

Corporate Social Responsibility Expenditure on the Financial Performance of Financial Institutions with the special reference of Rural Development Bank (RDB)

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Abstract

CSR activities and expenditure have gone up significantly in last few years. Part of this increase attributed to certain directions of the Sri Lankan financial sector. Besides providing goods and services in order to achieve profitability, they also serve as a source of livelihood for many, pay taxes that enable governments to operate, and have an impact on the physical and social environment. However, the practice of social responsibility poses a challenge to many financial institutions in Sri Lanka including the RDB. The socially responsible acts of financial have been assumed to have negative effect on the expenditure and profitability of some financial institutions thereby affecting their profit margins in the short-term. This research therefore focused on determining the extent of the effects of corporate social responsibility (CSR) expenditures on the financial performance of financial institutions. A survey and interviews of some selected department heads at the RDB and reviews of the annual CSR reports revealed that the immediate effect of socially responsible activities on the financial performance of financial institutions tends to be negative. In the long term, such efforts have the potential to accrue positive impacts for financial institutions that engage in socially responsible behaviors as part of their core functions. It is therefore recommended that financial institutions need to undertake socially responsible activities that are part of their core functions so as to overcome the initial shocks that are associated with such programs.

Keywords: Corporate Social Responsibility, Rural Development Bank, CSR Expenditure and Financial Institution

Introduction

There is no doubt about the critical role businesses play in the political, socio-cultural, and economic development of society through the range of goods and services, taxes and royalties, as well as the opportunities they offer for improved quality of life for citizens (Jamali and Mirshak, 2007). However, the debate as to whether the idea of corporate social responsibility (CSR) ought to be incorporated into the core activities and operations of businesses and corporations has raged on since the late nineteenth Century.

Advocates for socially responsible companies have called for the introduction of some form of social business ethics with the purpose to get companies to incorporate social responsibility into their core activities. The critics on the other hand argue that companies should not be forced either by law or moral conventions because social responsibility could mean weakened economic growth and competitive position. In spite of these ongoing debates, companies have started to be involved in more socially responsible acts (Adamsson and Johansson, 2008).

Objective of the Study

The focus of many businesses over the years is profit and cared less about the welfare of the communities they operated. This led to the myth that profit and growth are the sole purpose of business. According to Friedman (1970), in a free society, there is one and only one social responsibility of business - to use its resources to engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

Friedman prefers that the state addresses social problems, arguing that an executive, by taking money and resources that would otherwise go to owners, employees, and customers, and allocating them according to the will of the minority, fails to serve the interests of its principals. In this way, the executive imposes tax and spends the proceeds for “social” purposes, which is intolerable, since she or he has neither the skills nor the jurisdiction to do so. On the other hand, there are many appeals by others for corporate adoption of the CSR principles. Although the government is mainly responsible for addressing those issues, the contribution of private firms can be substantial. Meanwhile, the minds of most business managements are tuned in to the ascertainment of profit maximization; performance of social responsibility is regarded as a ‘foreign imposition’ and financial burden which will adversely affect the income and expenditure of the business.

Instead, banks may prefer mobilizing funds for promotional activities such as advertisements in the media which may yield short term benefits rather than socially investing in the communities they are located that may result in long term effects (Jamali and Mirshak, 2007). But it has been argued that CSR may function in similar ways as advertising does and therefore, increase overall demand for products and services, and/or reduce consumer price sensitivity (Sen and Bhattacharya, 2001). The practice of CSR may also have the potential to enable firm to develop intangible resources (Hull and Rothernberg, 2008, Waddock and Graves, 1997).

It seems that shareholders of companies think significantly about returns that come from their investments in the form of huge dividends. This may compel businesses to cut down on their expenditure especially on socially responsible activities, and limit themselves mostly to profit generating activities that will increase profitability (Wen, 2009). Meanwhile, increased competition and commercial pressure are combining with rising regulatory standards and consumer demand to create a whole new playfield for businesses. Traditional expectations of business are also changing.

It is no longer enough to simply employ people, make profit and pay taxes. Companies are now expected to act responsibly, be accountable and benefit society as a whole. The practice of CSR is increasingly becoming part of good management principles, such that, institutions that risk responsible behaviour in their communities risk the chance of being “accepted” by the same community in which they take their employees, customers and suppliers. Although mostly voluntary, some forms of CSR

practices are emerging as de facto industry standards that provide the desired legitimacy, consistency and comparability required by businesses and its stakeholders (Jamali and Mirshak, 2007).

