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INTEGRATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) PRINCIPLES IN ISLAMIC FINANCE

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ABSTRACT

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This study examines the integration of Environmental, Social, and Governance (ESG) principles within Islamic finance through a systematic literature review of research published between 2019 and 2024. Findings indicate a strong conceptual alignment between ESG and maqāṣid al-sharī'ah, particularly in environmental stewardship, social justice, and ethical governance. Empirical studies show that ESG implementation enhances the sustainability reporting, reputation, and financial stability of Islamic financial institutions, although challenges remain in standardization, human resource capacity, and verification. Green sukuk emerges as the most significant ESG-aligned Islamic financial instrument, contributing to sustainable development and renewable energy financing. Nevertheless, regulatory gaps between global ESG frameworks and Shariah-specific standards hinder optimal adoption. This study concludes that strengthening regulatory harmonization, improving ESG literacy, and enhancing Shariah governance capacities are essential for advancing ESG integration in Islamic finance.

Keywords: *ESG Integration, Islamic Finance, Maqāṣid Al-Sharī'ah, Green Sukuk, Literature Review*

INTRODUCTION

Global financial systems have increasingly incorporated Environmental, Social, and Governance (ESG) principles as a framework for assessing corporate sustainability and long-term economic resilience (UNPRI, 2021; UN, 2023). Recent empirical studies show that ESG adoption enhances risk mitigation, transparency, and investor confidence across global markets (Friede, 2019; Broadstock et al., 2021). As environmental and social challenges intensify, the integration of ESG principles has become a strategic priority for governments and financial institutions seeking to strengthen sustainable finance agendas.

Parallel to these global developments, Islamic finance continues to expand as an ethical and fast-growing sector grounded in justice, transparency, and the prohibition of harmful activities (IsDB, 2020; IFSB, 2022). Recent studies highlight that Islamic banking performance is increasingly influenced by sustainability-driven expectations from stakeholders, particularly in Muslim-majority countries (Alsaifi & Elnahass, 2022; Ali & Khurshid, 2023). The ethical foundation of Islamic finance positions it as a compatible framework for sustainability integration, especially as demand for Shariah-compliant green investment instruments rises across global markets.

The alignment between ESG principles and *maqāsid al-sharī‘ah* has become a central theme in contemporary Islamic finance scholarship. Research indicates that the objectives of Shariah—promoting welfare, protecting the environment, ensuring social justice, and preventing harm—naturally reinforce the environmental, social, and governance pillars of ESG (Dusuki & Abdullah, 2007; Abdullah et al., 2020). Practical initiatives such as green sukuk issuances, sustainable Islamic banking strategies, and ESG-based Shariah screening models illustrate the operationalization of this alignment in various jurisdictions (Hossain et al., 2022; Ahmed et al., 2023). Countries like Indonesia and Malaysia have emerged as global leaders in Islamic sustainable finance, supported by robust regulatory frameworks and government-backed green financing programs (Ministry of Finance Indonesia, 2023; SC Malaysia, 2023).

Nonetheless, several challenges continue to impede the comprehensive integration of ESG within Islamic finance. Key issues include inconsistencies in ESG disclosure standards, variations in regulatory frameworks, limited data quality, and differing interpretations of Shariah principles across jurisdictions. Studies also highlight the need for harmonized ESG–Shariah metrics, improved governance structures, and cross-country regulatory cooperation to enhance the credibility and comparability of sustainability reporting (Rahman & Anwar, 2021; Saadaoui et al., 2023; Al-Tamimi et al., 2024). In response to these gaps, this study employs a systematic literature review to synthesize current progress, analyze persisting challenges, and propose future directions for strengthening ESG integration in Islamic finance.

LITERATURE REVIEW

ESG has become a global sustainability framework assessing environmental impact, social performance, and governance quality. Studies emphasize that ESG aligns naturally with Islamic finance values grounded in ethics, justice, and welfare (Dusuki & Bouheraoua, 2019). Since Shariah prohibits harmful activities, ESG serves as a modern operationalization of Islamic ethical mandates. It also complements the long-standing concept of Sustainable and Responsible Investment (SRI) in Islamic finance (Haniffa & Hudaib, 2020). Empirical studies show that ESG disclosure in Islamic banks is still dominated by governance-related information, while environmental and social disclosures remain less emphasized (Sarea & Salama, 2022). Global inconsistency in ESG reporting continues due to the absence of Shariah-specific standards. Panel data research indicates that stronger Shariah Governance significantly increases ESG disclosure levels, highlighting the vital role of Shariah Supervisory Boards (Alshbili & Elamer, 2023).

Green sukuk has become a crucial tool in financing renewable energy and climate mitigation projects. Indonesia, as the pioneer of sovereign green sukuk, has demonstrated significant impact on national green development (World Bank, 2021). Scholars argue that green sukuk strengthens the alignment between Shariah compliance and global sustainability goals (Hossain et al., 2022). Key challenges include environmental impact verification and post-issuance reporting (OECD, 2020). Moreover, green Islamic financing products require robust certification to avoid greenwashing (Rahman & Nor, 2023). Conceptual studies argue that ESG dimensions can be systematically mapped to the *maqāsid al-sharī'ah* objectives, such as environmental protection under *ḥifẓ al-nafs* and governance under *ḥifẓ al-māl* (Auda, 2020). However, operationalizing measurable indicators remains a challenge. Scholars have proposed hybrid evaluation frameworks such as the *maqāsid*–ESG weighted index to simultaneously capture Shariah compliance and ESG performance (Mohammed & Razak, 2022).

