CSR

Corporate social responsibility can be defined as the business commitment to produce a significant contribution to the sustainable economic development, this can be achieved through the cooperation with different parties (employees, customers, suppliers, community and the public) to improve the quality of life to achieve mutual benefits for all counterparts (The world business council for sustainable development (WBCSD,2004). It is also known as sustainable responsible business (SRB). Another definition of CSR is that: "strategies performed to conduct business in ethical ways"(Haryono and Iskandar, 2015).

Despite the wide variety of CSR activities among different organizations, there has been a common practice that is called the triple bottom line (TBL). The TBL encompasses three components or three dimensions that are; people (represent social dimension), profit (represent economic dimension, and planet represent environmental dimension). Evaluating the three dimensions properly will cover corporate sustainability and capital growth (Sharma, 2011).

There is some criticism to the TBL approach; as it may be misleading because it does not indicate an accurate and precise meaning. This is may be due to the different and qualitative nature of social and environmental dimensions, compared to the economic dimension that is quantitative and measurable. In sum these arguments assure that the performance of an organization cannot be measured by a single factor or indicator (Tashiba Dixon, 2014).

Supporters of CSR state that firms can do have benefits from adopting CSR activities, such as enhancing reputation and creation of business value, greater employee and customer loyalty and retention, the last represents special importance for a firm because attracting new customers is costlier than retaining current customers (Lance, 2001, Bebbington et al., 2008).

2.2 Dimensions of CSR:

CSR contains four dimensions: Social, Economic, Environmental, and Ethical.

- Social dimension:

According to Dyllic and Hockers (2002), firms face challenges that leave no choice other than expanding the range of CSR activities to include its customers and stakeholders. With the growing awareness of stockholders of the firm's CSR activities, firms are encouraged to spend more time, money and resources on CSR activities to boost its sustainable activities for marketing purposes. (Lii&Lee, 2011).

Social marketing is a somehow novel concept that seeks performing activities for the benefit of both the customers and the society. This goal can be achieved through the reduction of harmful impacts and the maximization of the positive impacts on the society (Mohr et al. 2001).

- Environmental dimension:

It is important for firms to consider the environmental impacts of its activities on the surrounding environment; due to the growing interest of public and stakeholders to firm's environmental impacts such as emission, water and air pollution etc. In addition, there is a common belief that the prospector firms are rewarded by more customer loyalty (Chatterji et al. 2009).

Shareholders have a positive attitude towards the firm's eco-friendly activities; on the contrary, they act negatively towards the harmful activities that have bad effects to environment (Flammar, 2013).

- Economic dimension:

Many studies addressed the expected benefits of CSR activities. Also there are different and may be contradicting results as some studies indicate a positive association and some failed to detect any association (Cavaco&Crifo, 2014).Four situations may arise:

a) The decrease in financial performance with the increase of CSR activities; that creates a conflict of interest as firms lacks the motives to invest in CSR activities.
b) The increase of financial performance may result from the decrease of CSR activities.
c) The win-win situation: that occurs when the increase of CSR activities leads to the enhancement of financial performance.

d)The lose-lose situation that happens when the expansion of CSR activities leads to the deterioration of financial performance.

- Ethical dimension:

It contains the unwritten codes of conduct that identify which behaviors, activities are authorized, and which are prohibited, from organization and society. According to Jucan and Jucan, corporate social responsibility must have proactive procedures to anticipate problems that may happen. Ethical CSR activities must be engrained in the process of decision-making and integrated into business strategy. This part will be discussed in details later.

3. Research objectives:

1) To develop the ethical banking index.
2) To examine the association between ethical banking index and bank financial performance for the commercial banks operating in the Egyptian banking sector.
3) To examine whether this relationship (if exist) differs according to the classification of banks into high EBI and low EBI.

