Relationship Between Institutional Shareholdings of the Constituent Companies of FTSE Islamic Index and Corporate Social Performance: An Empirical Investigation

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Abstract: A business company which is defined as being socially responsible, demonstrates the perception of the link between social and financial performance. This characteristic may lead the business company to long-term competitive advantages in terms of improvement of financial performance. In the European countries, Islamic institutional investors such as mutual funds, equity funds, charities etc have become the predominant players and their influence in the western markets are growing. Present study hypothesises that Islamic or socially responsible institutional investors invest heavily in companies with strong corporate social performance. Empirical results indicate a significant, positive relationship between social performance and number of institutions holding shares of constituent companies of the Islamic index.

1. Introduction

There is almost a consensus of opinion among contemporary scholars that it is lawful (halal) to invest in the stock markets provided the company invested in is not engaged in a business not permitted by Shari'ah. There are certain forbidden companies for investment which include interest-based companies, conventional insurance companies, and manufacturers of liquors, casinos, nightclubs, pollution conviction(general and water pollution), nuclear power and so on. The Financial Service Authority in United Kingdom is particularly interested in setting up Islamic financial institutions to serve the Islamic community in UK which is about 340,000 households or a bridge to Islamic institutions in the Muslim world. The London based FTSE (Financial Times Share Index) Islamic Index which was initially pioneered on January 1999 by the international Investor (TII); is a global Islamic equity benchmark index. It is designed to track the performance of leading, publicly traded companies whose activities are consistent with Shariah principles. Therefore, the FTSE Islamic index was launched in response to the demand from Islamic investors looking to identify and invest in companies that are managing their risks and enjoining corporate social responsibility (CSR) with a view that
corporate social performance (CSP) is a risk-reducing measure. Islamic institutional investors which may also be called as socially responsible investors do invest in constituent companies of the Islamic indices which are listed on major stock markets.

Figure 1 depicts the selection criteria—how the FTSE Islamic index, identifies innovators in corporate social responsibility. It identifies companies that meet globally recognise and socially responsible criteria as they evolve:

working towards environmental sustainability

develop positive relationships with stakeholders

up-holding and supporting universal Islamic ethical values such as human rights, environments etc.

not to invest in the companies linked with interest-based companies, conventional insurance companies, manufacturers of liquors, and business of casinos, nightclubs, pollution conviction.

Figure 1: FTSE Islamic index selection criterion
The Islamic mutual funds, equity funds, investment companies, charities etc which are called Islamic institutional investors are growing rapidly in the western market (Wilson, 1997). They buy the shares of the companies listed in stock market without damaging their Islamic ethical value. In UK, corporate social performance (CSP) has come under increasing scrutiny from the ethical investment research institute Service (EIRIS) and ethical fund managers as institutional investors have responded to the external pressures (EIRIS, 1999). The extent to which investment selection is subject to external pressure for socially responsible (as well as Islamic) stocks, and the form it takes is the subject of interest in respect of legal requirement of the financial market. However, the trading preferences of Islamic institutional investors (shareholding of the constituent companies of FTSE Europe Islamic index) are largely dictated by nature of product in consonance with Shari’ah rules. Apart from the state regulatory compliance into the financial aspects of institutional investor decision making, Islamic institutional owner of the constituent companies in the FTSE Islamic indexes are also subject to shari’ah compliance which would Islamic indexes are also subject to shari’ah compliance which would influence the importance they attach to corporate social performance.

Relatively few studies have considered the relationship between corporate social performance (CSP) of the companies and holdings of Islamic institutional shareholders. Graves and Waddock (1994) find that the number of institutional investors in a corporation's stock is positively related to company social performance within a model that draws on efficient markets theory (Fama,1970). Johnson and Greening (1999) place the analysis within agency theory and find a positive relationship between pension fund investment and two aspects of social performance: a people dimension (such as community, women, minority, employees etc) and a product dimension (such as environment and product quality). This study will extend and contribute further of the existing literature by employing sample data of institutional investor's shareholding constituent companies of the FTSE European Islamic index. The main objective of the study is to investigate the relationship between institutional ownership and corporate social performance (CSP) of the companies where Islamic institutional investors are shareholders. Keeping in view, the present study will address the research question: does a high level of corporate social performance (CSP) lead to an increase in Islamic or socially responsible institutional ownership?

2. Corporate Social Performance

The corporate social performance is considered to be multidimensional and a comprehensive assessment of a company's social performance should encompass a range of aspects. While emphasising on good corporate governance, Hillman and Keim (2001) argue with empirical evidence that aspects of company's social
performance that help to propagate good relationships with key stakeholder groups such as employees can lead to long-term competitive advantages that confer improved financial performance.

