

Ethics and Social Responsibility in Islamic Banking

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Abstract

In this article the author tried to provide evidence on the basic relationship between the principles of Islamic banking with “ethics” and “social responsibility”. In comparison with the traditional conventional banking, Islamic banking strives for a just, fair and balanced society. However, its success depends on the practical application and strict compliance to the Shari’ah principle.

Keywords: Ethics, Ethical banking, Islamic Banking, Social Responsibility, Investment

Introduction

Selling a good product or service is no longer enough to attract today's socially conscious customers. Customers around the world are now considering “ethics” and “social responsibility” while deciding where to work, what to buy, where to shop and which products and services to recommend to others. Also, they are increasingly turning to social media to learn more about a company's social initiatives and their business practice or ethical conduct towards the community.

Banking sector, now-a-days, is playing a very significant and emergent role in improving socio-economic conditions of the community in which it operates, in addition to the regular business of making profit by acting as financial intermediary. Also, ethical practice and social responsibility has become critical factors for their long-term sustainable operation. Islamic Banking operates under the profound influence of *Shari’ah* (Law) and maintains a high ethical standard. This article provides a general overview of the practice of ethics and social responsibility by Islamic Banking institutions.

Objective of this Study

Islamic banks often describe themselves as providers of ethical financial services, this article strive to spell out explicitly its reusing or its significance. In brief, the objective of this article is to identify the basic concepts of ethics, social responsibility, Islamic banking and the major relationship among them. This article also provides a brief overview on the Islamic banking industry in Bangladesh perspective.

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Methodology

A descriptive qualitative research methodology was used by the researcher for this study. Considering the nature of the topic, no survey was administered, but intensive review on the available researches was done. Moreover, a comparative picture, in terms of quantitative data, between Islamic banks and the conventional banks of Bangladesh are shown in the study.

The researcher gathered information about the present existing condition and put emphasis on describing rather than on judging or interpreting. The researcher also suggests that further detailed research on this issue can be undertaken in future.

Conceptual Framework

Ethics

Nelson Education denotes that ethics are the rules that help us to tell the difference between right and wrong and encourage us to do the right thing. They can help people decide on the best course of action in situations where they aren't sure what to do. It also indicates that ethical behavior is based on values such as trustworthiness, respect, responsibility, care, justice, good citizenship, and on adherence to moral rules. Our values tell us what we think is important and this, in turn, helps us to make decisions about right and wrong. For example, a person who values trustworthiness is unlikely to betray a friend. Morals are the rules we use to decide what's good and what's bad. For example, one moral rule might be that stealing is bad because it harms the person you steal from.

Business ethics, also known as corporate ethics, is a form of applied ethics or professional ethics that examines ethical principles and moral or ethical problems that arise in a business environment. Business ethics applies to various aspects of business conduct and is applicable to the conduct of individuals and entire organizations.

However, Steiner & Steiner (2008) think that business ethics is the study of good and evil, right and wrong, and just and unjust actions in business. They identified the following items as major sources of ethical values:

- **Religion:** The great religions converge in the belief that a divine will reveal the nature of right and wrong behavior in all areas of life, including business. Christian managers often seek guidance in the **Bible**. In Islam the **Koran** is a source of ethical inspiration. In the Jewish tradition, managers can turn to rabbinic moral commentary in the **Talmud** and the books of **Moses** in the **Torah**.
- **Philosophy:** Over 2,000 years philosophy has produced a stream of notions about what is right and wrong.

