

## ESG REPORTING PRACTICES AMONG ISLAMIC BANKS: A GLOBAL PERSPECTIVE

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### ABSTRACT

Environmental, Social, and Governance (ESG) or sustainability reporting have considerably increased in the last decades. The year 2020 marks a turning point in the United Nations' (UN) 2030 Agenda. The Sustainable Development Goals (SDGs) have created new expectations and gained support among corporate actors who rely on well-informed, timely, and strategically positioned markets. In recent years, research in sustainability practices has expanded globally. However, the banking industry received less attention from the academics since banks are generally not considered the main contributor to sustainability problems. Contrary to this, ESG and Islamic finance are under increasing academic attention, with the latter predicted to be more sensitive to sustainability due to its founding principles. Currently, the global Islamic asset under management (AUM) has increased by 2.3 times in the last decade to reach US\$140 billion by the end of 2020. Using the library-based research methodology, this research aims to provide a comprehensive overview of ESG reporting in Islamic banks from a global perspective. Based on this analysis, it is argued that Islamic banks lack sufficient investment in ESG-friendly initiatives. A brief discussion on the classification of ESG components and analysis of key frameworks and guidelines are provided to understand the regulatory framework that governs ESG practices. The article concludes with a recommendation for the necessary actions that can be adopted to enhance ESG practices in Islamic banks to ensure that they remain relevant and competitive with conventional banks.

**Keywords:** ESG, Sustainability Reporting, Islamic Finance, Islamic Banking.

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## **PELAPORAN ESG DALAM KALANGAN BANK ISLAM: PERSPEKTIF GLOBAL**

### **ABSTRAK**

Laporan ESG atau kemampanan telah meningkat dengan ketara dalam dekad yang lalu. Tahun 2020 menandakan titik perubahan dalam Agenda 2030 Pertubuhan Bangsa-Bangsa Bersatu (UN), kerana Matlamat Pembangunan Mampan (SDG) telah mencipta jangkaan baharu dan mendapat sokongan dari kalangan pelaku korporat yang bergantung pada pasaran yang bermaklumat, tepat pada masanya dan kedudukan strategik. Dalam beberapa tahun kebelakangan ini, penyelidikan dalam amalan kelestarian telah berkembang secara global. Walau bagaimanapun, industri perbankan kurang mendapat perhatian daripada ahli akademik kerana bank pada umumnya tidak dianggap sebagai penyumbang utama kepada masalah kemampanan. Bertentangan dengan ini, ESG dan kewangan Islam mendapat perhatian akademik yang semakin meningkat, di mana kewangan Islam diramalkan lebih sensitif terhadap kemampanan disebabkan oleh prinsip asasnya. Pada masa ini, aset Syariah di bawah pengurusan (AUM) global telah meningkat sebanyak 2.3 kali ganda sepanjang dekad yang lalu untuk mencecah AS\$140 bilion menjelang akhir 2020. Berasaskan metodologi penyelidikan perpustakaan, penyelidikan ini bertujuan untuk memberikan gambaran menyeluruh tentang pelaporan ESG di bank Islam dari perspektif global. Analisis ini berpendapat bahawa bank Islam kekurangan pelaburan yang mencukupi dalam inisiatif mesra ESG. Perbincangan ringkas mengenai klasifikasi komponen ESG dan analisis rangka kerja dan garis panduan utama disediakan untuk memahami rangka kerja kawal selia yang mengawal amalan ESG. Artikel ini diakhiri dengan cadangan untuk tindakan perlu yang boleh diterima pakai untuk meningkatkan amalan ESG dalam kalangan bank Islam bagi memastikan ia kekal relevan dan berdaya saing kepada bank konvensional.

**Kata kunci:** ESG, Laporan Kemampanan, Kewangan Islam, Industri Perbankan.

## INTRODUCTION

Several global initiatives have been made over the last three decades to address sustainability concerns, starting with the Millennium Development Goals (MDGs) in 2000 and continuing with the Sustainable Development Goals (SDGs) in 2015. Beyond the MDGs' focus on developing countries, the SDGs have taken a significant step forward by linking all countries together and universalizing sustainable development goals. The global financial sector, being the stakeholder, has stayed at the forefront of these efforts to achieve global sustainability.

The banking industry has evolved in operations, competitiveness, and product innovation.<sup>1</sup> Understanding how ESG activity affects bank value is critical. Events such as the 2008 Financial Crisis and the LIBOR scandal destroyed trust in financial institutions and exposed both banks' and regulators' complacency.<sup>2</sup> After the loss of confidence caused by the lack of transparency, the banking industry needs to strengthen stakeholders' confidence in the credibility of their reported activities. Recently, the outbreak of the COVID-19 pandemic has disrupted business commonalities and invigorated new norms and standards for firms' survival and resiliency.<sup>3</sup> As a result, banks and financial institutions have redefined their businesses, realigned capital flows toward sustainable investments, and integrated sustainability into risk management to re-establish trust, transparency, and longevity. This

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<sup>1</sup> Barry et al., "Ownership Structure and Risk in Publicly Held and Privately Owned Banks," *Journal of Banking & Finance*, no. 35 (2011): 1327–1340, <https://doi.org/10.1016/j.jbankfin.2010.10.004>.

<sup>2</sup> Hurley et al., "Understanding the Loss of Trust in Large Banks," *International Journal of Bank Marketing*, no. 32 (2014): 348–366, <https://doi.org/10.1108/IJBM-01-2014-0003>.

<sup>3</sup> Amina Mohamed Buallay et al., "Sustainability Reporting in Banking and Financial Services Sector: A Regional Analysis", *Journal of Sustainable Finance & Investment*, (2021): <https://doi.org/10.1080/20430795.2021.1978919>

capitalizes on stakeholders' growing interest in new socially responsible practices<sup>4</sup> and applying proper governance<sup>5</sup>.

It has been claimed that banks and other financial entities do not explicitly participate in environmental degradation activities. However, a finding revealed that 20 of the global largest banks are among those responsible for the pollution of the coal industry, as they provide 74 percent of the total funding for the sector.<sup>6</sup> This evidence refutes the notion that bank operations are unrelated to the environment and adds to the body of knowledge about banks' critical role in mitigating climate change by separating them from carbon-emitting industries. Therefore, banks play a significant role in the global financial stability<sup>7</sup> and are compelled to disclose their activities and implement better governance as they are aware of the following economic benefits.<sup>8</sup>

Some studies focus on the influence of ESG on banks. For instance, it was discovered that while ESG performance enhances bank value, the relationship is somewhat non-linear, with high levels of ESG

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<sup>4</sup> Maria del Mar Miralles-Quirós, Jose Luis Miralles-Quirós, and Jesús Redondo-Hernández, "The Impact of Environmental, Social, and Governance Performance on Stock Prices: Evidence from the Banking Industry." *Corporate Social Responsibility and Environmental Management* 26, no. 6 (2019): 1446–1456.

<sup>5</sup> Nicola Cucari, Salvatore Esposito De Falco, and Salvatore Esposito De Falco, "Diversity of Board of Directors and Environmental, Social Governance: Evidence from Italian Listed Companies." *Corporate Social Responsibility and Environmental Management* 25, no. 3 (2018): 250–266.