4. Practical implications:

1) The study provides useful information for Customers about the relationship between corporate social responsibility and the enhancement of banks' financial performance.
2) The findings of the study may be of good use to the Egyptian banks to enhance their disclosure systems.
3) The findings of the study may improve regulations and practices of CSR.
4) It may represent guidelines for bank management.

5. Literature review:

In recent years, firms seek to optimize the triple bottom line concept to sustainability management (Imran Ali et al. 2010). The aim is to achieve sustainability through the equal balance among economic, environmental and social criteria.

CSR is widely practiced because customers and governments are demanding more ethical and responsible behavior from organizations. In response, firms are racing and urging themselves to integrate CSR as part of their business strategies.

There are different types of approaches to deal with the issue of social responsibility; it depends on what is called firm specific characteristics: firm size, financial leverage, type of industry, and ownership structure ...etc.

Some previous studies suggested there is a positive link between corporate social performance and financial performance, such as Stanwick and Stanwick (1998) and Preston and O'Bannon (1997). In the study of Simpson and Kohers (2002), the results indicated there is a strong positive relationship between corporate social performance and financial performance in banking industry. Margolis et al. (2001), has found significant positive relationship between CSR and firm financial performance.

The instrumental stakeholders' theory stated that firm engagement in CSR activities increase stakeholders s' satisfaction and consequently improve firm financial performance.

There exists a positive relationship in a large number of previous studies as shown in the bibliographic study of Orlitzky et al. (2003), they examined 52 studies using the Meta analysis method over a 30-year period, the positive association really exists and a bidirectional relationship exists between the adoption of CSR activities and financial performance. This may require further analysis.

The above mentioned conclusion uphold the instrumental stakeholder theory, as management do achieve actual financial gains, it is also noticed that CSR positively impacts firm financial performance through two mediator factors; the first is that CSR activities improve the firm reputation which is reflected in less defensive community and more customer loyalty. The second is represented in the ability of CSR activities to generate revenues through increasing the firm ability to raise prices and extending customer base.

According to Friedman (1979), firms should not integrate CSR into firm's operation unless two requirements are available; the first is the existence of cost reduction and the second is the existence of positive impacts of CSR activities on firm performance.

Lopez et al. (2007) analyzed 110European firms to examine the relationship between CSR and financial performance using ROA to measure financial performance and the Daw Jones sustainability index to measure corporate social responsibility. The study suggests that the effect of CSR on performance indicator is negative in the short run.

At last, there might be no relationship between corporate social responsibility and financial performance. The study of Aupperel et al. 1985 was conducted on 241 CEO'S to investigate the relationship between CSR and financial performance on both long and short run. The findings suggest that there is no significant relationship between CSR and financial performance no matter on the short run or on the long run.

6. Research methodology:

6.1 The study variables:

Corporate social responsibility (CSR):

There is a continuous and mounting debate around what good corporate is since the seventies of the late century. It is argued that the firm should only pursue the objective of increasing profits and to maximize shareholder returns. The agency theory supposes that management may over-engage in CSR to enhance their personal reputation and consequently this may lead to decreasing profits. Friedman (1970) on the contrary, many different points of view consider the potential benefits of the strategic investment in CSR performance that may be result in more profits and higher shareholder value.

Positive association between CSR and financial performance is expected because the strategic investment in CSR will improves firm competitiveness through better risk management, cost savings and availability of finance. In accordance with this view, CSR may be identified as a source of competitive advantage. It is also expected that strategic investment in CSR is more likely to increase profitability (J. Nollet et al. 2015). It is noteworthy that the demand on socially responsible products increases with the increase of income, as it is income elastic. So, if the economy is in

recession: firms tend to reduce engagement in CSR activities, due to declining sales and profits.
The interest of CSR is increasing recently with the increasing awareness of firms to minimize the negative impacts of their activities on society and environment on one hand (white, 2012). On the other hand, firms are required to publish sustainability reports in response to the pressure of stakeholders and good governance requirements (Christian Hagberg et al. 2015).

