

## Impact of Financial Inclusion and Corporate Social Responsibility on Islamic Banks Financial stability with the Moderating Role of Corporate Governance

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**Abstract:** This research works is to analysis the impact of financial inclusion index (FII) and corporate social responsibility index (CSRI) on the banks financial stability (FS) and profitability with the interaction term of the corporate governance index (CGI). Data were taken from the Islamic banks and conventional banks Islamic branch. The data was taken from the period of 2008 to 2020 to analysis the influence of financial inclusion index (FII) and corporate social responsibility (CSRI) index with the interaction effect of corporate governance index. The generalized moment of method was used to control the problem of the endogeneity from the model. Financial stability was proxy by Z-score and FI of the FI service. Corporate governance index measured the corporate boards and (CSRI) was measured through donation to the society. The empirical consequences of this research study have the following conclusion: Firstly, FI has a constructive and significant influence on the FS and profitability of the banks. Secondly, CSRI has positive relationship with the banks stability and profitability. Finally, the interaction term corporate governance (CGI) strengthens the relationship among the FI and CSRI with the stability and profitability.

**Keywords:** Financial stability; Profitability; Financial inclusion, CSR; Corporate governance index

## Introduction

Internationally, FI has gain a great momentum from last few decades and promoting of economic growth and stability. FI define, the access to and access and use of financial product and service by the without discrimination and affordable to low section of the society (Demirguc-Kunt et al. 2018). This research study has few purposes, First, it makes an attempt to scrutinize the direct influence of the FI (hereafter, FI) on the Islamic banks' financial stability and profitability. Secondly, this study also explores the lasting effect of CSR on the Islamic banks' FS and profitability. Thirdly, this research works mainly focused on the interaction to check that whether corporate governance index moderate this link or not is tested. Last few decades, the term FI has taken a great attention in the field of the research, academia and policy-maker (Mukherjee and Sood 2020). .

Application of the FI technology industry has been accelerating in recent few fiscal years. Likewise, the research also define, that FI is the delivery of the financial service to the society without discrimination to low income group with Optimize cost (Kelkar, 2010). Financial expansion service was first time discussed in the past literature by the (Schumpeter, 1911). Numerous, research studies found the mixed evidence association among the financial service and development. Few works examine that access to finance enhance the economic growth (Sing, 2014 & Mishra, 2015). Not influence on the economic growth (Robinson, 1952). "FI" define easily access and an affordable to financial product and service. Rangarajan (2008) define, "FI is the procedure ensuring access of the weaker section to financial service and product timely and affordable. Reddy (2007), reveals that FI main purpose to bring out from the financial crunch on to the financial product and service.

Prior research works used different FI indicators (Yadav et al. 2020; Reis, 2022). However, Sinclair (2001) argued the FE is procedure where people of the region have not access to financial services. Moreover, Carbo et al. (2005) argued that where individual and group of the society not able to access to the economic provision. Prior literature use numbers of the proxy for the FI such the broadly use indicators for the FI is the number of the adults (Per 1000 adults persons), number of ATM cards, number of banks branch, number of credit card. Ozili, (2018) says that FI as the procedure of confirming that the inclusion is the straight forward access the financial service of individuals and participate in the financial sectors. Chibba, 2009; Allen et al. 2016; Nawaz et al., (2017) contended that FI can enhance the basic need of the low income group in the developing countries.

Ness, (1992) define, that CSR is the plane of the organization where the repay some part of the profit for environmental issue. Moreover, Carroll, (1979) says that the organization not only

increase the wealth of the firms but also contribute to social issue. While, Margolis et al. (2009) argued that the CSR enhance the financial profitability of the organization in the light of the stakeholder theory. The main reason behind the success of the organization depends on the strong association among the stakeholder and management of the organization (Hammann et al. 2009). Benlemlih, (2019) stated that when an organization engaged in the social activities then reduce the agency problem due to payment of the high dividend to stakeholder. Wibisono, (2007) recommended to organizational sector that the engagement of CSR activities of the firm should be treated as an investment tool not treated as a cost.