The myopic institutions theory (Hansen & Hill, 1991) argues that the institutional owners tend to be more shortsighted than individual investors. This shortsightedness occurs, ex-hypothesis, because institutional money managers must compete for accounts and are reviewed and rewarded on the basis of annual or quarterly performance. Accordingly, it is assumed that their investment decisions will be based on the same short time horizons. The theory is relevant because investments in corporate social performance tend to be long-term, and so there may be an incompatibility between an institutional owner’s time horizon and the time needed to realize the benefits from a commitment to CSP.

Again, a theoretical question may arise in respect of relationship between corporate social performance and investment risk. Shane and Spicer (1983) argue that investors consider low-CSP companies to be riskier investments outlets. This risk may arise from the possibility of costly sanctions resulting from adverse legislative or regulatory actions, judicial decisions, or consumer’s negative reaction. This cause will increase the future cost and revenues. Shane and Spicer (1983) conducted survey which show “a seemingly widespread view within the investment community that a moderate to strong association does exist” (pp.1978-1996) between the risk of a company and its concerning social responsibility. They noted that, in terms of the theory of finance, an investment in a company that is socially irresponsible could be inefficient.

In their study, Coffey and Fryxell (1991) examine the relationship between institutional ownership and corporate social performance. They find a negative association between compliance with the Sullivan Principles and institutional ownership. They do not find any significant relationship between corporate charitable giving and institutional ownership but discover a significant, positive relationship between women empowerment on the board of directors and institutional ownership. Their mixed findings explained the structure of their study, which does not control for profit, company size, or industry; any of these variables could have confounded the estimations. Since their study is purely cross sectional in design, no inference could be made about the direction of causation. Although this study is a valuable contribution to the literature, but it is not definitive and seems to leave unresolved the true relationship between corporate social performance and institutional ownership. Little empirical work has been done on the question of institutional risk aversion. It is generalised that traditional financial risk aversion, interpreting increased CSP as a risk-reducing measure and assuming that, ceteris paribus, institutional investors will view high social performance favourably.
According to the Islamic business ethics, the Islamic institutional investors need to operate their business in ethical and social responsible manner (Naqvi, 2003). Therefore, the corporate social responsibility is a natural commitment of the Islamic financial institutions. Besides, non-participation of their investment in the interest-based companies, conventional insurance companies, and manufacturers of liquors, casinos, nightclubs, pollution conviction, nuclear power etc; one unique example of the Islamic financial institutions is that they pay Zakah at the rate of 2.5% out of their annual profit which are related to social welfare. Despite Islamic financial institutions have played a great role in the field of corporate social responsibilities, only a few studies highlighted their corporate social performance. The present study argues that by choosing a company who practices the Islamic business ethics, an investor might get a reasonable return with less risk. Investors are assumed to be shared the profit and loss in their investments and application of Islamic business ethics in the business may reduce risk and providing an incentive for company to invest in positive CSP measures.

3. Methodology and Data

The model we use to examine the corporate social performance (CSP) is:

\[ IO_t = I_t(CSP_{t-1}, Cost\ Variabel_{t-1}) \]

Where, \( IO = \) measure of institutional ownership,
\( CSP = \) measure of corporate social performance,
\( t = \) time.

Hypothesis

As Fama (1970) stated, we consider that the CSP as a risk-reducing measure, together with the predictions of efficient market theory that a rational investor faced with a choice of decision between two companies with the same expected return, will select the one with less risk, lead to the following hypothesis:

H1: Improvements in a company's corporate social performance will increase Islamic institutional ownership.

3.1. Data

Our samples consist of UK quoted 67 companies which are listed on the London Stock Exchange, drawn from the constituent companies of the FTSE Europe Islamic Index. This index has approximately more than 350 of the companies. The FTSE Islamic index has been designed to track the performance of leading, publicly traded companies whose activities are consistent with Shari'ah principles. Our sample that have been the FTSE Europe Islamic index constituents in any quarter.
during 2003 and 2004. The list of a sample of 67 UK quoted companies is shown in the appendix 1.

**Dependent Variables**

The main focus of this research is the behaviour of institutional owners with respect to corporate social performance. Institutional ownership is measured in two ways: (1) as the number of institutions that held shares in each company and (2) as the percentage of each company's outstanding shares owned by institutions. Institutional ownership data is drawn in June 2003 share ownership analysis databases of more than 2000 listed UK companies managed by one of the largest company registrars in UK. Ownership data are continuously updated to incorporate underlying beneficial ownership changes and investment managers' holdings from share trading information based recorded at the London Stock Exchange.