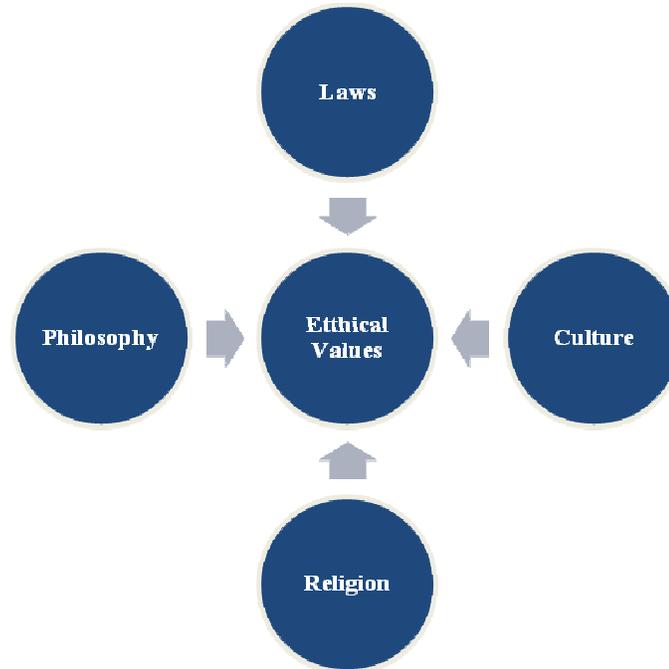


Figure-1: Major sources of ethical values in business (Steiner& Steiner, 2008)

- **Cultural:** Cultural experience shapes ethical values transmitted across generations.
- **Law:** The law codifies, or formalizes, ethical expectations. Legal expectations are enforced through damages, criminal prosecution of managers and corporations, sentencing and fines.

Josephon (2013) identified ten major benefits of ethical behavior. He point out that ethical behavior build public trust and enhance business reputations. He also indicates that it is a code that helps demonstrate the company's values to socially responsible investors; offer protection in preempting or defending against lawsuits; enhance morale, employee pride, loyalty and the recruiting of outstanding employees; help promote constructive social change by raising awareness of the community's needs and encouraging employees and other stakeholders to help; promote market efficiency – especially in areas where laws are weak or inefficient – by rewarding the best and most ethical producers of goods and services.

Another author Mullan (2009) identified six major types of benefits for establishing a business ethics programs. He mentions that positive public image comes from publicizing and following a company's values. It also prevents and reduces criminal penalties. This is a tremendous asset to companies under regulatory scrutiny. By establishing a business culture business ethics program helps in employee retention. He also states that it focuses on the benefits of market leadership, since when a company fully integrate its values into its culture, quality rises due to the employee's focus on the values. Customers see that employees care about the customer's concerns. Employees reflect appropriate values in their attitude and conduct, Roy Koerner in his

article “*Want More Profit? Try Ethical Business Practices*” points out that business demonstrating the highest ethical standards are also the most profitable and successful. Finally, by setting the example in the community and market, the entire industry has a new standard, which allows the community and the market to recognize the company as a leader. When the word gets out, competitors will have to answer questions about why they are not establishing values as essentials.

Social Responsibility

Social responsibility is an ethical framework which suggests that an entity, be it an organization or individual, has an obligation to act for the benefit of society at large. Social responsibility is a duty every individual has to perform so as to maintain a balance between the economy and the ecosystems. A trade-off may exist between economic development, in the material sense, and the welfare of the society and environment. Social responsibility means sustaining the equilibrium between the two. It pertains not only to business organizations but also to everyone who’s any action impacts the environment. This responsibility can be passive, by avoiding engaging in socially harmful acts, or active, by performing activities that directly advance social goals¹.

It can also be termed as the obligation of an organization's management towards the welfare and interests of the society in which it operates. It also defines Corporate Social Responsibility as is a company’s sense of responsibility towards the community and environment (both ecological and social) in which it operates. Companies express this citizenship (1) through their waste and pollution reduction processes, (2) by contributing educational and social programs, and (3) by earning adequate returns on the employed resources².

Social responsibility of business comprises of certain duties towards concern such as economic development, the environment, human rights, poverty and hunger.

Islamic Banking

Islamic banking refers to a system of banking or banking activity, which is coherent with the principles of the *Shari’ah* (Law) and its practical application. Since this system of banking is grounded in Islamic principles, all the undertakings of the banks follow Islamic morals through the development of Islamic economics. Therefore, it could be said that financial transactions within Islamic banking are a culturally distinct form of ethical investing (for example, investments involving alcohol, gambling, pork etc. are prohibited under *Shari’ah*).