Research Problems

There are many CSR issues that corporations in Sri Lanka must be concerned with. However, awareness of CSR among most Sri Lankan companies, especially financial institution is low and where they are practiced; the impact of financial institutions' CSR has not been significantly felt even by the communities that contribute to the growth such institutions. At best, CSR is widely regarded as a philanthropic "add-on."

The foregoing has attracted the need to explore how corporate social responsibility expenditures impact on the financial performance of financial institution in Sri Lanka. Ample research exists on the relevance of CSR but some gaps still exist on whether the expenditure on these activities does affect the financial performance of institutions.

Research Questions

This study sought to fill that gap by focusing on the RDB, a financial institution to answer the following vital questions:

1. Which CSR activities does the RDB engage in?
2. What is the RDB's CSR expenditure?
3. Is there a relationship between CSR and financial performance at the RDB?

Review of Literature

Corporate Social Responsibility

Strategic managers are consistently faced with the decision of how to allocate scarce corporate resources in an environment that is placing more and more pressures on them. Recent scholarship in strategic management suggests that many of these pressures are coming directly not from traditional concerns of strategic management but instead from concerns about social issues in management. Strategic resource allocation decisions have always been complex, but now they are even more so, since companies are assessed not only on the financial outcome of their decisions but also on the ways in which their companies measure up to a broader set of societal expectations.

Prahalad and Hamel (1994) indicate that influences on strategic decisions now come from influences that go well beyond traditional Industry-based competitive forces identified by Porter (1980). Changing customer expectations, regulatory shifts, problem of excess capacity (and presumably the associated employees), and environmental concerns are now becoming important influences on strategy (Prahalad and Hamel, 1994). These emerging influences on strategic decision making are the result of the impact of different stakeholder expectations and a company's interactions with a range of stakeholders arguably comprise its overall corporate social performance record.

What is CSR?

According to one of the most frequently cited definitions, CSR is "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis" (Commission of European Communities, 2001). In reality, the distinction between companies' voluntary and

mandatory action is sometimes blurred in the developing world. As Graham and Woods (2006) point out, voluntary initiatives may have mandatory aspects and national regulatory frameworks may incorporate the use of voluntary instruments. Also, debating whether companies should go beyond their legal obligations and voluntarily adopt CSR initiatives makes little sense in many developing countries. In some countries, for example India and Pakistan, it is the rule rather than the exception that companies do *not* comply with existing legal frameworks related to corruption, payment of taxes, fair trade practices, respect for human rights, customer services, environmental protection, etc. In this respect I agree with the adoption of a broader definition of CSR, as an umbrella term for a variety of theories and practices all of which recognize the following: (a) that companies have a responsibility for their impact on society and the natural environment, sometimes beyond legal compliance and the liability of individuals; (b) that companies have a responsibility for the behaviour of others with whom they do business (e.g. within supply chains); and that (c) business needs to manage its relationship with wider society, whether for reasons of commercial viability, or to add value to society (Graham and Woods, 2006).

History and development of CSR

Although CSR has only recently risen to prominence as a serious discipline in management, contributing to society is not a totally new concept for firms. In late 1770s, Adam Smith introduced the expression ‘the invisible hand’ to demonstrate how capitalists inadvertently brought about domestic economic prosperity even though their real intentions were the pursuit of self-interest. Smith argued that the metaphorical ‘hand’ helps produce benefits to society even when the capitalists did not plan for such social benefits. The invisible hand produces outcomes that may not be consciously planned. To Smith, social welfare is a by-product of capitalists’ activities. The impact of corporate activities on society has been thence debated by practitioners and researchers right up to this day.

Despite the many debates and discussions on the social responsibility of firms, there remains a big question of what CSR actually is. As Kitchin (2002) stated, ‘one moment CSR seems to mean the engagement of nongovernmental organizations (NGOs), the next it is all about charitable donations, and 5 minutes later it seems to mean the ethical treatment of employees. One minute the NGOs are calling the shots, the next the accountants are in on the act selling reputation assurance’. Different authors seem to have different explanations as to what CSR is. Some argued that CSR is an excellent tool to market the firm and should therefore be led by marketers or be used to enhance the company’s brand. Others argued that firms should be socially responsible because that is the right way to behave.

Financial performance and CSR

In forming the conceptual framework and hypotheses, it is evident that there are two issues to address in the relationship between CSR and financial performance: (1) the sign of the relationship, and (2) the direction of causation. The sign of the relationship may indicate negative, neutral or positive linkages between CSR and financial performance. Separately, it is possible that changes in CSR influence financial performance, or the opposite, that change in financial performance influence CSR.