<sup>6</sup> Heffa Schücking et al., *Bankrolling Climate Change—A Look into the Portfolios of the World's Largest Banks*. (The Netherlands: Technical Report urgewald, groundWork, Earthlife Africa Johannesburg, BankTrack, 2011).

<sup>7</sup> Bert Scholtens and Sophie van't Klooster, "Sustainability and Bank Risk," *Palgrave Communications* 5, no. 1 (2019), <https://doi.org/10.1007/s41599-019-0315-9>.

<sup>8</sup> Osama F Al Kurdi, "A Critical Comparative Review of Emergency and Disaster Management in the Arab World," *Journal of Business and Socio-Economic Development* 1, no. 1 (2021): 24–46, <https://doi.org/10.1108/JBSED-02-2021-0021>.

activity having a detrimental effect on bank value.<sup>9</sup> Research on banks from common law countries where the awareness of the ESG practice is among the best globally suggests that the market values the three individual ESG dimensions separately, and banks experienced high-value relevance of ESG performance after the financial crisis in 2007-2008.<sup>10</sup> A study examined the effect of ESG practices on the reputation of Italian banks and the likelihood of them facing sanctions. While bank sanctions are positively related to ESG, the increased use of ESG practices stems from banks' desire to improve their reputation.<sup>11</sup>

Governments and financial regulators remain the primary source of reporting requirements and guidance, followed by stock exchanges and industry associations. New regulatory requirements, both voluntary and mandatory, have been focusing on human rights, work, and climate change.<sup>12</sup> Voluntary codes and guidelines continue to be a catalyst for innovation.<sup>13</sup> Simultaneously, there has been a push for stricter mandatory reporting requirements to advance reliable and comparable disclosure in the developed markets.<sup>14</sup> Large and publicly traded companies continue to be the primary targets of reporting requirements. Sector-specific approaches are becoming more

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<sup>9</sup> Wajahat Azmi et al., "ESG Activities and Banking Performance: International Evidence from Emerging Economies," *Journal of International Financial Markets, Institutions, and Money* 70, no. 3 (December 2020): 101277.

<sup>10</sup> Maria del Mar Miralles-Quirós, Jose Luis Miralles-Quirós and Jesús Redondo Hernández, "ESG Performance and Shareholder Value Creation in the Banking Industry: International Differences," *Sustainability* 11, no. 5 (2019): 1404-1418.

<sup>11</sup> Pina Murè et al., "ESG and Reputation: The Case of Sanctioned Italian Banks," *Corporate Social Responsibility and Environmental Management* 28, no. 1 (September 2020): 265-277.

<sup>12</sup> Cornis van der Lugt and Peter Paul van de Wijs, *Carrots & Sticks 2020 - Sustainability Reporting Policy: Global Trends in Disclosure as the ESG Agenda Goes Mainstream*, (Global Reporting Initiative (GRI) and the University of Stellenbosch Business School (USB), 2020).

<sup>13</sup> *Ibid*

<sup>14</sup> "Sustainability Reporting Policy: Global Trends in Disclosure as ESG Goes Mainstream", WBCSD, accessed April 10, 2022, <https://sdghub.com/project/carrots-sticks-2020-report/>.

prevalent, with the financial services and heavy industries being the most targeted.<sup>15</sup>

Financial market regulators, stock exchanges, and industry bodies are more active in issuing codes, guidance, standards, self-regulatory requirements, and questionnaires.<sup>16</sup> Market regulators, such as securities exchange commissions and stock exchanges, have often published updated corporate governance codes. Like B3 in Brazil, some have introduced 'report or explain' requirements related to the SDGs.<sup>17</sup> Others partner with governmental regulators, such as the China Securities Regulatory Commission, working with the China Ministry of Environmental Protection in issuing mandatory environmental disclosure requirements for listed companies.<sup>18</sup>

As tracking progress toward global sustainability goals becomes more critical, it is timely to use the SDGs to evaluate the suitability of nonfinancial reporting policies. The experience of the 2020 pandemic strengthens the case for the SDGs to be used as a common framework for concerted action by public and private policy actors.<sup>19</sup> The COVID-19 pandemic has highlighted the critical nature of global collaboration between state and non-state actors. As a global framework, the SDGs prioritize essential material issues for the planet and emphasize the importance of collaborative action.<sup>20</sup>

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<sup>15</sup> *Ibid*

<sup>16</sup> Cornis van der Lugt and Peter Paul van de Wijs, *Carrots & Sticks 2020 - Sustainability Reporting Policy: Global Trends in Disclosure as the ESG Agenda Goes Mainstream*, (Global Reporting Initiative (GRI) and the University of Stellenbosch Business School (USB), 2020).

<sup>17</sup> "B3 Announces Results of Report or Explain for Sustainable Development Goals (SDG)", B3, accessed April 22, 2022, [https://www.b3.com.br/en\\_us/newa/report-or-explain-for-sustainable-development-goals-sdg.htm](https://www.b3.com.br/en_us/newa/report-or-explain-for-sustainable-development-goals-sdg.htm).

<sup>18</sup> Mark Uhrynuk, Alexander W. Burdulia & Joey C.Y. Lee, "China Publishes Environmental and Social Disclosure Rules for Listed Companies", Mayer Brown, accessed April 22, 2022, <https://www.eyonesg.com/2021/07/china-publishes-environmental-and-social-disclosure-rules-for-listed-companies/>.

<sup>19</sup> "Transforming Our World: The 2030 Agenda of Sustainable Development" accessed April 10, 2022, <https://sdgs.un.org/2030agenda>.

<sup>20</sup> *Ibid*

To date, the research on ESG practices has mainly focused on the ESG disclosures on nonfinancial firms, with little done to evaluate the ESG practices of banks. The most available literature on ESG and banks focused on the financial performance of conventional banks in developing countries<sup>21,22</sup> and emerging economies.<sup>23</sup> For example, several works of literature focused on the relationships between ESG pillars and bank financial performance in European banks<sup>24,25</sup> and emerging economies,<sup>26</sup> and the results are not unanimous. However, the literature mentioned above does not discuss the sustainability or ESG framework as well as the ESG practices of Islamic banks, which is the main discussion of this paper. Furthermore, the dynamic of ESG and Islamic finance is still an empirical issue. This paper seeks to uncover this new area of ESG and Islamic finance by presenting an analysis of the ESG practices among the listed Islamic banks.

The increased demand for relevant data, including disclosure of the verified statement, demonstrates an interest in advancing the implementation of sustainability commitments.<sup>27</sup> This is borne by the interest of data collectors, aggregators, and financial analysts. Meanwhile, disclosure types and reporting formats continue to be diverse. In the coming years, developing a policy that ensures the disclosure of high-quality and valuable information will be critical for providing relevant information to reporting organizations' decision-

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<sup>21</sup> Batae et al., "The Relationship between Environmental, Social, and Financial Performance in the Banking Sector: A European Study," *Journal of Cleaner Production*, no. 290 (2021): 125791, <https://doi.org/10.1016/j.jclepro.2021.125791>.