There was growing criticism to the study of Alexander and Buchholz (1978) for using a reputation index to measure CSR performance. Many factors moderate the relationship between CSR and financial performance. (Brammar and Millington, 2008). These factors are referred to as firm specific characteristics such as firm size, financial leverage and ownership.
Corporate social responsibility is the independent variable. That is represented by the rank of the bank in the S&P /EGX /ESG Index (the source of published data: environmental, social, and governance). It is considered as an aggregate measure for the three components of CSR on the social side, environmental side and governance side.

Firm size:

According to the economic theory, firm size is expected to have an influence on the relationship between CSR and financial performance. There is some evidence that big firms tend to be more socially responsible than small firms. [simpson and Kohers, 2002, Martinez and Valeriano, 2015,)Many studies state that there is a positive relationship between corporate social responsibility and financial performance. While other studies have recorded the existence of a negative relationship between CSR and financial performance. In addition, a number of studies fail to come to a conclusion whether there is a negative, positive or no relationship between corporate social responsibility and financial (Peng and Yang, 2014).

Financial leverage:

It is the use of debts to finance activities and to have additional assets. Alternatively, a bank with significantly more debts than equity is highly leveraged. It is the ratio of equity to total assets (ET).

Non- performing loans (NPL):
It is used as a proxy for the quality of loans provided by the bank. It is defined as the sum of borrowed money upon which the debtor has not made his scheduled payments for at least 90 days. And it may be either in default or close to default. Loan loss provisions LLP is the indicator of non-performing loans.

Financial performance:

There is no assent in the related literature on a single measure of financial performance. There are two types of measures in general (Moor et a. 2014):

- The accounting measures: it encompasses return on assets (ROA), and return on equity (ROE), net profit (Tang et al. 2012,). Fortunately, accounting- based measures are not negatively affected by investor's psychology and it can provide good estimates for some items such as goodwill and depreciation (McWilliams and Siegel, 2001).
- The market measures: in this kind of measures; stock price, stock market returns or market value are used to measure financial performance.

6.2 The field study:

To construct the ethical banking index based on the opinions of all stakeholders; questionnaires were distributed to 35 banks including managers, employees and customers. The questionnaire contains 15 Likert scale questions. And the response rate was over satisfactory with a 80 %.

Table (1/1): Ethical Index Factors

F1 Transparency	F2 Social responsiveness and responsibility	F3 Honesty and integrity
- Declining falsified statements. - Reporting about credit types. - Fair evaluation of projects revenues.	-Restricting loans to projects with environmentally harmful activities. -Financing projects that contribute to social welfare. -utilization of bank assets in projects with highly positive social value added. -Offering loans with low interest rates to small and medium size enterprises.	-Prohibition of misreporting and illegal practices. - Full commitment to CBE guidelines and other supervisory institutions. Providing services equally to all customers

Table (1/2): Ethical Index Factors

F4 compliance	F5 Reliability	F6 Guarantees
Products and services are identical. Congruence of charge. Standards and rules of services are congruent.	Reviewing banking ethical performance Making incentives for ethical practices. Maintaining customer information privacy	Banks are developing guarantee systems to poster investments.

It could be seen that ethical banking index comprises of six factors that are transparency, reliability, honesty and integrity, compliance, guarantees and social responsiveness. These factors include offering loans to SMEs with low rate of interest, utilizing assets in profitable projects and with highly socially benefit, limiting loans to harmful projects to environment, reviewing ethical performance of banks by the board of directors, assigning incentives on ethical performance.

This is consistent with the study of (Md.Chowdury, 2011).