The Sri Lankan context

Privatization, the opening of Sri Lanka to foreign investment and increased domestic private investment have transformed Sri Lanka's private sector into the country's largest employer and most important source of revenue, as has occurred elsewhere around the world. The way the private sector acts and performs, therefore, will have more impact on the development of the country and its people than any other area of society, including government, NGOs and religious organizations. The connection between business and social evolution has long been recognized and the private sector has become both the primary engine of financial growth and a major contributor to human resource development.

Context for Grasping CSR Consciousness in Sri Lanka

For more than 2500 years, Sri Lankan cultural, social, political and economic life has been subjected to turbulent changes. These have generated an impetus for major developments in the economy of the country. Till 1505, Sri Lanka was an independent state with agriculture as the predominant economic activity. During this period, engaging in business was considered to be less socially acceptable (Chandraprema, 1989). Merchants from India, Arabia and China were the main traders who engaged in trade. From 1505 till 1948 Portuguese, Dutch and British colonists ruled Sri Lanka. The Dutch laid the formal foundation for business in Sri Lanka with the establishment of the Dutch-East India Company. The Dutch were followed by the British who significantly influenced what Sri Lanka is today. The British started to restructure the economy by shifting it from a subsistence agricultural economy to a trading economy based on tea, natural rubber and spices. Private companies were formed in the early period of the 18th century and in the late 1800s Sri Lanka had a stock market. John Keells Group, Aitken Spence, Brown & Company and Hayleys were some of the companies listed in the stock market. Many of these companies yet continue to do business in Sri Lanka mostly under Sri Lankan ownership. With these developments, a dual economy began to emerge in the well-developed corporate export based sector and the mass agricultural based subsistence sector (based in rural areas). Yet, in Sri Lanka taken as a whole, the public attitude towards doing business has not changed significantly. 75% of the population is rural and agriculture dominates. As a result, a feudal mentality prevails in the minds of the majority. There is, however, some recognition for the indigenous entrepreneurial community of businessmen who emerged from the southern part of Sri Lanka. The masses generally felt that the British based private companies were exploiting them. This resulted in an emergence of anti-capitalistic ideas from the 1920s (following in the footsteps of the Russian revolution). After independence in 1948, Sri Lanka experienced an era of socialist based inward looking development policies. The state became the source of ultimate welfare for the people. A large number of nationalized ventures were incorporated in the 1960s, especially in the larger industries such as cement and steel. All private enterprises including foreign based companies (i.e. tea plantations) were nationalized. The political establishment had public support for these, as people seemed to have lost faith in private enterprises.

Nature of CSR Initiatives of some Sri Lankan Corporate Entities

CSR initiatives of Sri Lankan firms can be understood from two broad perspectives

a) Externally focused (popular visible level) and b) the internal policy level. The former includes themes that appeal to the public at large. For instance, Union Assurance, an insurance company, has been carrying out a public awareness campaign on general safety aimed at children. The company sponsored a public awareness campaign on precautions

to be taken in lighting fireworks in festive seasons. This has resulted in a significant reduction in burn accidents. In another campaign the same company highlighted the need for precaution in crossing public roads. The company requested pedestrians to raise and wave their hands to the drivers of vehicles before crossing public roads with a view to reducing accidents. The same company erected notice boards on the banks of reservoirs, rivers and beaches where it is dangerous to swim. Sampath Bank, a local commercial bank, sponsors a public awareness campaign about preserving forests. One foreign company importing and distributing cement sponsors a reforestation program. D Samson Industries, a local shoe manufacturing and distributing company, organizes an island-wide school art competition with a view to enhancing the artistic skills of children. More examples can be cited as evidence of extensive externally focused CSR practices.

CSR Activities of the Private Sector in Sri Lanka

Corporate Social Responsibility (CSR) is a concept whereby companies undertake certain responsibilities towards society independent of their business concerns. Although the activities are not directly related to their business, there is an indirect impact on the business which is a positive one. For example: there is a positive image of the company in the eye of the public and the employees' morale is boosted, which in turn has a positive effect on the productivity of the company.

The research showed various forms of CSR activities being performed by the private sector. Many companies have a social responsibility statement in their annual reports. In many instances CSR seems to be an integral component of business. Charitable activities by the business community in support of various social causes are not an entirely new concept. However, they are ad hoc and seen as purely optional initiatives. CSR can be seen as a concept which brings benefits to both business and to the community. It is a win-win situation. Its ambit has to be explored fully in order to tap its potential.