<sup>22</sup> Buallay and Amina, "Is Sustainability Reporting (ESG) Associated with Performance? Evidence from the European Banking Sector. Management of Environmental Quality," *International Journal*, no. 30 (2018), <https://doi.org/10.1108/MEQ-12-2017-0149>.

<sup>23</sup> Azmi et al., "ESG Activities and Banking Performance: International Evidence from Emerging Economies," *Journal of International Financial Markets, Institutions and Money*, no. 70 (2020): 101277, <https://doi.org/10.1016/j.intfin.2020.101277>.

<sup>24</sup> *Ibid*

<sup>25</sup> *Ibid*

<sup>26</sup> *Ibid*

<sup>27</sup> "IOSCO calls for oversight of ESG Ratings and Data Product Providers", accessed May 23, 2022, <https://www.iosco.org/news/pdf/IOSCONEWS627.pdf>.

makers and stakeholders.<sup>28</sup> Assuring that this information is disclosed following established reporting frameworks and harmonizing the reporting landscape presents an opportunity for policymakers and regulators alike. Considering the matter, this paper aims to elaborate some key global frameworks used by banks to disclose their ESG practices or sustainability reporting. Secondly, the paper analyses how Islamic banks globally comply with the sustainability framework, explicitly focusing on the ESG components. The primary objective is to recommend some best practices that Islamic banks can adopt to encourage the disclosure of ESG practices.

## DEFINITION AND CLASSIFICATION OF ESG

The Global Reporting Initiative (GRI) defines ESG or sustainability reporting as the following mix of economic, environmental, social, and governance disclosure.<sup>29</sup> Sustainability reporting is measuring, reporting, and being accountable to internal and external stakeholders responsible for organizational performance in terms of sustainable development. Sustainability reporting is a broad concept used interchangeably to convey economic, environmental, and social implications (e.g., triple bottom line, corporate responsibility reporting, etc.).<sup>30</sup> The World Bank defines CSR as "businesses' commitment to act ethically and contribute to sustainable economic development by collaborating with all relevant stakeholders to improve their lives in ways that benefit business, the sustainable development agenda, and society."<sup>31</sup> Therefore, a sustainability report should give a fair and

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<sup>28</sup> *Ibid*

<sup>29</sup> "GRI, Our Mission and History", accessed April 3, 2022, <https://www.globalreporting.org/about-gri/mission-history/>.

<sup>30</sup> "GRI, IFRS Foundation and GRI to Align Capital Market and Multi-Stakeholder Standards", accessed April 3, 2022, <https://www.globalreporting.org/about-gri/news-center/ifrs-foundation-and-gri-to-align-capital-market-and-multi-stakeholder-standards/>

<sup>31</sup> Djordjija Petkoski and Nigel Twose, "Public Policy for Corporate Social Responsibility", Global e-Conference on Public Policy and Corporate Social Responsibility (CSR), accessed March 23, 2022, <https://efaidnbmnnnibpcajpcgclefindmkaj/viewer.html?pdfurl=https%3A%2F%2Fweb.worldbank.org%2Farchive%2Fwebsite01006%2FWEB%2FIMAGES%2FPUBLICPO.PDF&clen=850029&chunk=true>



realistic depiction of a reporting organization's sustainability performance, encompassing positive and negative contributions.

There has been a growing interest in sustainability disclosure among stakeholders, academics, and businesses in the last few years. Several projects have been launched to establish standards to improve sustainability reporting transparency. Globally, there are numerous NGOs that provide standards and guidelines to corporations. The GRI is arguably the most important global organization and is recognized by many as the global standard in nonfinancial reporting covering all three aspects of sustainability – social, environmental, and economic.<sup>32</sup> In 2000, GRI released the first edition of its standards for sustainability reporting. The second generation of sustainability reporting standards was released two years later, in 2002. GRI published its first taxonomy for third-generation recommendations in 2006. The fourth-generation standards, which include reporting principles, were released in 2013.

GRI continued to launch the first worldwide guidelines for sustainability reporting in October 2016. The GRI Standards are divided into four categories: universal, economic, environmental, and social, and there are sub-standards and guidelines for each standard. Companies must comprehend the significance of these standards and implement policies and procedures that will assure their future success. However, assessing corporate reporting using a standard indicator is unlikely to provide high-quality data that is relevant, comparable, and comprehensive for all stakeholders as businesses were incentivized to disclose ESG issues to reduce the possibility of financial fines.<sup>33</sup> The 2021 Universal Standards for GRI reflect the latest best practices for reporting on an organization's impacts on the economy, environment, and people, including their human rights. They represent due diligence expectations for sustainability implications issued by the United Nations (UN) and the Organization for Economic Co-operation and

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<sup>32</sup> Anne Toppinen and Kaisa Korhonen, "Global Reporting Initiative and Social Impact in Managing Corporate Responsibility: A Case Study of Three Multinationals in the Forest Industry," *Business Ethics: A European Review* 22, no. 2 (2013): 202-217.

<sup>33</sup> Daniel Murphy and Dianne McGrath, "ESG Reporting—Class Actions, Deterrence, and Avoidance," *Sustainability Accounting, Management and Policy Journal* 4, no. 2 (2013).

Development (OECD).<sup>34</sup> The greater focus on ESG measures helps provide a better understanding of a firm's sustainability<sup>35</sup> and has aided regulators in compelling businesses to disclose ESG information.<sup>36</sup>

To better understand ESG, it is essential to comprehend how ESG is classified. Refinitiv has one of the most comprehensive ESG databases in the industry, covering more than 80% of the global market capitalization and more than 500 different ESG metrics since 2002.<sup>37</sup> Refinitiv's ESG scores are intended to transparently and objectively assess a company's relative ESG performance, commitment, and effectiveness based on publicly available data.<sup>38</sup> These are classified into ten categories that reformulate the three pillar scores and the final ESG score, reflecting a company's ESG performance, commitment, and effectiveness as determined by publicly available data.<sup>39</sup> The Refinitiv Eikon Datastream introduced the most comprehensive classification, which divides the ESG into ten dimensions as described in Table 1.<sup>40</sup>

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<sup>34</sup> “Review of GRI Universal Standards”, accessed Sept 10, 2022, [https://www.globalreporting.org/media/tyghiekh/universal\\_standards\\_final\\_project\\_proposal\\_approved.pdf](https://www.globalreporting.org/media/tyghiekh/universal_standards_final_project_proposal_approved.pdf)

<sup>35</sup> Kemal Cek & Serife Eyupoglu, “Does environmental, social and governance performance influence economic performance?” *Journal of Business Economics and Management*. 21. (2020). 1165-1184. 10.3846/jbem.2020.12725..

<sup>36</sup> Zuraida Zuraida, Noor Houqe and Tony van Zijl, “Value Relevance of Environmental, Social and Governance Disclosure,” *SSRN Electronic Journal* (2016), <https://doi.org/10.2139/ssrn.2376521>.

<sup>37</sup> “An Overview of Environmental, Social and Corporate Governance – ESG”, accessed March 23, 2022, <https://www.refinitiv.com/en/financial-data/company-data/esg-data>.