**Independent Variables**

The independent variables include corporate social performance: company profitability, size, debt level and industry as control variables. We use 2002 data for each of these variables, providing a one-year lag between the measurement of the independent and dependent variables.

**3.2 Measurement of Corporate Social Performance**

Corporate social performance (CSP) is certainly a difficult task to measure consistently (Geertman, 1991; Wood, 1991). It is necessary that CSP should be uniformly measured across a wide range of companies and for a consistent range of important social issues. The independent variable used in this study is an index of CSP that we consider to satisfy these requirements. For the purpose of this study, an index is generated which gives a single numerical CSP value for each company in an analysis, from data developed by Ethical Investment Research Service (EIRIS), an independent research company of UK, specialising in the assessment of CSP for investors. The EIRIS assesses companies on eight attributes of CSP, providing a multidimensional appraisal of their social behaviour. These eight attributes include (i) community relations, (ii) employee relations, (iii) environment, (vi) product, (v) treatment of women and ethnic minorities, (vi) military contracts, (vii) nuclear power, and (viii) war. For each of the first five attributes, the EIRIS rates a company using a five-step scale ranging from 'major strength' to 'major weakness' (EIRIS, 1999). We converted these ratings to numerical values, with +2 representing a major strength and -2 representing a major weakness. For the last three attributes, the EIRIS assesses only weakness. Thus, after conversions, these three attributes had values of -2, -1, or 0. The EIRIS rates each company on each of the eight attributes by referring to a consistent, largely objective, set of screening criteria. The similar method is followed in this study too.
The assessment procedure used by the EIRIS offers several benefits (EIRIS, 1999).

1. It rates each company on multiple attributes considered important to social performance.

2. Because one group is doing the ratings, using an objective set of screening criteria, the ratings are applied consistently across all companies and are replicable.

3. Because the EIRIS operates a service that supplies information to the investment community at large, it rates all of our sample of UK based 67 companies at FTSE Europe Islamic index.

4. The group doing the rating consists of knowledgeable individuals not affiliated with any of the rated companies or with researchers performing studies. Thus, the company's scaling process provides unique access to a wide range of consistently rated companies across a number of important social performance attributes.

In this process, there is a limitation of the EIRIS data in that all attributes are given equal importance, whereas most observers of corporate social performance consider some areas more important than others. To deal with this issue, we used weights developed by Ruf, Muralidhar, and Paul (1993) to compute a weighted average across the eight attribute ratings for each company in the study. This process resulted in a single-value CSP index for each company ranging from -2.0, for companies rated lowest on all eight attributes, to +1.66, for those rated highest on all eight.

**Control Variables**

Some differences in institutional ownership may result from company's profitability, size, debt level, and industry. We, therefore, controlled for each of these variables to isolate the unique contribution of CSP to investment decisions. The company's profitability is measured by return on assets and equity. Size is measured by total assets and sales. Accounting data is downloaded from DataStream International. Industries are broken down by four digit FTSE Global Industry Classification System codes and represented in the model by dummy variables. We use regression analyses to test our hypotheses, employing the two measures of institutional ownership as the dependent variables and controlling for profit, size, debt level, and industry.

**4. Empirical Results**

The table 1 shows that on average, institutions owned about 55% of the equity in the studied companies. There is considerable variance in this figure, ranging minimum
7% to maximum 89%. The average number of institutions holding with a minimum of 25.1 and maximum 1411. Average sales for the companies in our data set are about £622 million with average assets of £1204 million. Average return on equity (ROE) is 14% for the group, return on assets (ROA) about 6% and ratio of debt to total assets, 19%. The debt-to-asset ratio is significantly correlated with both assets and return on assets for the companies. This multicollinearity caused the estimated regression coefficient of the debt-to-asset ratio to be insignificant when entered as an explanatory variable in the presence of the other two variables. There was also a low correlation between the two measures of institutional ownership, indicating that an increase in the number of institutions holding a company does not necessarily lead to an increase in the number of shares held by institutions.

Regression Analysis and Results

The institutional ownership is used as the dependent variable to calculate all the six regression models employed in the study. Number of institutions holding shares in a company is the proxy for institutional ownership in the first three models. The percentage of a company's shares owned by institutions represented institutional ownership in the second three models. In all six models, the corporate social performance (CSP) index is the principal independent variable. In all equations, size, financial performance, debt-to-asset ratio and industry are control variables the squares of sales and assets are also included because the controlling for other variables, we found that the number of institutions owning a company's stock showed a quadratic relationship with company size.