According to H.C.Rathnasiri on his exploratory study on "Corporate Social Responsibility Practices of Sri Lankan Private Sector" is to capture the current status of Corporate Social Responsibility (CSR) understanding, commitment and practices of Sri Lankan private sector firms. The study provides an overview of company practices as well as of employee and civil society experiences and perceptions of CSR.

According to Pirithiviraj J.C.D and K. Kajendra (2010) in their study on "Relationship between Market Orientation and Corporate Social Responsibility with special reference to Sri Lankan Financial Sector" it has been found that variables of market orientation; customer orientation, competitor orientation and inter-functional coordination are positively related to corporate social responsibility. Therefore it can be derived that there is a positive relationship between market orientation and corporate social responsibility. Thus the more an entity incorporate needs, wants and expectations of the customers, the more it can initiate measures satisfying the social expectations of their customers. Hence, if an organization wants to improve its socially responsible business behavior it has to move towards market orientation practices such as customer orientation, competitor orientation and inter-functional coordination.

Practice of CSR

Many businesses in Sri Lanka practice some form of social activity, usually through charitable giving to religious or educational institutions. This is a positive foundation for future work and shows the willingness of business to support social investment. However, most businesses have only a general understanding of CSR and have become involved in initiatives without an overall policy.

The good intentions of Sri Lankan business and its interest in serving society contain the potential to transform informal practices into more structured and integrated initiatives. However, there is little or no engagement with civil society and government at present, no coordination of effort and little exposure to best practice to catalyze change. Engagement is required to help the private sector understand how its long-term interests are linked to the development of society around it. This engagement is essential to the definition and implementation of sustainable CSR efforts because individual businesses rarely have the experience to address challenges that lie outside the scope of their core business activities.

There is limited coordination of socially responsible practices in the private sector, although it enjoys a history of philanthropy. The latter has sparked a growing interest in CSR and led to some business organizations in Colombo actively building up their knowledge of its practice. These organizations have shown signs of moving towards a focus on more strategic CSR programmes and overall policy. However, a more cooperative approach is needed to strengthen CSR practice. The organizations at the forefront of CSR need to engage others in dialogue to provide opportunities for shared learning and the development of best practice. Anecdotally, the opposite appears to be happening. The short-term view of the benefits of CSR has created an insular and competitive approach which is healthy at one level— because there is a limited history of CSR in Sri Lanka— but which desperately requires shared learning if it is to evolve into best practice. There are some encouraging signs that this is changing but more formal interaction is needed. The private sector should consider cooperation on initiatives of mutual concern. Effectiveness, especially on national or regional issues, can be greatly improved through the pooling of resources and integration with government and other development objectives.

Corporate Social Responsibility and Natural Disaster Reduction in Sri Lanka – May 2002 by Madhavi Malalgoda Ariyabandu & Preethi Hulangamuwa in their study found that the extent of the private sector's involvement in disaster reduction activities in Sri Lanka is extremely small. This sector's involvement in this sphere is largely seen in response to emergencies, in the form of relief.

Research Methodology

This study employed descriptive research design. Descriptive research is directed towards the determining of nature of a situation, as it exists at the time of study. Descriptive research is used to portray an accurate profile of persons, events, or situations (Robson, 2002).

The Regional Development Bank of Sri Lanka (RDB) was purposively selected for the study. The study focused on the top level management, namely heads of finance and planning, retail banking, research and marketing and estate departments of the Bank. Semi-structured interviews were conducted with the officials to obtain qualitative information. Secondary data was also obtained from internal documents such as the bank's policies of CSR, annual reports, CSR reports and other publications prepared from 2007 to 2014.

Information obtained from the secondary sources included RDB's CSR expenditures, Return On Equity (ROE) and Net Interest Margin (NIM) which were used as financial performance measures. Return on equity (ROE) measured how well a company uses reinvested earnings to generate additional earnings, giving a general indication of the company's efficiency (Bodie, Kane, and Marcus, 2002). It measures the firm's overall

profitability relative to the equity base available to the firm. In other words, it tells how much is earned by the firm based upon the amount of equity the owners have invested in the business. For firms in the commercial banking sector an ROE of 12.5% or greater is desirable.