<sup>38</sup> *Ibid*

<sup>39</sup> *Ibid*

<sup>40</sup> “Environmental, Social, and Governance Scores from Refinitiv, November 2021” accessed 20 March 2022, [https://www.refinitiv.com/content/dam/marketing/en\\_us/documents/methodology/refinitiv-esg-scores-methodology.pdf?clen=3135760&chunk=true](https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/refinitiv-esg-scores-methodology.pdf?clen=3135760&chunk=true).

Table 1: ESG Components

ESG Pillars	Main Categories	ESG Description
Environment	Emission	The emission reduction score measures a company's commitment and effectiveness towards reducing environmental emissions in its production and operational processes. <sup>41</sup>
	Environmental Innovation	The innovation score reflects a company's capacity to reduce its customers' environmental costs and burdens, creating new market opportunities through new environmental technologies and processes or eco-designed products. <sup>42</sup>
	Resource use	The resource use score reflects a company's performance and capacity to reduce materials, energy, or water and find more eco-efficient solutions by improving supply chain management. <sup>43</sup>
Social	Community	The community score measures the company's commitment to being a good citizen, protecting public health, and respecting business ethics. <sup>44</sup>

<sup>41</sup> *Ibid*<sup>42</sup> *Ibid*<sup>43</sup> *Ibid*<sup>44</sup> *Ibid*

	Human rights	The human rights score measures a company's effectiveness in respecting fundamental human rights conventions. <sup>45</sup>
	Product responsibility	The product responsibility score reflects a company's capacity to produce quality goods and services, integrating the customer's health and safety, integrity, and data privacy. <sup>46</sup>
	Workforce	The workforce score measures a company's effectiveness in providing job satisfaction, a healthy and safe workplace, maintaining diversity and equal opportunities, and development opportunities for its workforce. <sup>47</sup>
Governance	CSR strategy	The CSR strategy score reflects a company's practices to communicate that it integrates economic (financial), social and environmental dimensions into its day-to-day decision-making processes. <sup>48</sup>
	Management	The management score measures a company's commitment to following best

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<sup>45</sup> *Ibid*

<sup>46</sup> *Ibid*

<sup>47</sup> *Ibid*

<sup>48</sup> *Ibid*

		practice corporate governance principles. <sup>49</sup>
	Shareholders	The shareholder's score measures a company's effectiveness towards equal treatment of shareholders and the use of anti-takeover devices. <sup>50</sup>

(Source: Environmental, Social, and Governance Scores from Refinitiv, November 2021)<sup>51</sup>

## ESG REPORTING FRAMEWORK: A GLOBAL PERSPECTIVE

Companies are required to play a role in social and environmental protection in business activities, as the interests of stakeholders other than shareholders, such as communities and the environment at large, may be affected by problems caused by harmful corporate behaviour.<sup>52</sup> ESG issues are significant to investors for a variety of reasons. Some investors may only perceive them as a source of economic value, while others consider ESG issues to concern moral principles, risks, and opportunities. Investors who consider ESG issues, whether motivated primarily by economic value, moral principles, or a combination of the two, may help bring about constructive change in society and the environment.

Several principles, standards, and organizations serve as a common reference point for investors considering ESG issues, including the United Nations SDGs, GRI, the Sustainability Accounting Standards Board (SASB), and Principles for Responsible Investment (PRI).

<sup>49</sup> *Ibid*

<sup>50</sup> *Ibid*

<sup>51</sup> *Ibid*

<sup>52</sup> Safrina Safrina, "Why CSR Is Relevant To Environmental Protection? A Study Of CSR Performance On Indonesian Limited Liability State-Owned Companies," *IJUM Law Journal* 29, no. 2 (2021): 43-67. [https://doi.org/10.31436/iiumlj.v29i\(S2\).679](https://doi.org/10.31436/iiumlj.v29i(S2).679).

These bodies' publications influence practices in both ESG investing and Islamic finance.

### International Frameworks and Guidelines

There are several internationally accepted sustainability frameworks and guidelines with complementarities and synergies. Some have comprehensive sustainability scope, while others are aimed at specific sectors or focused on a single issue such as greenhouse gas emissions, climate change, or the impacts of business activity on sea or forests.<sup>53</sup> Table 2 lists these frameworks, along with brief explanations of each.

Table 2: Sustainability Frameworks

No.	International Framework	Brief Description of Framework
1	Sustainable Development Goals (SDGs)	The SDGs are intended to apply to all countries – rich, poor, and middle-income – to promote prosperity while safeguarding the environment and addressing climate change. They emphasized equity to meet the unique needs of women, children, and disadvantaged populations to ensure that "no one is left behind." <sup>54</sup>
2	Global Reporting Initiatives (GRI)	Corporate social responsibility with equal weight on environmental, social, and governance factors. Heavy on

<sup>53</sup> Khariyah Mat Yaman and Zuhairah Ariff Abd Ghadas, "Sustainable Construction in the Digital Age: Special Reference to Theories of Sustainability and SDGs in Green Building," *IIUM Law Journal* 30, no. 1 (2022): 35-68, <https://doi.org/10.31436/iiumlj.v30iS1.698>.

<sup>54</sup> "Sustainable Development Goals", accessed March 22, 2022, [https://www.who.int/health-topics/sustainable-development-goals#tab=tab\\_1](https://www.who.int/health-topics/sustainable-development-goals#tab=tab_1).

		stakeholder engagement to determine materiality. GRI requires the company to conduct a materiality assessment to identify the topics material to their business. <sup>55</sup>
3	The Sustainability Accounting Standard Board (SASB)	SASB's mission is to bring organizations and investors together to discuss the financial implications of ESG. Industry-specific standards prioritize the material aspects of a business's sustainability performance. <sup>56</sup>
4	Principle for Responsible Investment (PRI)	The PRI defines responsible investment as a strategy and practice incorporating environmental, social, and governance (ESG) factors in investment decisions and active ownership. <sup>57</sup>
5	Task Force on Climate-related Financial Disclosures (TCFD)	The Task Force was created to develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters

<sup>55</sup> “GRI, Consolidated Set of GRI Standards 2021”, accessed March 22, 2022, <https://www.globalreporting.org/standards/>.

<sup>56</sup> “Understanding SASB Standards”, accessed March 22, 2022, <https://www.sasb.org/standards/>.

<sup>57</sup> “An Introduction to Responsible Investment”, accessed March, 22, 2022. <https://www.unpri.org/investment-tools/an-introduction-to-responsible-investment>.

		appropriately assess and price climate-related risks. <sup>58</sup>
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Source: Author's own source

As mentioned in Table 2, The United Nations adopted the SDGs in 2015 as a universal call to action to end poverty, protect the environment, and ensure that by 2030, all people enjoy peace and prosperity. The SDGs, which have become part of national public policy in many countries, stand as an official declaration of the unacceptable economic and financial behaviour of individuals, firms, and corporations that has caused enormous disruption to nature and human life.<sup>59</sup> The call for all economic and financial decisions to include the sustainability of all stakeholders has been central to international organizations' policies, led by the UN SDGs. The nature of global crises is not limited to a single country but calls for an organized, systemic, and global mobilization. Every stakeholder, including banks and financial institutions, must participate. The 17 SDGs are interconnected; they recognize that actions taken in one area affect outcomes in other areas and that development must strike a balance between social, economic, and environmental sustainability.<sup>60</sup>

According to the KPMG Report in 2020, GRI is the world's most widely adopted sustainability reporting framework. GRI was named the UN Global Compact's official reporting standard, making it the default reporting framework for more than 5,800 associated businesses.<sup>61</sup> It is one of the world's oldest, most widely used, and most respected reporting methodologies. GRI provides companies with standards to report their ESG information to all stakeholder groups.<sup>62</sup> It is a holistic approach to reporting and strives to provide information

<sup>58</sup> "TCFD- Task Force on Climate-Related Financial Disclosure", accessed March 22, 2022, <https://www.unepfi.org/climate-change/tcfd/>.