In the model 1, the Return on Equity (ROE) is the proxy for financial performance and assets is the proxy for size. In this model there is a significant and positive relationship (p<.001) between corporate social performance and institutional ownership when other factors are held constant (Table 2). In the model one, the multiple R² (coefficient of determination) is 47% and the R² for the industry dummy variable alone is 12%.

In the model 2 and model 3, the results are similar. These results differ from the model 1 in the profitability and size proxies only. In the model 2, sales replace assets. CSP is still significantly related to institutional ownership (p<.001) and the explanatory power of the model increases. In the model 3, where we used Return on Asset (ROA) to control for financial performance and assets to control for size, the relationship between CSP and institutional ownership is still significant (p<.01), although somehow less so. The results from all the three of these models provide strong support for our hypothesis, which postulated that high CSP values would result in high levels of institutional ownership. All these models explain at least 47% of the variance in institutional ownership.
Results revealed that the use of control variables are plausible and reasonable. From our analysis a significant and positive relationship between company's financial performance and institutional ownership is evident which suggest that there is a strong financial performance which leads to increases institutional ownership. Although other variables held constant. On the other hand, there is a negative relationship between the debt-to-asset ratio and institutional ownership. This relationship is significant in all but the model 3 where multicollinearity reduces its significance (please see table 2). It may be said that the institutional investors prefer companies with low debt ratios which indicate that institutional investors are risk-averse. With respect to company size, the quadratic relationship; the results show that, other things being equal, institutional investors prefer large companies when companies pass some size threshold, those investors view them less favourably and highly susceptible to risk.

On the other hand, the results of model 4, model 5, and model 6 (please see table 3) that used percentage of shares institutionally owned as the dependent variable are largely insignificant. These three models (4, 5, and 6) show a positive relationship between corporate social performance and the percentage of shares owned by institutions, but it is not significant in any of the three. The size and firm Financial performance are also insignificant. The debt to-asset ratio is significant in model 4 and model 5, paralleling the results of model 1 and model 2 which indicates risk aversion on the part of institutional owners.

It is clear from the results that a company incurs no penalty in terms of its attractiveness to institutional investors for improvement in CSP ratings. The first set of equations clearly suggest that institutions respond favourably to such improvements. There is some consistency between the results of this study and those of Coffey and Fryxell (1991). They found that a significant and positive relationship between the number of ethnic minority members on a board of directors and institutional ownership level. In the recent years there has been a rapid increase in ethical investing and information about companies’ CSP records. In their study, Coffee and Fryxell (1991), suggest that institutional investors are taking this information into account in deciding whether or not to own stock in a given company. The results of this study are consistent with a steady accumulating body of evidence that provides little support for the myopic institutions theory.

The regression results also give a strong evidence of institutional risk aversion, indicating that when company size, financial performance, and industry variables are all held constant, there is a negative relationship between the debt-to-asset ratio and institutional ownership. This risk aversion, then, can be translated into a preference for strong CSP, which is what seems to emerge. Using efficient market theory, we interpret this reduction in risk as a lower risk adjusted return. Such a decrease would lead a rational investor to place a higher value on a stock,
which in turn would cause managers to be more willing to make decisions that would yield higher CSP. Question may arise why there is difference in the significance levels of the first three and the second three equation, need some explanation. The correlation table shows a very weak relationship between the percentage of shares owned and the number of institutions holding shares in a company. Possible explanation may that many of the new money management institutions are small ones, and this fact seems to be one reasonable explanation of the differences in the significance level of the two groups of models.

This research advances the study of corporate social performance and Islamic institutional ownership performance measure. The results indicate that Islamic institutions buy stock in companies when corporate social performance improves. The evidence suggests that managers can conclude that improving a company's social performance will not depress institutional stock ownership.

5. Conclusions

Financial Times Share price Index (FTSE) Islamic Index (Europe) is designed to track the performance of leading, publicly traded companies whose activities are consistent with Islamic Shariah. In order to address the research question: does a high level of corporate social performance (CSP) lead to an increase in Islamic institutional share holders in a company, this study examines the relationship between institutional ownership of the constituent companies of the FTSE Europe Islamic index and corporate social performance. The results indicate a company's corporate social performance (CSP) leads to an increase in number of institutions holding stock of that company, so into increase the shares of the Islamic institutional investors. Therefore, we can draw our conclusion from the results that improvements in a company's corporate social performance will increase Islamic institutional ownership.
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