The net interest margin, on the other hand, is a measure of how well the institution was able to maintain a spread between its interest incomes to its interest expenses. In very simplistic terms, the higher the net interest margin the better, as it indicates a very positive spread between what is being paid out in interest expense versus what is being earned as interest income. There are no general rules of thumb for the NIM, but typical net interest margins vary from 4% to 5%. The Pearson's correlation statistics was used to generate the relationship between corporate social responsibility variables and financial performance of the bank.

Data Presentation

CRS Activities by RDB

The study revealed several CSR activities of RDB. These activities were mainly poverty and social interventions. The CSR activities allowed for public interaction, such as safe-drinking events or applying a donation to a community charity when consumers purchase certain brands of products, require community involvement for success. The CSR activities of RDB again create a platform for farmers to showcase their farm produce. Evidence of such is ASL which is aim at directing farmers on how to assess credit facilities at a reduced rate. To encourage consumer acceptance and reward sustainability behavior, RDB often offer discounted pricing or offset programs on agric inputs. The RDB CSR products and services are categorized into three broad areas which are economical, social and environmental.

In terms of the economical, the activities included the supply of fertilizers, Farmers day sponsorship, outboard motors for fishermen and supply of poultry birds and feeds. The environmental activities of the Bank consisted of tree planting, protecting water bodies, provision of irrigation systems in the Northern part of Sri Lanka. The Agricultural Development Bank in collaboration with the Forestry to curb on illegal chain saw operators.

The social issues related to the various social interventions investments that were made by the Bank such as investing in capital gaps in disadvantaged communities and underserved markets; financing for social enterprises, affordable housing, small business development; comprehensive community development services, including specialized non-profit services; micro-credit financing to petty traders; providing agricultural inputs and accessories to farmers; including community investment products; and providing social deposit accounts targeted at economic development, child care, giving out three bed room house for winners of national best farmers ward.

CSR Expenditure at RDB

A trend analysis of the social responsibility of RDB and its contributions to the agricultural sector specifically has been presented below. These contributions toward the agricultural industry have been earmarked for the same reasons or expectations as presented above. Since RDB is mostly agric-oriented focus on the agric sector is not only seen as vital but specifically because of the multiplier effect on the performance of the

organization, community upgrading and eventually on the economy at large.

Annual financial reports show that overall expenditure on the bank's corporate social activities has been increasing over the years. On Figure 2, it was observed that the CSR expenditures rose steadily and sharply from 2007 through to 2014; but seems to plateau afterwards until it started rising slowly from 2008 to 2014.

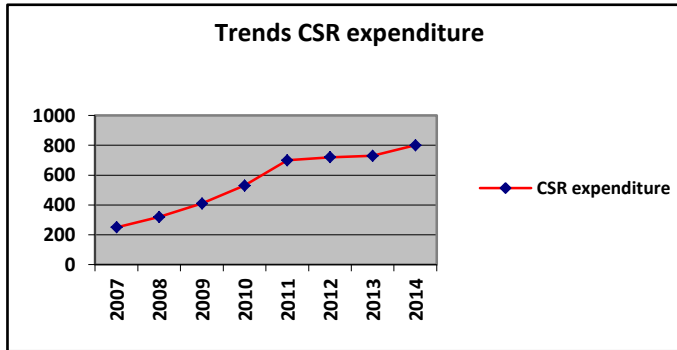


Figure 1. CSR Expenditures at RDB (Millions Rs.)

Source: Authors' own construct based on RDB Annual Reports (various years).

Relationship between CSR and Financial Performance

The trend analysis shows that indicators of financial performance have been falling steadily and concurrently over the years. The display on Figure 2 shows that the performances of the bank over the years 2007-2014 have been falling. The empirical puzzle had been whether this has been due to the corporate social responsibility activities engaged by the bank. A Pearson correlation analysis was performed on the variables in order to determine the degree and the direction of relationship among them. Indeed the correlation statistics calculated shows that ROE and NIM are positively related but the association between them is not strong (0.535 ; $p = 0.175$). This result is very important as it gives an indication of the independent strength of the individual performance indicators. With this in perspective, then the relationship between these individual indicators and CSR variables are not achieved independently without the effect on other financial indicators.

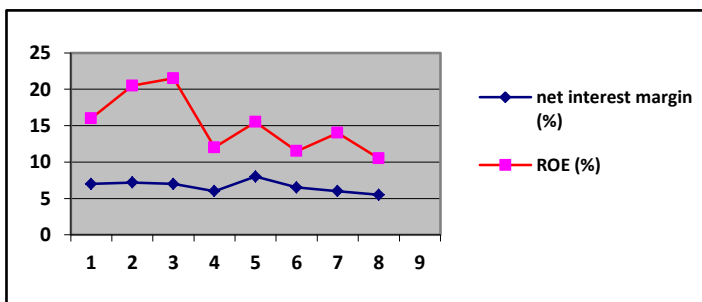


Figure 2. Trend of Bank's Performance

Source: Authors' own construct based on RDB Annual Reports (various years).