<sup>59</sup> "Transforming Our World: The 2030 Agenda for Sustainable Development" accessed April 3, 2022, <https://sdgs.un.org/2030agenda>.

<sup>60</sup> *Ibid*

<sup>61</sup> "The Time has Come. The KPMG Survey of Sustainability Reporting 2020", accessed April 3, 2022, <https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/11/the-time-has-come.pdf>.

<sup>62</sup> *Ibid*



comparably. They are intended to deliver a high-level overview and a detailed breakdown of the organization's material topics.<sup>63</sup>

SASB offers disclosure standards for more than 75 industries to ensure that information disclosed is most pertinent to an organization's financial performance.<sup>64</sup> The standards prioritize financially material aspects to aid in the decision-making process for business and investment. SASB Standards guide how to report material information and can be used with other frameworks.<sup>65</sup>

An international group of institutional investors developed the Principles for Responsible Investment (PRI) in response to the growing importance of environmental, social, and corporate governance issues in investment practices.<sup>66</sup> Kofi Annan, the then-Secretary-General of the United Nations, invited a group of world's largest institutional investors to participate in a process to develop the PRI in early 2005.<sup>67</sup> A 20-member investor group comprised of representatives from institutions in 12 countries was aided by a 70-member expert panel consisting of representatives of the investment industry, intergovernmental organizations, and civil society.<sup>68</sup> The PRI works to achieve this sustainable global financial system by encouraging the adoption of the principles and collaboration on their implementation, promoting good governance, integrity, and accountability, and addressing impediments to a sustainable financial system inherent in market practices and structures and regulation.<sup>69</sup>

The Task Force on Climate-related Financial Disclosures (TCFD) is an initiative launched in December 2015 by the FSB (Financial Stability Board), an international organization founded with the support of G20 members to promote global financial stability.<sup>70</sup> The

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<sup>63</sup> *Ibid*

<sup>64</sup> "Understanding SASB Standards", accessed March 22, 2022, <https://www.sasb.org/standards/>.

<sup>65</sup> *Ibid*

<sup>66</sup> "PRI (2017a) A Blueprint for Responsible Investment", accessed April 10, 2022, <https://www.unpri.org/download?ac=5330>.

<sup>67</sup> *Ibid*

<sup>68</sup> *Ibid*

<sup>69</sup> *Ibid*

<sup>70</sup> "Recommendations of the Task Force on Climate-Related Financial Disclosures", accessed April 10, 2022, <https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf>.

TCFD's mission is to assist investors, lenders, and insurance underwriters in identifying the information necessary to appropriately assess and price climate-related risks and opportunities and to make recommendations regarding consistent corporate disclosures that will assist financial market participants in assessing their climate-related risks.<sup>71</sup>

Multiple market development and heightened regulatory and legal scrutiny indicate that the importance of transparency and accuracy of ESG reporting is on the increase. Regulators and investors increasingly demand the communication of a thorough sustainability assessment and management of related risks and opportunities. Table 3 listed significant initiatives of countries' market drivers to enhance the ESG reporting landscape. The initiatives taken by countries such as Malaysia, Indonesia, Singapore, Philippines, Hong Kong, and Thailand are discussed in Table 3.

Table 3: Initiatives by Countries to enhance ESG Reporting

No	Country	Brief Description of Initiatives
1	Malaysia	Bursa Malaysia published sustainability reporting guides for companies to adopt Task Force on Climate-Related Financial Disclosures (TCFD) recommendations. <sup>72</sup>
2	Indonesia	Under Indonesia Financial Services Authority, all listed companies are required to publish sustainability reports. <sup>73</sup>
3	Singapore	Singapore Exchange (SGX) introduced sustainability reporting on a "comply or explain" basis and mandated all SGX-listed

<sup>71</sup> *Ibid*

<sup>72</sup> "Sustainability Reporting Guide, 2nd Edition", accessed April 15, 2022, [bursasustain.bursamalaysia.com/droplet-details/resources/sustainability-reporting-guide-2nd-edition](https://bursasustain.bursamalaysia.com/droplet-details/resources/sustainability-reporting-guide-2nd-edition).

<sup>73</sup> "Indonesia Stock Exchange", accessed April 15, 2022, <https://sseinitiative.org/stock-exchange/idx/>.

		issuers to prepare yearly sustainability reports. <sup>74</sup>
4	Philippines	SEC Philippines released the Sustainability Reporting Guidelines for Publicly Listed Companies and required companies to attach their sustainability reports to their annual reports. <sup>75</sup>
5	Hong Kong	HKEX released the Environmental, Social, and Governance Reporting Guide that set out the "comply or explain" matters and encouraged disclosing additional ESG issues and KPIs. <sup>76</sup>
6	Thailand	Thailand's SEC issued a new Corporate Governance Code which required that a company's board ensures adequate sustainability reporting. <sup>77</sup>

Source: Author's own source

As discussed in Table 3, the initiatives taken by various countries indicate a positive development where different kinds of policies and regulations are being developed to promote ESG or sustainability reporting. The next section of this paper discusses ESG reporting and Islamic finance.

<sup>74</sup> "Sustainability Reporting", accessed April 15, 2022, <https://www.sgx.com/regulation/sustainability-reporting>.

<sup>75</sup> "Sustainability Reporting for Listed Companies", accessed April 15, 2022, <https://www.sec.gov.ph/wp-content/uploads/2019/10/2019MCNo04.pdf>.

<sup>76</sup> "Environmental, Social and Governance Reporting Guide", accessed April 15, 2022, <https://en-rules.hkex.com.hk/node/1892>.

<sup>77</sup> "CG Thailand for Sustainability of Business and Society", accessed April 15, 2022, [https://www.sec.or.th/cgthailand/EN/Pages/CGCode/CGCodePart02\\_2.aspx](https://www.sec.or.th/cgthailand/EN/Pages/CGCode/CGCodePart02_2.aspx).

## ESG REPORTING AND ISLAMIC FINANCE

Islamic finance and ESG share similar principles of being an excellent steward to society and the environment by preventing harm and attaining benefits from products and services offered.<sup>78</sup> In Islamic finance, negative screening is the most commonly used ESG strategy.<sup>79</sup> To comply with Islamic restrictions, Islamic financial institutions must conduct negative screening on the client's core business.<sup>80</sup> Islamic finance should not invest in activities that are prohibited by Islam, such as *riba*-based businesses, excessive *gharar*, alcohol, pornography, or gambling.