In light of the stakeholder, there is an affirmative association among the social and performance. Waddock and Graves (1997) proposed two theory slack resources and good management theory to enhance financial performance. To check the connection between the CSR and corporate governance of Islamic banks, the study finds that there is a positive and substantial association between CG and social activities (Mallin et al. 2014). Moreover, the research also investigates that public ownership, foreign and board independence has a positive relationship with CSR while CEO duality has no influence on CSR (Khan et al. 2013; Jo and Harjoto, 2011).

### **Significant of the study**

Theoretically, this research works contributed to the available literature by the filling the gap of the studies that did not examine theoretically and empirically by the using the Public good theory, financial intermediation theory, Echelon theory, diffusion of innovation, agency theories and financial intermediaries. The finding of this research works are expected to contribute that FI and CSR has positive factor to enhance the FS of banking sectors. The findings provided by this research can be used by microfinance providers to improve the financial stability and profitability of Islamic banks of Pakistan. The research also helps of the policy to in the field of academia and policy maker to implement the financial inclusion model in Pakistan. The current research as a source of the further research studies for the future.

### **Review of literature**

CG plays and enhances an imperative role in the country's FI (Dalwai & Chugh, 2014). CG has two main achievements in the statement enhance the financial inclusion system and maximizes the stakeholder wealth. FI provided the basic financial service at low, affordable, and without discrimination available to the whole members of the society. The examiner examined that the large board size of the banks is less effective than the small one due to the coordination problem (Jensen, 1993). The Board of directors showed positive signs with the performance of the financial institution (Jackling and Johl, 2009; Naushad and Abdul Malik, 2015; Srairi, 2015). Numerous research works also show the inverse relationship among financial performance (e.g., Yermack, 1996; Lee and Chen, 2011). According to the research the data was taken of the data of the Indian

listed using GMM the research results examine that the CG has a substantial influence on the banks' profitability (Alamaqtari et al. 2020; Aslam and Haron, 2020; Orazalin and Mahmood, 2019; Shabbir et al. 2020; Farag et al. 2018; Abdulazeez et al 2019; Mollah et al. 2017).

The main determination of this research works is to scrutinize the role of the FI on Indian financial development (FD). For, this purpose the author taken the data from the period of 1980 to 2017 is to inspect the link between the FI service and FD. FI was measured through the FII through Principle component (PCA). The research found that FI is the vital element of the development of the financial sector of the India (Lenka, 2019). The data collected from the Islamic development banks member countries from the time frame of 2000 to 2016 to investigate the influence of the FII on the economic growth. A dynamic generalized moment of the method results indicates that FII is bi-directional association among the FII and economic growth (Ali et al. 2020). The research works derived that the access to financial service is key driver of the financial efficiency of the banking sectors (Ahamed et al. 2021). The research says that more FI engagements were enhanced and accelerate the financial performance and reduce the financial distress of the banking sectors.

Platonova et al. (2018) collected the figures of GCC nations to examine the effect of the CSR and performance of the banking sectors. The study results examine that social engagement has a major and positive connection with the Islamic banks of GCC. However, few research studies say that there is no significant relationship between CSR and financial performance (Newell and lee 2012; Theodoulidis et al. 2017; Siueia et al. 2019; Vo, 2011; Rettab et al. 2009). In light of the stakeholder, there is an affirmative association among the social and performance. Waddock and Graves (1997) proposed two theory slack resources and good management theory to enhance financial performance. To check the connection between the CSR and corporate governance of Islamic banks, the study finds that there is a positive and significant association between CG and social activities (Mallin et al. 2014). Moreover, the research also investigates that public ownership, foreign and board independence has a positive relationship with CSR while CEO duality has no influence on CSR (Khan et al. 2013; Jo and Harjoto, 2011). Numbers of research works examine that corporate governance has enhanced the banking FP (Hussien et al. 2019; Grassa and Matoussi, 2014; Wasiuzzaman and Gunasegavan, 2013). So, the good corporate governance of any banking sector enhances the performance of the banks and reduces the agency problem between the management and stakeholder. Agency theory supports the links between the CG and the performance of the firm (Fama and Jensen, 1983).