As said by Shaikh (2013) it is banking practiced according to the teachings of the religion of Islam. Islamic banking is a form of banking that is harmonious with the goodness of humanity on Earth. The goodness in four different spheres: man to God, man to man, man to creatures of soul i.e. animals of all kinds, and man to inanimate creatures, i.e. nature. Islamic banking is supposed to be based on fairness and justice to all parties concerned, the bank as well as the public who use

¹ Wikipedia

² Business Dictionary

the service. One major obstruction of justice is usury which is manifest in the interest-based financial system. Islamic banking rejects interest based loans as being predatory and unfair. Most people borrow because they are in need, and need in itself is hurtful to human dignity. So to force people in need to pay penalties for their need is the epitome of inhumanity. This banning of the interest mechanism, is therefore, the cornerstone of Islamic banking.

The sources of Islamic financial system regulation could be traced back from four main books- which form the core of the Islamic legal system, also known as "*Shari'ah*". These are the Holy Quran, the Sunnah, the Ijma, and the Qiyas. (Ullah& Chowdhury, 2013:1)

Islamic Banking institutions mobilize financial resources and invest them in an attempt to achieve predetermined acceptable social and financial objectives under Islam. Both mobilization and investment of funds are conducted in accordance with the Islamic principles.

The economy of Bangladesh started its journey with the existing commercial banks of before West Pakistan who followed the interest based banking system. Establishment of Islamic Development Bank (IDB) during these venties and some successful initiative for Islamic banks in the Islamic world led the establishment of first Islamic bank in Bangladesh. Two professional bodies "Islamic Economics Research Bureau" (IERB) and "Bangladesh Islamic Bankers Association" (BIBA) took practical steps, for imparting training on Islamic Economics and Banking to a group of bankers and arranging some national and international seminars/ workshops to mobilize local and foreign people and attract investors to come forward to establish Islamic banks in Bangladesh. Being inspired a number of Muslim entrepreneurs working under the aegis of Muslim Businessman Society (MBS) with the active support from government establish the first Islamic bank in the name of Islamic Bank Bangladesh Limited in 1983. Later, more banks (including foreign banks) operating based on Islamic *Shari'ah*. Besides, a number of conventional banks have entered into the interest free Islamic banking by opening Islamic banking branch.

Literature Review

Many researchers have worked on the importance of ethical and social responsible financial transactions especially on banking sectors. Notable ones are as follows:

Green (1989:1) considers companies do have ethical responsibility and are not protected by limited liability from the consequences of their actions. A company's record and the perception of its ethics affect its reputation and ensure long term success or failure.

Seznec (1999, p.161-170) mention that Islamic banking offers a means of reintroducing ethics in to the global financial system. They also mention that within the broader financial system, Islamic finance can play a role in reestablishing a sense of ethics that has been lost and to try to make its concept and products acceptable to ethically minded Muslims, Christians, Jews and others who are engaged in financial transactions.

Hasanuzzaman (2003) identifies that the edifice of the entire Islamic way of life rests on absolute ethical values. Justice and equity, honesty, integrity, veracity, leniency, compassion, tolerance, selflessness, benevolence, cooperation, mutual consideration, sacrifice and harmlessness, are the guiding values in all walks of life, business being no exception.

Mohammad(2007, p.8) the notion of social responsibility and justice has been an integral part of Islamic society for nearly 14 centuries. But Islamic literature remains scattered, fragmented and lacks a coherent framework that would allow such a concept in Islam to be systemized. The consistency of the conceptual framework of CSR in Islam with contemporary business practices was explored using a survey of Islamic banks located in different parts of the world. The survey revealed that many current practices of Islamic banks mirror the expected behaviors or practices generated in Islamic Framework. This study was a modest step towards filling this lacuna by presenting a systematic and coherent framework of CSR in Islam.

Sairally (2008:1) in her writing states that in order to fulfill the *Shari'ah* objective of promoting the welfare of society, Islamic financial institutions (IFIs) are expected to consciously align their decisions and actions so that these are “ socially responsible”. She also mention that the ethical credentials of Islamic financial institutions (IFIs) make them attractive to not only Muslims but to also a wide spectrum of ethically- conscious consumers who desire a socially just financial system.