The banking and financial services sector responds much slower than other sectors to sustainability challenges.<sup>81</sup> One empirical research found that bank disclosures did not focus on environmental impact.<sup>82</sup> Similarly, one study found that the financial sector was still behind other sectors in managing environmental and social effects<sup>83</sup> causing the financial industry faces sustainability challenges. Financial institutions have suffered public discredit and distrust due to their unfavourable situation during the economic crisis. Various industries that Islamic banks finance, such as agriculture, transportation, manufacturing, mining, and healthcare, have substantial ESG challenges and Islamic banks are expected to share risks with those they fund.<sup>84</sup> Therefore, sustainability practice is critical for

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<sup>78</sup> “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals”, accessed June 14, 2022, [www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investinga-guide-for-investment-professionals.ashx](http://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investinga-guide-for-investment-professionals.ashx).

<sup>79</sup> *Ibid*

<sup>80</sup> *Ibid*

<sup>81</sup> Marcel Jeucken, *Sustainable Finance and Banking: The Financial Sector and the Future of the Planet*, 1st ed. (London: Routledge, 2001), <https://doi.org/10.4324/9781849776264>

<sup>82</sup> *Ibid*

<sup>83</sup> Robert Earhart et al., “*Sustainable Banks: Trust and Leadership the Role of the State within Private Banks*,” Working paper in progress, Sustainable Banking and Public Policy Consortium, 2020.

<sup>84</sup> Mohammad Hassan Shakil et al., “Do Environmental, Social and Governance Performance Affect the Financial Performance of Banks? A Cross-Country Study of Emerging Market Banks,” *Management of Environmental Quality an International Journal* 30, no. 3 (2019): 1331-1344.

establishing and maintaining trust in Islamic banks.<sup>85</sup> An effective management instrument offers stakeholders confidence as the company is perceived as responsible and trustworthy as the businesses they finance.<sup>86</sup>

The financial sector has started to recognize that their activities affect and are affected by the environment.<sup>87</sup> After the financial crisis in 2008, some banks could survive and continue to grow, while others collapsed.<sup>88</sup> Banks that survived and grew were those that operated sustainably and focused on environmental, social, and governance practices.<sup>89</sup> Thus, banks must focus on ESG and financial value to develop sustainably, considering the significant impact of banks and financial institutions on the economy.<sup>90</sup>

Sectors and industry-focused reporting provisions become critical in securing the disclosure of more relevant and material information, considering the context of individual industries and their value chains. While the financial sector has always been an essential tool for development throughout history, in recent years, capital expansion within the financial industry has become the goal on its own rather than a tool for promoting economic activity and growth for the country. As a result, the financial sector has grown through manufactured products and methods, further separating it from the real economy.<sup>91</sup>

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<sup>85</sup> Pablo Rodríguez Gutiérrez, Fernando Fuentes García and Sandra Sanchez, "Transparency in Social Disclosure in Financial Institutions through Spanish CSR Reports in the Context of Crisis," *Universia Business Review* 2 (2013): 84-107.

<sup>86</sup> Belén Fernandez-Feijoo, "Crisis and Corporate Social Responsibility: Threat or Opportunity?," *International Journal of Economic Sciences and Applied Research* 2, no. 1 (2009): 36-50.

<sup>87</sup> Kent Matthews and John Thompson, *The Economics of Banking*, 2nd ed. (Wiley, 2008)

<sup>88</sup> Robert Earhart et al., "Sustainable Banks: Trust and Leadership the Role of the State within Private Banks," Working paper in progress, Sustainable Banking and Public Policy Consortium, 2020.

<sup>89</sup> *Ibid*

<sup>90</sup> Dragan (Santamarian) and Oana Raluca, "Pathways to sustainable banking management," *Annals of The University of Oradea, Economic Science Series* 21, no. 2 (2012): 545-550.

<sup>91</sup> Ahmad Ali Jan, Fong-Woon Lai and Muhammad Tahir, "Developing an

Islamic banking was founded on higher social justice objectives: developing risk-sharing financial intermediation for socially responsible economic activities.<sup>92</sup> As a result, the pioneering Islamic banks were formed as investment houses. The savers invest their funds in a profit-and-loss sharing investment with the Islamic Bank, such as *Mudarabah*. The Islamic Bank will then invest the funds on a profit-and-loss sharing basis with its individual and corporate customers.<sup>93</sup> Risk-sharing ventures result in more equitable wealth distribution. Investors take on risk for a corresponding return and are compensated when entrepreneurs profit. The greater the profit earned the greater the investors' share. If no profit is generated, there is no return on investment. Compared to interest-based lending, the lender receives a fixed rate of return regardless of whether the borrower incurs a loss.<sup>94</sup>

Islamic Banking's second objective is to invest funds solely in socially responsible economic activities.<sup>95</sup> Islamic banking has developed various tools, such as proceeds tests, screening methodologies, and certification processes, to help investors avoid investing in socially harmful sectors such as alcohol, gambling, speculative trades, and weapons.<sup>96</sup> These activities are viewed as socially detrimental and are therefore prohibited by God. Today, the sustainable and green finance industries use similar tools to avoid financing or investing in businesses that violate ESG standards.<sup>97</sup>

Western markets have dominated responsible finance, which has grown dramatically, but this should not obscure emerging markets' future growth potential. With a population of 1.65 billion Muslims, most of whom live in emerging markets throughout the Organization of Islamic Cooperation (OIC) countries, there is a sizable opportunity

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Islamic Corporate Governance Framework to Examine Sustainability Performance in Islamic Banks and Financial Institutions,” *Journal of Cleaner Production* 315, no. 1 (2021): 128099, <https://doi.org/10.1016/j.jclepro.2021.128099>.

<sup>92</sup> “Islamic Banking”, accessed May 2, 2022, <https://www.islamic-banking.com/explore/islamic-finance/islamic-banking>

<sup>93</sup> *Ibid*

<sup>94</sup> *Ibid*

<sup>95</sup> *Ibid*

<sup>96</sup> *Ibid*

<sup>97</sup> *Ibid*

to profit from offering products that adhere to their values.<sup>98</sup> However, Muslims' investing values substantially overlap with what is viewed as socially responsible. Prior research indicates that Islamic businesses have more robust environmental and social practices.<sup>99</sup> Islamic banks are expected to perform well in the environmental dimension of ESG, as they offer a diverse range of products and schemes that exclusively support climate-friendly investments, such as Green Sukuk. Additionally, the prohibition of *riba* (interest), profit/loss and risk-sharing, and the assurance of social equity, justice, and inclusion through *zakat* and other similar schemes, make Islamic banks more vocal proponents of social responsibility.<sup>100</sup> Finally, an independent Shari'ah board ensures that Islamic banks have more robust governance mechanisms and institutional quality than their conventional counterparts.<sup>101</sup>

The ESG requirements are entirely consistent with Islamic values-based investments, which prioritize minimizing harm and maximizing benefit to society, including the environment. Avoiding investments in companies that pollute the environment, harm the ecosystem, use child labour, or forced labour, or fail to provide diversity and equal opportunity, among other things, are consistent with Shari'ah higher objectives. Although Islamic banks have historically focused on a narrow definition of prohibition around Islamic law prohibitions such as alcohol, tobacco, and gambling, they are beginning to broaden their intention to include ESG considerations. Additionally, research from Refinitiv's EIKON database, which covers over 6,500 publicly traded companies, demonstrates a strong correlation between Shari'ah compliance screening and improved ESG performance.<sup>102</sup> According

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<sup>98</sup> Mumtaz Hussain, A. Shahmoradi and Rima Turk Ariss, "An Overview of Islamic Finance," *Journal of International Commerce, Economics and Policy* (JICEP) 7, no. 1 (2016): 1-28, <https://doi.org/10.1142/S1793993316500034>.

