Do ethics imply better governance? **The case of Islamic and socially responsible equities**

By: Dr Choudhary Wajahat Naeem Azmi
(Post-Doctorate, INCEIF) and
Zaheer Anwer (INCEIF)

There are different ways through which debt exerts pressure on managers to align their interests with those of shareholders. For instance, it does this by reducing free cash flows (Jensen, 1986; Stulz, 1990)[1], by increasing monitoring by debt holders (Ang, Cole, & Lin, 2000) and by increasing takeover threats (Williams, 1987). In this respect, another line of arguments indicates that good corporate governance is associated with lower agency issues (McKnight & Weir, 2009; Rashid, 2016). As per this view advanced by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000), both debt and governance mitigate agency conflicts and essentially play the same role; therefore, they can be good substitutes for each other.

1 Reducing the free cash flows via debt payments also ensures that the mangers do not overinvest (Harvey, Lins, & Roper, 2004; D'Mello & Miranda, 2010).

The empirical evidence of this so-called substitution hypothesis is provided by Arping and Sautner (2010) and Jiraporn, Kim, Kim, and Kitsabunnarat (2012). Taking a cue from this, low debt firms are supposed to have better governance structures compared to high debt firms.

We hypothesize that if the substitution hypothesis holds, then *Shariah*[2] stocks should manifest better governance quality than Non-*Shariah* stocks. *Shariah* stocks are characterized by limited debt and hence provide a natural experimental ground to test the claim of the substitution hypothesis as well as the empirical findings of Arping and Sautner (2010) and Jiraporn et al. (2012). Thus, the primary objective of this paper is to examine the level of corporate governance practices in *Shariah* stocks vis-à-vis Non-*Shariah* stocks. In addition, we observe that there is a possibility that if *Shariah* stocks are better governed, it may not be due to their debt constraints but rather due to the negative sector screening. The companies passing *Shariah* screening refrain from unethical business activities and therefore are expected to manifest higher levels of corporate governance. If their higher governance standards are due to negative sector screening instead of low debt, their governance performance should be on par with socially responsible investing (SRI) or ethical stocks. Hence, the supremacy of *Shariah* firms in terms of governance or ESG factors can be established only if they are better governed than the SRI firms. Therefore, we also compare the governance standard of *Shariah* firms with that of SRI firms as our supplementary objective.

Findings and discussion

To achieve our objectives, data comprising constituents of the Dow Jones US Index (DJUSI) and Dow Jones *Shariah* Market Index (DJIM-US) are utilized for the period from 2006 to 2015. Our results show a significant *Shariah* dummy, implying that the *Shariah* stocks have better corporate governance structure/practices. These results are consistent across various governance proxies such as Governance Index, Environmental, Social, and Governance (ESG) score, Bloomberg ESG Disclosure Scores and the percentage of outside directors and different models. Interestingly, when we add screening (*Shariah*) specific variables including debt criteria in our model,

2 In the paper, we use words Islamic and *Shariah* interchangeably. Similarly, we use words Socially responsible and ethical interchangeably.

Thus, the primary objective of this paper is to examine the level of corporate governance practices in Shariah stocks vis-à-vis Non-Shariah stocks.

the *Shariah* dummy becomes insignificant[3]. These results are not in line with Hayat and Hassan (2017) as they found no governance difference between *Shariah* and Non-*Shariah* firms except for one specification. This paper, however, confirms the findings of Arping and Sautner (2010) and Jiraporn et al. (2012) and hence is in line with the substitution hypothesis. Likewise, while comparing the difference in governance level between *Shariah* and SRI firms, we found that for a sample of only SRI stocks, *Shariah* firms are found to be better governed. In summary, *Shariah* firms are better governed not only in comparison to non-*Shariah* stocks but also in comparison to their possible substitute, i.e., ethical stocks.

Conclusion

These findings have several implications. The most important is that *Shariah* firms are better even in terms of ESG scores. Although these firms may not be *Shariah* by choice, better scores in terms of ESG criteria do indicate that these firms fulfil the moral and social obligations highly recommended in *Shariah* teachings. These results provide some consolation to the *Shariah* investors as the *Shariah* screening criteria is often perceived as void of ESG factors. The results also address the concerns of critics of *Shariah* screening as the better governance that *Shariah* stocks implicitly take various governance measures into account. Most importantly, our findings are useful for ethical investors as well as ethical portfolio managers because they can consider *Shariah* stocks as a suitable asset class in the portfolio formation. Moreover, conventional managers can also consider *Shariah* firms as an investment opportunity to exploit their low debt characteristics.

3 In the case of Bloomberg ESG Disclosure Scores, the Islamic dummy remains significant.