### **Hypothesis development**

*H1: Financial inclusion has a positive and significant with the FS and Profitability*

*H2: Corporate social responsibility has a positive association with FS and Profitability*



$$BP_{it} = \beta_0 + \beta_1 BP_{it-1} + \beta_2 (FI_{it})(CG_{it}) + \beta_3 (CSR)(CG) + \beta_4 (CV_{it}) + \beta_5 (\epsilon_{it}) \dots \dots \dots 06$$

Above same model was run for CSRI

Summary Statistics of Islamic Banks Stability and Profitability<sup>IB</sup>

Variables	Observation	Mean	Std. Deviation.	Mini	Max
Financial Stability	234	1.057	0.262	-0.185	1.89
ROA	234	0.015	0.112	-0.051	0.293
CG Index	234	0.012	1.100	-0.071	1.092
CSR Index	234	0.173	1.180	-1.211	1.306
FII	234	0.123	1.201	-1.015	1.801
Banks Age	234	13.021	1.808	12.400	29.41
Banks Size	234	81.005	12.010	10.000	18.101

Tables II: Correlation of Matrix of Islamic Banks Stability and Profitability<sup>IB</sup>

Variables	ROA	ROE	FS	FII	CSRI	CGI	BA	BS
Return on asset	1							
Return on equity	0.681***	1						
FS	0.598***	0.57***	1					
FII	0.600***	0.485***	0.491***	1				
CSRI	0.471***	0.430***	0.418***	0.590***	1			
CGI	0.430***	0.476***	0.298***	0.441***	0.491***	1		
BA	0.496***	0.492***	0.312***	0.427***	0.520***	0.477***	1	
BS	0.341***	0.390***	0.412***	0.471***	0.481***	0.690***	0.371**	1

Note \*\*\* level at 1%, \*\* level at 5% and \* showed at 10%

The table 3 shows the direct influence of the FII on the association with the financial stability and return and CSRI direct influence with the FS and profitability of the Islamic banks in Pakistan.

The research works found that FI significant impression on the financial stability and profitability of the Islamic banks. CSR index has also a significant effect on the FS and profitability of the Islamic banks. Firstly, this research effort makes a theoretical justification and contribution among the FI and social activities on the FS and profitability. Previous inquiry works found miscellaneous outcomes in the literature such as (Okpara 2011; Siddik et al. 2018; Khan, 2011; Hannig and Jansen, 2010; Flammer, 2013; Aras et al. 2010; Sheikh, 2019; Samy et al. 2010; Oyewumi et al. 2018).

The results of this research study same with the past results efforts that FI has an optimistic and noteworthy influence on FS and profitability. The results of the research study examine that CSRI has a positive and generous influence on FS and profitability. Previous investigation efforts have found the same research results that CG has a positive and noteworthy influence on the bank's FS and profitability. Secondly, this research examines that CG mechanism is foremost and contingent factor interaction relationship among the FI and CSR with the FS and profitability. Prior research works found mixed results in the literature (Claessens, 2006). This research works also found empirical support from the positive and significant impact among the FI and CSR on the bank's FS and profitability from the national and international studies such as (Ramazan et al. 2021; Anarfo et al. 2020; Lu et al. 2021). In case, the interaction term effect CGI has significantly enhanced FI index and CSR with the FS and profitability of the Islamic banks.