Khan (2009) agrees that Islamic finance is a form of ethical investment and ethical lending. Under this system loans and investments are made without interest. Islamic banking operates with the same purpose as conventional banking except that it operates in accordance with the rules of *Shari'ah*, known as *Fiqh al-Muamalat* (Islamic rules on transactions). Islamic finance and banking were practiced predominantly in the Muslim world throughout the Middle Ages, fostering trade and business activities. In Spain, the Mediterranean and Baltic countries, Muslim merchants became indispensable middlemen for trading activities. It is claimed that many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

Goyal & Joshi (2011) thinks that social and ethical issues such as social banking, ethical banking, green banking, global banking, rural banking and agri- banking help in achieving sustainable development of banking and finance. They also state that Banks can protect themselves as a socially and ethically oriented organization by disbursement of loans merely to those organizations, which has environmental concerns. For social banks, the responsibility for the whole of society is the most important measure for a good lending practice and is more important than profit.

Dakhlallah & Miniaoui (2011) Prohibition of *Riba* is central to Islamic financial ethics and law. Whilst, non- Islamic banks rely primarily on the interest rate instruments, Islamic banks use a variety of contracts and instruments that have been developed in compliance with *Shari'ah* laws.

They also mention that according to the literature, Islamic banks outperform non-Islamic banks especially during the last financial crisis.

Jasevičienė (2012:114) suggests that the sophisticated and reliable operation of banks can be judged both in terms of its legal and economic aspects, and ethics. The application of the requirements of the code of ethics improved the image of the banks, which leads to a higher success of operations. Ethical judgments stir confidence in the public and the businesses with regard to the operations of a bank and its financial services and help develop a better reputation for a bank, maintain good relations with the clients and gain a sharper edge on the market.

Hannan (2014) postulates that the objective of Islamic Banking is not only to earn profit, but to do good and bring welfare to the people, Islam upholds the concept that money, income and property belong to Allah and this wealth is to be used for the good of the society. Islamic Banks operate on Islamic principles of profit and loss sharing and other approved modes of Investment. It strictly avoids interest which is the root of all exploitation and is responsible for large scale inflation and unemployment. An Islamic Bank is committed to do away with disparity and establish justice in the economy, trade, commerce and industry; build socio-economic infrastructure and create employment opportunities.

Tlemsani& Matthews(2015) in their writing examine the foundations of Islamization in the global financial sector. They also identify how Islamic banking can be implemented in a hyper-competitive environment. They also identified of interest are concerned with issues of fairness and justice rather than efficiency narrowly defined. These principles focus on the necessity of sharing risk in a fair and stable society, and upon problems of exploitation in markets where power is asymmetric this is real usury issue.

Practice of Ethics and Social Responsibility in Islamic Banking

Investing, under the influence of Islamic principle, includes serious consideration of the business to be invested in, its policies, the products it produces, the services it provides, and the impact that these have on society and the environment. In other words, Islamic Banking institutions must take a close look at the business they are about to become involved in.

Also, under Islamic banking also considers a customer, whether individual or corporate, isn't just a customer, but is a partner with the Islamic Banking institutions or owner of goods or assets. This means they share the risks, as well as the profits of such a partnership or ownership. Also, this unique arrangement is done ensuring complete transparency at all times in line with *Shari'ah* (Law).

In all facets of the financial system, Islam has certain rules, certain regulations as to how Muslims should go about participating in these activities. For example, in share trading or the securities market, Islam looks at the activities of the companies, to establish whether or not the companies are involved in activities which are in line with *Shari'ah*.

Regulatory framework for Islamic Banking

At the micro level, institutions that wish to offer *Shari'ah* compliant products have to have a *Shari'ah* Supervisory Board (SSB) (or at least a *Shari'ah* scholar). It is their responsibility to review and approve financial practices and products for compliance with Islamic principles. However, just as *Shari'ah* itself is open to interpretation, so *Shari'ah* scholars often disagree as to what is *Shari'ah* compliant or not. Thus the laws that govern Islamic finance and the regulation of Islamic finance institutions continue to vary (mainly across jurisdictions).

At the macro level, given the markets where Islamic institutions initially developed, and the fact that the largest proportion of the market still remains in those jurisdictions, it is unsurprising that the major regulatory institutions are located in countries like Bahrain and Malaysia. The following are the most influential standard setters regarding accounting for Islamic financial institutions (Tayyebi, 2008:4).

Principles of Islamic Banking

The followings are the fundamental four principles of Islamic Banking (Bjorklund & Lundstrom, 2004:24):

- There must be some risk, whether funds are used in commercial or productive venture;
- All funds should preferably finance in socially productive activity;
- Financial risk must lie solely with the lender of the capital and not with the manager or agent who works with the capital, and
- Interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used.