<sup>99</sup> Abdul Qoyum et al., "Does the Islamic Label Indicate Good Environmental, Social, and Governance (ESG) Performance? Evidence from Sharia-Compliant Firms in Indonesia and Malaysia," *Borsa Istanbul Review* 22, no. 2 (2021), <https://doi.org/10.1016/j.bir.2021.06.001>.

<sup>100</sup> *Ibid*

<sup>101</sup> *Ibid*

<sup>102</sup> "Islamic Finance ESG Outlook 2019 Shared Values", accessed May 10, [https://www.refinitiv.com/content/dam/marketing/en\\_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf](https://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf).

to Refinitiv's Islamic Finance ESG Outlook 2019, Shari'ah-compliant companies have an average ESG score of 6% higher than those not subject to the Shari'ah screening process. The research suggests combining Shari'ah and ESG screening may improve overall risk-adjusted return on investments.<sup>103</sup>

The responsible finance industry includes investors focused on both impact and returns. This group of investors is preoccupied with the effects of their investments on their social responsibility concerns, even if it means preceding financial gains.<sup>104</sup> On the other hand, investors' primary objective is to maximize their economic profits without jeopardizing widely shared ESG standards that adversely affect others. Islamic finance has benefited from standard-setting organization, most notably the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which was established in 1990, and the Kuala Lumpur-based Islamic Financial Services Board (IFSB), which was established in 2002. The AAOIFI has a corporate social responsibility guideline known as "Corporate Social Responsibility, Conduct, and Disclosure for Islamic Financial Institutions," which outlines mandated and voluntary activity and acts as a common reference point in Islamic banking.<sup>105</sup>

Various Islamic finance professionals believe the industry offers a viable solution to the world's economic and social problems. Many also see parallels with the largely secular, socially responsible sector and acknowledge its faith-based history.<sup>106</sup> However, not everyone in the Western world views anything 'Islamic' with the same optimism; instead, they view areas of the world where Muslims are the majority as growth opportunities, whether emerging or developing markets. Correcting some misconceptions about Islamic finance's objectives and demonstrating the socially responsible sector's shared faith-based foundations can help bridge the divide between the two industries.

Additionally, Islamic finance offers a unique perspective on sustainability that transcends asset classes and places a premium on the

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<sup>103</sup> *Ibid*

<sup>104</sup> *Ibid*

<sup>105</sup> "Corporate Social Responsibility, Conduct, and Disclosure for Islamic Financial Institutions" accessed May 2, 2022, <http://aaoifi.com/themencode-pdf-viewer-sc>.

<sup>106</sup> *Ibid*



broader economic activity enabled by financial services.<sup>107</sup> At the same time, much of the responsible finance industry has shifted towards viewing the investment criteria that define it as responsible as an add-on to financial criteria; Islamic finance places responsibility at the heart of the entire financial sector rather than separating it.

Due to the high degree of complementarity between Islamic and ESG investing, Islamic investment managers have reached a broader investor base, including socially responsible investors outside of Islamic jurisdictions looking to diversify their portfolios.<sup>108</sup> Numerous factors have contributed to the increased alignment of Islamic finance and ESG. To start, regulators increasingly require banks in general, and Islamic banks, to consider and report on their activities' ESG impact.<sup>109</sup> Shari'ah-sensitive investors are also increasingly concerned with Shari'ah compliance and the ESG impact of their investments, particularly in the pandemic aftermath. Second, a critical pillar of Islamic finance is a negative screening of Shari'ah-compliant products to avoid industries deemed to be illegal or unethical, such as tobacco, alcohol, weapons, and gambling, a practice used in ESG investing. Shari'ah scholars are also increasingly advocating for "positive screening," in which Islamic banks must consider Shari'ah compliance and social and environmental responsibility.

Islamic finance is a rapidly growing industry. By the end of 2019, the sector had increased by 14% to US\$2.88 trillion in assets, and global Islamic finance assets are expected to reach \$3.69 trillion in 2024, according to Refinitiv and the Islamic Corporation for the Development of the Private Sector's 2020 Islamic Finance Development Report.<sup>110</sup> In reaction to these trends, significant

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<sup>107</sup> "Empowering Sustainability and ESG Integration in Islamic Finance" accessed May 2, 2022, <https://www.thejakartapost.com/academia/2021/06/25/empowering-sustainability-and-esg-integration-in-islamic-finance-.html>.

<sup>108</sup> "Islamic Finance ESG Outlook 2019 Shared Values", accessed May 10, [https://www.refinitiv.com/content/dam/marketing/en\\_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf](https://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf).

<sup>109</sup> *Ibid*

<sup>110</sup> "ICD-REFINITIV Islamic Finance Development Report 2020, Progressing Through Adversity" accessed May 10, 2022, [https://icd-ps.org/uploads/files/ICDRefinitiv%20IFDI%20Report%2020201607502893\\_2100.pdf](https://icd-ps.org/uploads/files/ICDRefinitiv%20IFDI%20Report%2020201607502893_2100.pdf).

advances in the financial sector have occurred, including the emergence of green bonds and green Sukuk.<sup>111</sup> Similarly, the rising attention on sustainable development in financial markets and the emerging private and public efforts present significant prospects for sustainable finance in general and Islamic finance in particular. To respond to these demands and opportunities, Islamic banks and financial institutions must develop the necessary frameworks, mechanisms, practices, and measurements to demonstrate their sustainable development credibility in economic, social, environmental, and governance spheres.<sup>112</sup>

As the industry grows in the coming years, there is an unprecedented opportunity for Islamic finance and ESG to converge and drive global sustainable investment. Islamic finance and ESG investing are complementary approaches to capital raising and investing that share several fundamental principles. Islamic finance is based on the principles of justice, empowerment of all stakeholders, ethical behaviour, and social responsibility – all of which are central to sustainability efforts and initiatives.

### **ESG Reporting and Islamic Finance – Malaysia Perspective**

Countries with more vital ESG standards, including Malaysia, have generally been safer and more resilient to the COVID-19 pandemic's disruptions.<sup>113</sup> Simultaneously, Islamic finance has demonstrated resilience during this difficult period through the continued issuance of green and sustainable Sukuk – a trend expected to continue in the short-to-medium term.<sup>114</sup> In 2014, Malaysia's Securities Commission introduced the Framework for Sustainable and Responsible Investment Sukuk. Its sovereign wealth fund, Khazanah Nasional Berhad, issued

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<sup>111</sup> *Ibid*

<sup>112</sup> *Ibid*

<sup>113</sup> Nor Fadzlina Nawi et al., “Policy, Legal and Regulation Research in The Sharing Economy: A Bibliometric Analysis and Systematic Literature Review,” *IIUM Law Journal* 30, no. 1 (2022) :1-33, <https://doi.org/10.31436/iiumlj.v30iS1.697>.