The results as shown in Table 1 illustrates that ROE is significantly negatively correlated to CSR expenditures and number of branches (both at $p < 5\%$ level). This suggests that when RDBs CSR activities including the number of branches increases, ROE of RDB falls, holding other factors constant. Results also show that net interest margin also had a negative relationship with the corporate social responsibility and the number of branches. Indeed whilst that of the number of branches was significant; it is found that CSR did not have any significant impact on NIM.

Table 1. Financial Performance Indicators and Corporate Social Responsibility

		CSR	Branches	ROE	Net Interest Margin
CSR	Person Correlation	1	.802*	-.730*	-.260
	Sig. (2-tailed)		.017	.040	.534
	N	8	8	8	8
Branches	Person Correlation	.802*	1	-.713*	-.722*
	Sig. (2-tailed)	.017		.047	.043
	N	8	8	8	8
ROE	Person Correlation	-.730*	-.713*	1	.535
	Sig. (2-tailed)	.040	.047		.172
	N	8	8	8	8
NIM	Person Correlation	-.260	-.722*	.535	1
	Sig. (2-tailed)	.534	.043	.172	
	N	8	8	8	8

The positive relationship observed for CSR, number of branches (0.802; $p < 5\%$) shows that the increase or expansion of the bank over the country affects positively and significantly its social responsibility activities; since projects are community-based. A historical examination of RDB's CSR activities shows that the bank used to concentrate most of its social activities in the agric sector mainly to boost the industry and make it more commercially viable; however with time, various dimensions have enrolled into the social projects including the donation of desktop computers, in 2011, to the Sri Lanka Education Service for the promotion of ICT across the country.

Discussions

The findings of the research indicate that when many components of social responsibility are performed the total expenditure increases which impact negatively on the financial performance of the bank in the short-term. It means that the expansion of corporate social responsibility beyond the operations of the bank, but such expenditure will not yield direct returns on the firm in the short term. Meanwhile, such activities invariably leads to some improvement in the overall living standards of the country as well as improving economic growth as the multiplier effects impact on growth indicators. The medium to long term benefits are rather seen when living standards or economic growth indicators are enhanced, the bank will thrive as the rippling effect affects the industry in which the bank is skewed towards. Indeed a company that pursues a vigorous CSR is also entitled to some tax exemptions which can impact on the financial performance of the company in the medium term.

Additionally, a positive relationship is observed when CSR is highly concentrated in sectors which are important to the organization or in areas where the bank has its

competitive advantage. In this scenario any investments made will in turn yield returns that will directly boost the performance of the company. For RDB, such a sector is the agric sector. Any investments made in the agric sector therefore directly yields returns as the extra cost are covered as the stakeholders are improving in welfare and their engagements. For instance, fertilizers to cocoa farmers will help farmers improve upon yield which will invariably results in higher farmers' income; and since these farmers are saving with the bank the increase in income levels will mean higher savings and investments in the bank. Because there is a mixed relationship between the corporate social responsibility and the bank's performance, it confirms the conclusions drawn by Adams and Zutshi (2004) that there is no relationship between CSR and financial performance.

Conclusion

The study examined the effects of corporate social responsibility activities on the financial performance of the bank. This was measured with indicators such as Return on Equity and Net Interest Margin. The study depicted that corporate social responsibility leads to decrease in financial performance when activities are expanded outside its functional areas. However, positive financial performance is realised when corporate social responsibility activities are limited to the areas where the bank has achieved competitive advantage. The research suggests that firms with better CSR performance are better positioned to obtain financing in the capital markets, which positively affects their ability to undertake major strategic investment decisions and eventually yield positive stock returns

Recommendations

Donations are often ad hoc and limited to philanthropic activities or simple donations, which tend to be focused on the short term and contribute little in terms of sustained benefits for either the community or the company. Banks on the other hand should engage more in activities and practices which are both more closely linked to the core business and are more directly profitable, increasing their awareness of "the business case for CSR" and strengthening their planning processes. Both internal and external CSR practices should be integrated into banks' strategic planning in order to specifically target those elements that impact positively on their competitiveness and profitability. This will also increase the sustainability and the overall development impact of companies' initiatives.

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