Islamic Banking system is fundamentally based on Profit and Loss Sharing (PLS) which is also known as participatory mode, i.e., *musharakah* and *mudarabah*, and purchase and hire of goods or assets and services on a fixed- return basis, i.e., *murabaha*, *istisna'a*, *salam* and leasing³. On the other hand, the conventional banks give greater emphasis on credit-worthiness of the clients compared to risk sharing approach and concentration on viability of the projects by the Islamic banks (Zahiruddin & Rahman, 2007). So we can see that the first principle of Islamic Banking is inherent with ethical and socially responsible banking.

The objective of Islamic Banking is not only to earn profit, but to do well and bring welfare to the people. Islam upholds the concept that money, income and property belong to Allah and this wealth is to be used for the good of the society. So, the second principle of Islamic Banking is integral part of ethical and socially responsible banking.

The third principle pertaining to financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment

³ Islamic Banking.com, 2014

is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk (Zahirrudin& Rahman,2007).

Fourth Principle of Islamic Banking focuses on Riba. Both payment and receipt of interest (*Riba*) is prohibited and considered as a sin under the Islamic principle. Conventional banking to be ethical and socially responsive may follow the similar investment mechanisms, but the major differences among conventional and Islamic Banking will be Riba. According to Bjorklund and Lundstrom (2004), Warde (2000), Akacem & Gilliam (2002) and Naseret.al. (1997), there are three main justifications for the prohibition of *Riba* and these are strongly related to each other. Firstly, *Riba* is Unfair. In traditional interest based borrower –lender relationship, the borrower has the chance to receive all the profit or the risk to face the losses that occur. The Lender earns money no matter the outcome of the venture may be. Equity is another reason why the concept of interest is rejected. The rich have a surplus of money while the poor and needy are the once forced to borrow. Interest can therefore be seen as rewarding the rich and penalizing the poor(Naser & Moutinho, 1997; Akacem & Gilliam, 2002). Secondly, *Riba* is exploitative. *Riba* is seen as exploitative since it favors the rich with a surplus of money and punishes the poor and needy that is forced to borrow. Islam emphasis risk sharing in business ventures. The profits or losses should be shared between the borrower and the lender. Lenders should be entitled to a share profits from any venture they have helped to finance (Warde, 2000; Akacemet.al., 2002). Lastly, *Riba* is unproductive. The issue of fairness is related to the issues of efficiency and productivity. Money should be used in economic ventures and contribute to the economy and enhance welfare. Abstaining from consumption, saving money, is not an act that should be rewarded. In Islam the idea of getting a return for money only deposited in a bank is unacceptable. To justify reward the savings must be turned into productive use in thereby contribute to the economy with risk-sharing as a part, according to the teachings of Islam (Akacemet.al., 2002 Warde, 2000; Naseret. al., 1997).

Difference between Islamic Banking and Conventional Banking

Conventional banks use money as a commodity which leads to inflation. Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development (Maldives Islamic Bank, 2011).

According to the Islamic principles of social responsibility and Justice, Islamic bank must care for the less fortunate in society to maintain equilibrium and social justice. There are different methods of wealth distribution for poverty alleviation used by Islamic banks. The usual methods include Zakat and Sadaqah. Zakat is the yearly obligation of wealthy Muslims to poor and it is the share of the poor in the property and wealth of the rich. It is considered an obligatory form of “charity”. It is a fixed proportion collected from the surplus wealth and earnings of a Muslim after subtracting the basis living expenses. Similarly, *Sadaqah* (Charity), a voluntary act of giving for the cause of God “Allah”, a deep humanitarian and social- political value (Anas & Mounira, 2009). These acts make the Islamic Bank different from other conventional banks.

According to Islamic values business and ethics both are interrelated. Hence, Islamic Banking deals with financial and investment instruments that are not only profitable but are also ethically motivated. For that reason at the last few decades ethical banking or Islamic banking is not only considered for Muslims and in the aftermath of global financial crisis, it is growing from a niche market to a large market to serve up Muslims and non- Muslims alike.