6.3 Data collection and the sample of the study:

- The sample period begins from 2010- 2015.
- The data are available from central bank of Egypt publications and banks' reports.
- Independent variable is corporate social responsibility (CSR) that is measured by ethical banking index (EBI).
- Dependent variable is corporate financial performance that is measured by:
  - Return on assets (ROA)
  - Return on Equity (ROE)

Table (2): Descriptive statistics for the variables

	Mean	Standard deviation
ROA	1.0	0.9
ROE	1.99	1.91
Ln Assets	3.7	1.7
Lev.	0.57	0.55
NPL	4.1	5.6

6.4 The statistical model:

The complete case regression model:

The scores of ethical banking index falls between 0 and 1, it means that the independent variable is limited to certain values (censored). Linear regression model is not appropriate to deal with censored independent variables, as it produces biased estimators. A large number of studies use the complete case analysis method to address the problem of truncated covariates (Roberto, R. and Thomas,M., 2007).

Using the complete case regression analysis has superiority when the sample size is large and the censored data is relatively small; the use of complete case analysis provides consistent and unbiased estimates of the regression coefficients. We use the maximum likelihood method to solve for β_i and $\varepsilon_{\sim i}$.

Where the distribution of y is the product of X and $\varepsilon_{\sim i}$. And the likelihood of y. We use the maximum likelihood method to solve for β_i and $\varepsilon_{\sim i}$. Where the distribution of y is the product of X and $\varepsilon_{\sim i}$. And the likelihood of y

$$\text{Log } L = \sum_{Yi>0} - \frac{1}{2}\left[\log(2\Pi) + \log \sigma^{2} + \frac{(Yi-\beta Xi)2}{\sigma 2}\right] + \sum_{Yi=0} \log\left[1-F\left(\frac{\beta Xi}{\sigma}\right)\right]$$

The formula contains two products; the first is over the observations undertaking high ethical banking index where $X_i > 0$, (not censored) and the second product is over the observations that are censored.
where $X_i = 0$
Where:
Xi is the vector of censored independent variables.
β_i is the vector of unknown parameters.

$\varepsilon_{\sim i}$ N (0, σ)

6.5 Research hypotheses:

H1: There is a significant relationship between EBI and ROA.

H2: There is a significant relationship between EBI and ROE.

6.6 Empirical study:

The study seeks to examine the relationship between bank commitment to social responsible activities measured by ethical banking index and bank financial performance.
The current study uses the complete case regression analysis to investigate the relationship between CSR measured by the ethical

banking index (EBI) and the bank performance. Including control variables that are:

Bank size: the natural algorithm of total assets is a proxy for bank size.

Financial leverage: the total liabilities to total assets is a suitable measure of financial leverage.

The study uses the complete case regression analysis to investigate the relationship between CSR measured by the ethical banking index (EBI) and the bank performance. Including control variables that are:

Bank size: the natural algorithm of total assets is a proxy for bank size. Financial leverage: the total liabilities to total assets is a suitable measure of financial leverage.

7. Results and discussion:

The reliability test:

The study used Alpha Chronbach's to-test the reliability and stability of the questionnaire. And to be certain of the reliability of respondents in answering questions.

Table (3): Reliability test

Variables	No. Of values	Chronbach's alpha
Transparency	3	0.87
Social responsibility	4	0.79
Honesty	5	0.74
Compliance	3	0.53
Reliability	4	0.82
Guarantees	1	0.57
Total	20	0.0.72

It is obvious that the overall reliability measure is good >0.7, and that is very acceptable and suggests a relatively high internal consistency. In addition, it indicates that the questionnaire is internally consistent and reliable such that we cannot omit a single part without harming its reliability.

Table (4): The correlation matrix

	F1	F2	F3	F4	F5	F6
F1	1	0.19	0.85	-0.27	0.76	-0.09
F2		1	0.25	0.55	0.09	0.5
F3			1	0.34	0.77	0.08
F4				1	0.14	0.45

F5					1	0.14
F6						1

The correlation matrix revealed that there is a strong relation between compliance, social responsiveness and guarantees; on the other hand, there is a high association between honesty, reliability and transparency.