Empirical evidence shows that strong ESG practices enhance long-term profitability, operational efficiency, and institutional stability (Nawaz & Haniffa, 2021). Islamic banks with higher ESG scores tend to have lower reputational and market risks. Governance effectiveness—especially the Shariah Supervisory Board—strengthens the positive relationship between ESG and institutional resilience (Benevene & Buonomo, 2022). Nonetheless, some studies note an increase in short-term operational costs linked to ESG implementation (El-Halaby & Hussainey, 2021). Major challenges include the absence of standardized ESG reporting for Islamic financial institutions, limited technical capacity, and weak third-party verification mechanisms (OJK, 2021). Many Islamic banks remain at the early adoption stage and lack comprehensive environmental risk assessment systems (Rini et al., 2022). Although Indonesia's green sukuk demonstrates strong allocation reporting, impact reporting requires significant improvement (World Bank, 2022).

RESEARCH METHODS

This study adopts a systematic literature review by collecting peer-reviewed articles published between 2019–2024 from domestic and international journals. Keywords used included ESG, Islamic finance, Shariah governance, and green sukuk. Articles were screened for relevance, methodological quality, and full-text availability. Thematic synthesis and content analysis were applied to categorize findings into conceptual, empirical, and regulatory themes (Sulaeman & Abdallah, 2023; Khatibi et al., 2024).

RESULT AND DISCUSSION

The findings of the literature review indicate that the integration of ESG within Islamic finance is deeply aligned with the objectives of *maqāsid al-sharī'ah*, particularly in protecting the environment, promoting social justice, and ensuring responsible governance. The results show that the Sharia framework not only supports ESG but can further strengthen moral and ethical dimensions in sustainable finance. Studies such as Abdullah et al. (2020) and Laldin & Furqani (2022) highlight that ESG can function as an integrative framework that complements Islamic principles by ensuring long-term ethical sustainability. In terms of implementation, the literature shows that Islamic banks have begun adopting ESG reporting within sustainability reports, although maturity levels vary significantly. Governance remains the most frequently disclosed dimension, while Environmental and Social aspects still require further enhancement. Research by Alsaifi & Elnahass (2022) and Ali & Khurshid (2023) demonstrates that disclosure quality improves with digitalization and ESG rating agencies, yet challenges such as standardization gaps and the absence of Sharia-specific indicators continue to hinder consistency.

The review also highlights the crucial role of the Sharia Supervisory Board (SSB) in ensuring that ESG practices comply with Islamic principles. Active involvement of the SSB

enhances accountability, governance quality, and reduces greenwashing risks, as evidenced by Hassan et al. (2023). However, SSB members need additional training and competencies related to environmental and social issues to ensure more comprehensive oversight (Rahman et al., 2021). Another significant result is the growing role of green sukuk as a major innovation supporting ESG integration in the Islamic capital market. Indonesia is recognized as a global pioneer in issuing sovereign green sukuk, which has successfully funded renewable energy and climate mitigation projects, as shown in the studies of Cevik & Rahman (2019) and OECD (2021). Nonetheless, improvements are still required in third-party verification, impact reporting, and standardization to avoid greenwashing risks (Hayat & Anwer, 2023).

The findings further reveal that ESG positively influences both the financial and non-financial performance of Islamic financial institutions. Studies by Buallay (2022) and Widodo & Yusuf (2021) show that ESG disclosure enhances stability, reputation, operational efficiency, and reduces cost of capital. However, initial investment costs remain a major barrier, particularly for smaller institutions, necessitating regulatory support and incentives. Specifically in Indonesia, the findings indicate the absence of a dedicated ESG framework tailored to Islamic finance. Although OJK has issued the Sustainable Finance Roadmap, discrepancies between global standards (GRI, AAOIFI, IFSB) and Sharia principles remain. Studies by Setiawan & Putri (2021) and Hasan & Nugraha (2023) recommend the establishment of an ESG–Sharia Alignment Framework to ensure coherent, relevant, and Sharia-compliant implementation. Overall, the literature shows that ESG serves as a strategic factor in enhancing the competitiveness of Islamic financial institutions. With rising global investor interest in sustainable instruments, Islamic finance is positioned to become a leader in ethical and sustainable financing, as highlighted by Razak & Othman (2023) and Yusof & Tahir (2022). Products such as renewable energy financing and social impact sukuk can further support financial inclusion and generate meaningful environmental and social impact.

CONCLUSIONS

This literature review concludes that integrating ESG into Islamic finance is conceptually strong due to its alignment with maqāsid al-sharī'ah and its proven impact on institutional stability, transparency, and stakeholder trust. Green sukuk serves as a successful embodiment of ESG in Shariah-compliant markets. However, regulatory fragmentation, skill gaps, and inconsistent reporting pose significant barriers. Strengthening harmonized frameworks between OJK, DSN-MUI, AAOIFI, and IFSB is essential to ensure standardized implementation. With proper governance, capacity building, and regulatory alignment, ESG can become a strategic pillar for enhancing global competitiveness and sustainability in the Islamic finance industry.

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