Islamic Banking in Bangladesh Perspective

Bangladesh entered into the Islamic banking system only in 1983, with the establishment of Islamic Bank Bangladesh Limited. Since then, 8 full-fledged Islamic banks, 19 Islamic banking branches of 9 conventional commercial banks and 25 Islamic banking windows of 7 conventional commercial banks have been established. Islamic banks, with more than 20% market share, are now playing very important roles in mobilizing deposits and financing industry, services and other key sectors of the economy, and collecting foreign remittances in Bangladesh.

The aggregate assets owned by the Islamic Banks at the end of year 2014 were BDT 1.64 trillion against a paid-up capital of BDT 67.83 billion. During this time, the Islamic Banks made an operating profit of BDT 65.96 billion with an average EPS of BDT 1.45. The following table shows a comparative performance of the Islamic banks:

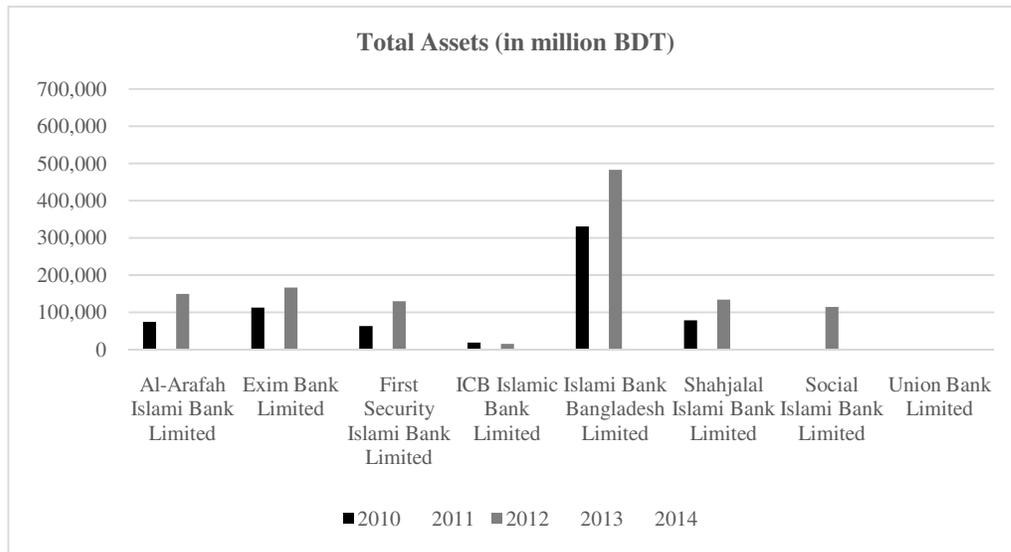
Table-1: Islamic Banks in Bangladesh with Key Financial Indicators

Name of the Banks	Total Assets (in M BDT)	Paid-up Capital (in M BDT)	Operating Profit (in M BDT)	EPS (in BDT)
Al-Arafah Islami Bank Limited	210,439	9,469.59	9,595.01	2.20
EXIM Bank Limited	232,833.95	12,838.65	10,315.07	1.92
First Security Islami Bank Limited	204,876.46	4,114.38	5,262.59	1.69
ICB Islamic Bank Limited	14,022.94	6,647.02	322.26	(0.43)
Islami Bank Bangladesh Limited	651,579.48	16,099.91	27,470.97	2.46
Shahjalal Islami Bank Limited	129,532.46	7,346.88	5,216.09	1.02
Social Islami Bank Limited	153,585.30	7,031.42	6,798.43	2.71
Union Bank Limited	40,951.53	4,280	982.34	0.26

Source: Annual Reports

In the last three years, the Islamic Banks maintained total assets of BDT 1.23 trillion on an average keeping an average 34.75% growth per year. The following graphs show a comparative position of their total assets:

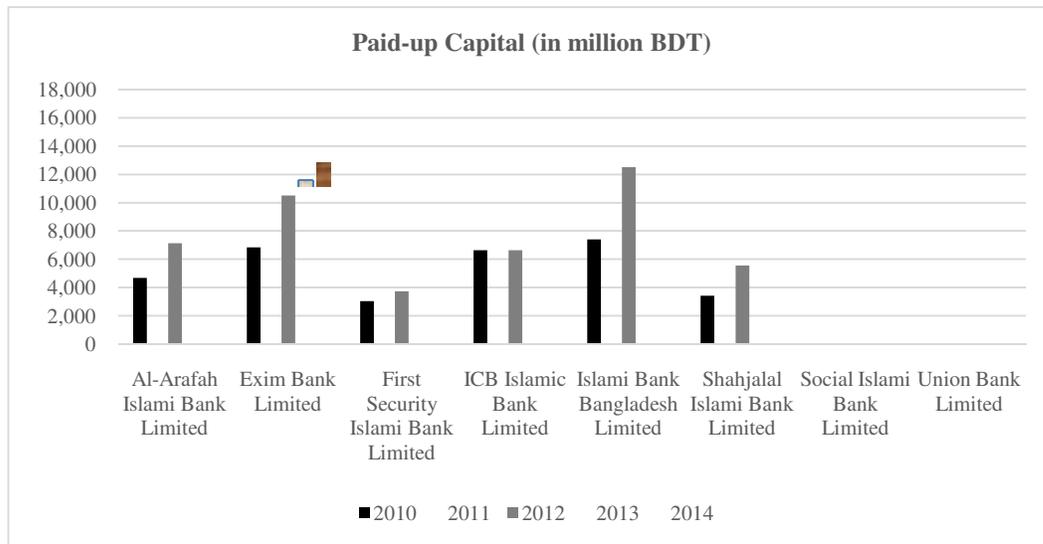
Graph-1: Comparative Position of Total Assets for Islamic Banks in Bangladesh



Source: Annual Reports

During similar time period, these banks maintained paid-up capital of BDT 59 billion on an average keeping an average 20.27% growth per year. The following graph shows a comparative position of their paid-up capital:

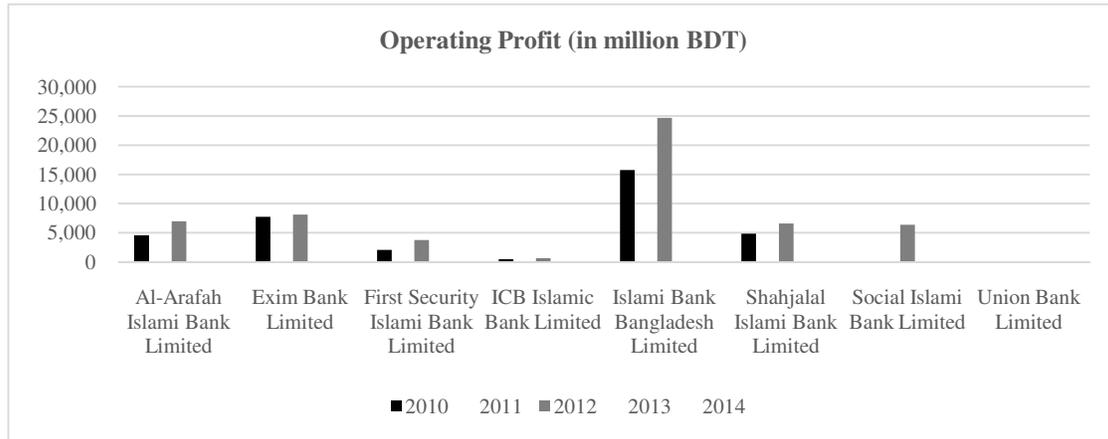
Graph-2: Comparative Position of Paid-up Capital for Islamic Banks in Bangladesh



Source: Annual Reports

During 2012-2014, these banks maintained operating profit of BDT 60 billion on an average keeping an average 18.43% growth per year. The following graph shows a comparative position of their operating profit:

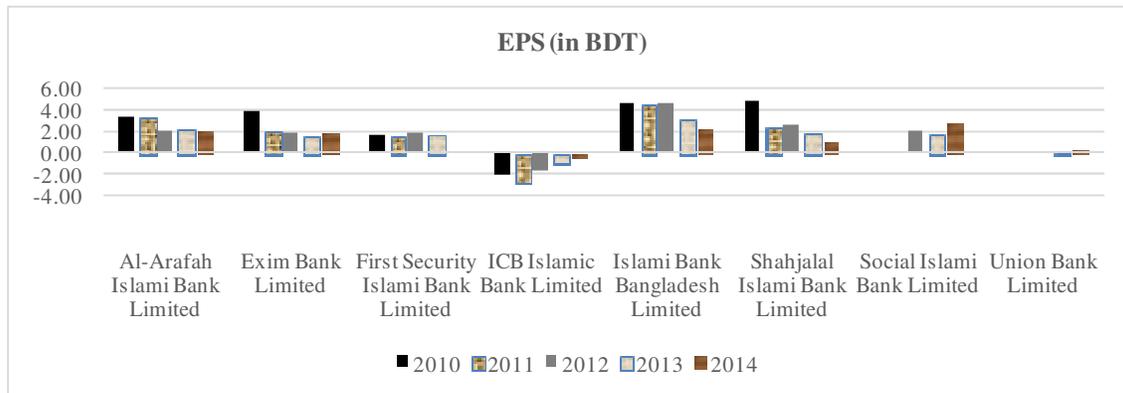
Graph-3: Comparative Position of Operating Profit for Islamic Banks in Bangladesh



Source: Annual Reports

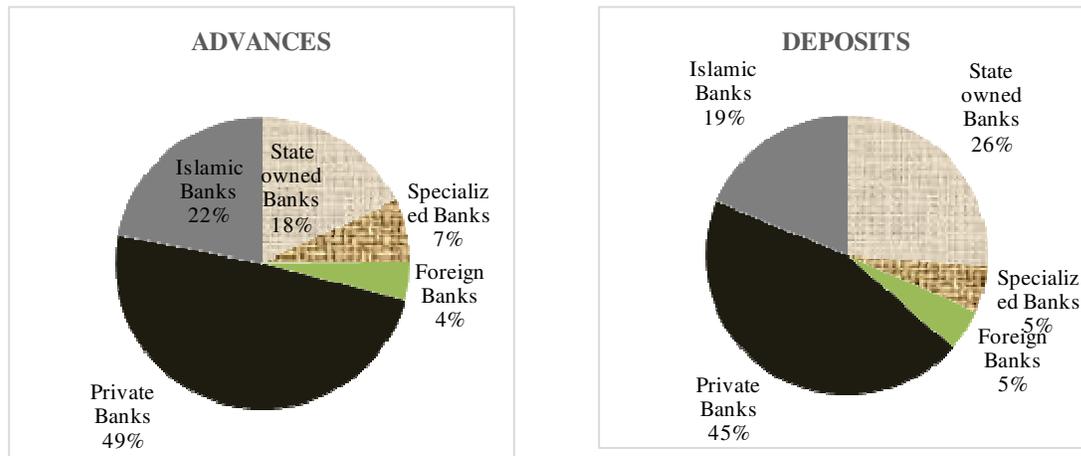
During the same period, these banks also experienced an average negative growth in their EPS of 4.30% per year. The following graph shows a comparative position of their EPS:

Graph-4: Comparative Position of Earnings per Share for Islamic Banks in Bangladesh



Source: Annual Reports

The Islamic Banks had extended BDT 1.12 trillion advances to its customers and collected deposits of BDT 1.29 trillion from the same at the end of quarter 4 of year 2014. The following graphs show the comparative performance of the Islamic Banks with the conventional banks:

Graph-5: Comparative Performance of the Islamic Banks with the Conventional Banks in Bangladesh

Source: Bangladesh Bank

Islamic Banks had made tangible contributions in sectors and sub-sectors of agricultural and rural investment programs. They are also playing a pivotal role in collecting foreign remittances and disbursing the same transferring among beneficiaries across the whole country. A total of 27,202 officials are working in 934 branches of Islamic banks including Islamic branches/windows of conventional banks at the end of 2014.

Conclusion

Islam is a religion of human life. The divine rules of Islam is established to make human life easy and peaceful. These also drive a society toward the development of economy and environment. As being founded on Islamic *Shari'ah*, Islamic banks by nature have the responsibility of protecting the interest of their clients and employees as well as protecting the society and environment from any negative consequences following from its actions. Besides it is the utmost duty of Islamic banks to do welfare for the society.

The Islamic banking market is growing in Bangladesh as it is in the other parts of the world. A good number of conventional banks (including multinational banks) have focused on this niche market. Hence, the ethics and social responsibility now have become an important issue to be addressed.

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