Table (5): The weighted ethical banking index

Ethical banking factor	Weight
F1: transparency	0.21
F2: Social responsibility and responsiveness.	0.28
F3:Honesty and integrity	0.15
F4: Compliance	0.16
F5:Reliability	0.16
F6: Guarantee.	0.04

The following scores of EBI for the Egyptian bank were obtained:

Table (6): The mean scores of EBI

Bank type	No. Of banks	Mean of EBI score
State-owned banks	3	0.52
Private banks	25	0.45
Foreign banks	7	0.12

The banks were classified into two groups according to compliance with EBI (high compliant & low compliant); It was found that about half of the Egyptian banks adopted about 55% of ethical bank policies. While the other half adopted about 11% of ethical activities. In addition, the following results were obtained.

Table (7): Ethical index results

Category	Total no. of banks	High compliant	Low compliant
State-owned banks	3	2	1
Private banks	25	13	12
Foreign banks	7	2	5
Total	35	17	18

To investigate the relationship between CSR (measured by EBI) and bank performance using the complete case regression analysis using the high EBI scores as the independent variable and the (ROA, ROE, Ln TA, Lev and NPL)

For display purposes, The EBI in relation to accounting ratios was divided into two parts: part (1) includes F1, F2 and F3:

Table (8): results of regression model of F1, F2, F3 and financial performance

	F1	F2	F3
intercept	1.89	1.98	0.227
High EBI	1.17	0.029	0.115
ROA	.917	0.16	0.007
ROE	1.97	0.092	0.002
Ln Assets	2.03	-0.0036	0.037
Lev.	-0.113	0.0016	0.003
NPL	-0.118	0.004	-0.161

The results show that the most weighted factor that has a positive impact on bank performance is the transparency as an important factor of ethical banking. It includes revealing the kind of projects that banks are funding, reporting maturity date of large loans. It reflects the way a bank uses its customer deposits.

Honesty and integrity is essential to reduce unfair practices. These findings are consistent with the results of the study of Soliman et al, (2007). Social responsibility and responsiveness is the third factor of importance. Its effect is apparent through lending projects that are socially responsible and have high value added and restricting loans to projects that harm the environment. Moreover, providing low interest rate loans to small and medium size projects.

Table (9): Results of regression of F4, F5, F6 and financial performance

	F4	F5	F6
intercept	0.22	2.26	0.896
High EBI	0.145	2.89	0.96
ROA	0.037	1.18	1.23
ROE	0.007	2.17	1.9
Ln Assets	0.087	2.23	0.911
Lev.	-0.012	-1.115	-0.054
NPL	0.3	-0.113	-1.22

Providing non-conventional guarantees of repayment of loans has a significant impact on profitability and asset growth. It has the ability to reduce the leverage of banks through improving the customer credit score.

The results indicate that banks that produce such kinds of guarantees are more profitable and have more assets growth potentials. As those banks are more energetic and have the ability to improve the credit score of their borrowers in the short run.

Board of directors involvement in reviewing ethical performance and putting incentives for ethical practices (reliability) have a positive impact on profitability, it also reduces the bank leverage but it doesn't affect the growth potentials.

8) Conclusion:

1) Egypt has taken wide steps on the road of privatization and structural reform program. This strengthens the soundness and resilience of the banking sector in the period of financial crisis in 2008-2009 and the period that follows.
2) Egyptian revolution caused many sufferings to the Egyptian economy such as increasing poverty, unemployment rates and social disturbance. Hence, banks were required to take a greater role in the economic development.
3) The central bank of Egypt has taken a bunch of effective procedures in response to the Egyptian revolution and its consequences on the banking sector through applying kind of special measures that comply with certain issues such as the issuance of the circulars and the guarantees' to all deposits in the banking system.
4) The results of the study indicate that the high score EBI banks reported better accounting results and financial performance, suggesting the notion that bank involvement in social responsible activities do not harm shareholders' wealth.
5) The high EBI banks are more oriented toward the stakeholder model that includes their relationships with customers, employees, the society and their shareholders also.
6) There is a significant relationship between high score EBI banks and financial performance.

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