Table#3, Direct and moderating role of corporate governance index with financial stability & profitability

Variables	GMM (M1 FS)	GMM (M2 (ROA))	GMM (M3) (ROE)	Variables	M1 GMM (FS)	M2 GMM (ROA)	M3 GMM (ROE)
Lagged FS	0.501*** (0.047)			Lagged FS	0.590*** (0.049)		
Lagged ROA		0.473** (0.038)		Lagged ROA		0.541*** (0.0335)	
Lagged ROE			0.578** (0.077)	Lagged ROE			0.478** (0.035)
FI	0.446** (0.028)	0.471** (0.028)	0.451** (0.023)	FI	0.385** (0.044)	0.074** (0.285)	0.027** (0.034)
CSR	0.289** (0.030)	0.209** (0.047)	0.217** (0.395)	CSR	0.081** (0.576)	0.056** (0.687)	0.035** (0.046)
CGI	0.371** (0.451)	0.381** (0.286)	0.398** (0.324)	CGI	0.068** (0.055)	0.076** (0.191)	0.034** (0.035)
BS	0.318*** (0.449)	0.267** (0.423)	0.569** (0.381)	FI *CGI	0.0561*** (0.056)	0.069*** (0.057)	0.045*** (0.040)

BA	0.391** (0.071)	0.289* (0.082)	0.380** (0.068)	CSR * CGI	0.0678*** (0.032)	0.0987*** (0.086)	0.021*** (0.051)
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Direct Diagnostic test			
Banks Dummy	Yes	Yes	yes
No. OBS	234	234	234
NO, Groups	18	18	18
No, Instrument	16	16	15
AR2	0.217	0.238	0.210
Hansen- J test	0.117	0.217	0.201

Diagnostic test of moderating role			
Banks Dummy	Yes	Yes	yes
NO.OBS	234	234	234
NO, Groups	18	18	18
No, Instrument	18	17	17
AR2	0.291	0.268	0.290
Hansen- J test	0.211	0.261	0.260

### Discussion and Conclusion

The research works investigate the link among the financial access and FS of the 217 countries of sub-Saharan. The data covering form the period of 1990 -2014 the examiner examine that the access of the financial service has significant driver of the financial sectors of the sub-Saharan countries (Anarfo and Gyeke-Dako, 2018). The research found that FI has positive and significant link with the firm growth (Chauvet and acolin, 2016). The dynamic generalized moment of method the finding of research show that digital financial access accelerates the FS of the Islamic banks (Hassan et al. 2021). Additionally, efforts explore the link among the access to financial service and FS covering the 1990 - 2017 of the Sub-Saharan countries. Several research works examined how to calculated and measure the FI (Garcia, 2016; Iqbal and Sami, 2017; Shanker, 2014). Moreover, Musau et al. (2018) investigate that due to the deposit and loan portfolio FI linked with the FS of the banking sectors.

FI enhance the financial development and reduced inequality and poverty (Emara and Said, 2021; Musau et al. 2018; Jungo et al. 2021; Huang and Zhang, 2020). Musau et al. (2018) said that more stable banks are able to offer financial product and service to FI. Whereas, Jungo et al. (2021) examined that financial institution play is an intermediating role among the financial system and

economy. FI plays a significant role in the monetary policy and controlling the inflation. Gaganis et al. (2021) state that FR effect still not clear whether its increase or decrease the financial efficiency of the banking system. Few other research studies examined that FR creates resistance during the financial crises and not able to promote the FS (Atellu et al. 2021 and Oduor et al. 2017).

The main aim of this research works is to analysis the direct influence of the FII on the Islamic banks FS and profitability. The second goal of this research works is to analysis the influence of the CSRI on the FS and Islamic banks profitability. Thirdly, this explores the interaction of effect of the corporate governance index on the association among the FI and Islamic banks profitability from the time period of 2008 - 2020. The research study find from the data that FI has significant influence on the FS and profitability on the Islamic banks three models. This works also found that an Islamic bank in case of the profitability and FS CSRI has significant impact on the FS and others model in Pakistan context. CG is the moderating factor among the FI and CSR with FS and profitability of the banks. The main finding this research works is to analyze that corporate governance positively and significantly moderates the relationship between FI, CSR, and FS and profitability.

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