<sup>114</sup> Ahmed W. Alam, Hasanul Banna and M. Kabir Hassan, “ESG Activities and Bank Efficiency: Are Islamic Banks Better?” *Journal of Islamic Monetary Economics and Finance* 8, no. 1 (2022), <https://doi.org/10.21098/jimf.v8i1.1428>

the first social impact Sukuk. BIMB, Malaysia's Islamic fund manager, signed the United Nations-backed Principles for Responsible Investment (UNPRI) in 2019 to incorporate ESG considerations into investments.

Bank Negara Malaysia (BNM) has already started getting Islamic banks to embrace ESG considerations and SDGs by launching the Value-based Intermediation (VBI) - to promote the Islamic banking industry to adopt the universal values in their banking practices.<sup>115</sup> In July 2017, the BNM published a strategic paper on VBI outlining strategies for enhancing Islamic banks' roles and impact in fostering a sustainable financial ecosystem. Bank Islam Malaysia Berhad, Bank Muamalat Malaysia, Agrobank, CIMB Islamic Bank Berhad, and HSBC Amanah Malaysia Berhad, the founding members of the VBI Community of Practitioners (CoP), collaborated on the VBI programme. The VBI is defined as an intermediation function that aims to achieve Shari'ah intended outcomes through practices, conduct, and offerings that positively impact the economy, community, and environment while also serving the shareholder's long-term interests.<sup>116</sup>

According to the VBI strategy paper, the Islamic finance industry is driven solely by a narrow focus on profitability, with little or no input from other stakeholders.<sup>117</sup> At the same time, good conduct reflects the regulatory environment and is not evidence of any higher goals.<sup>118</sup> VBI aims to change this by shifting the focus to a "triple bottom line" approach from the Global Alliance for Banking on Values (GABV).<sup>119</sup> The VBI scorecard will be used as a self-assessment tool by the banks. The scorecard will grade Islamic financial institutions on a scale ranging from "emerging" to "established" based on their financial

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<sup>115</sup> Bank Negara Malaysia, *Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance*, (Bank Negara Malaysia, 2018), accessed 9 April 2022, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/<https://www.bnm.gov.my/documents/20124/761682/Strategy+Paper+on+VBI.pdf/b299fc38-0728-eca6-40ee-023fc584265e?t=1581907679482>.

<sup>116</sup> *Ibid*

<sup>117</sup> *Ibid*

<sup>118</sup> *Ibid*

<sup>119</sup> Global Alliance for Banking on Values, "Principles", accessed April 9, 2022, <https://www.gabv.org/about-us/>.

performance and conduct in the real economy.<sup>120</sup> Thus, VBI embodies a vision for Malaysia's Islamic finance future. A system in which sustainable banks collaborate with active stakeholders to mitigate negative externalities and better align the banking industry with Malaysia's national objectives.<sup>121</sup>

Banks in Malaysia are also promoting various ESG initiatives, with the BNM developing a taxonomy that defines a green loan and requires banks to indicate whether certain loans are green and, if so, how green. Affin Hwang Bank structured the world's first SRI Sukuk in 2017 for Tadau Energy to finance the construction of a solar farm in Sabah. In 2018, it arranged another SRI Sukuk for a solar project at Universiti Teknologi MARA – the first green financing by a public university in Malaysia.<sup>122</sup>

## ESG REPORTING PRACTICES AND ISLAMIC BANKS

Integrating nonfinancial issues, such as environmental and social impact, alongside standard economic considerations is what sustainability integration in financing and investing activities entails. Because banks are a country's principal source of financing, their role in boosting influence is critical.<sup>123</sup> In this context, a bank's investment and financing decisions should consistently incorporate sustainability factors with lower environmental and social risks, thereby optimizing the relationship between financial risk and environmental and social risk. Regarding the Islamic financing modes, the Islamic banks should prioritize sustainable finance strategies and instruments such as green Sukuk, SRI Sukuk, and sustainability Sukuk, in which the funds are

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<sup>120</sup> Bank Negara Malaysia, *Value-based Intermediation Scorecard (Consultative Document)*, (Bank Negara Malaysia, 2018) accessed 9 April 2022, <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.bnm.gov.my/documents/20124/759040/Value-based+Intermediation+Scorecard+%28Consultative+Document%29.pdf>.

<sup>121</sup> *Ibid*

<sup>122</sup> The World Bank. (2017). Green Sukuk, accessed on Sept 10, 2022, from <http://www.worldbank.org/en/news/infographic/2017/09/19/malaysia-green-sukuk>

<sup>123</sup> Bert Scholtens and Sophie van't Klooster, "Sustainability and Bank Risk," *Palgrave Communications*, no. 5 (2019): 1-8, <https://doi.org/10.1057/s41599-019-0315-9>.

committed to environmental and/or social impact projects. Table 4 lists examples of ESG criteria assessed in investment decisions.

Table 4: Examples of ESG Considerations in Financing and Investment Decisions

ESG Pillars	Category	Example
Environment	Climate change	Carbon emissions, climate change mitigation, climate change adaptation, environmental strategy, sustainable agriculture
	Pollution	Air polluting emissions, spills, waste prevention, and management
	Water	Use of water resources, water management, and conservation
	Energy	Energy consumption, energy resources management
	Biodiversity	Land, flora, and fauna diversity
	Animal welfare	Animal testing
Social	Financial inclusion	Islamic social financing, diversity, and inclusion
	Women empowerment	Women entrepreneurs' access to finance
	Community involvement	Social impact of business operation, products and services community development
	Human capital	Diversity and inclusion, training and development
	Advancement of knowledge and art	Awareness, education, and art-related activities

Governance	Corporate governance	Board skills, the balance of power and authority within the board, quality of accounting and audit, management turnover, shareholders' rights, disclosure of remuneration, Board independence and expertise
	Market behaviour and business ethics	Blocking competition, short-selling, transparency for investors business integrity, executive pay

Source: CIBAFI adapted from OECD, 2020

## DISCUSSION

Table 5 produces a total of 12 listed Islamic banks located in Saudi Arabia (4), UAE (3), Qatar (3), and Kuwait (2). The information was derived from Refinitiv, also known as Refinitiv Eikon, hosted by Thomson Reuters for the year 2020. Refinitiv captures company-level ESG measures of the most comparable material per industry. These are grouped into ten categories that reformulate the three pillar scores and the final ESG score, reflecting the company's ESG performance, commitment, and effectiveness based on publicly reported information.<sup>124</sup> The category scores are rolled up into three-pillar scores – environmental (Env), social (Soc), and corporate governance (Gov). The ESG pillar score is a relative sum of the category weights, which vary per industry for the environmental and social categories.<sup>125</sup> For governance, the weights remain the same across all sectors. The pillar weights are normalized to percentages ranging between 0 and 100.<sup>126</sup>

The review is based on the four dimensions and ten subdimensions related to ESG. The four main scores, as mentioned previously, were the ESG total score (ESG) and its dimensions consisting of Environmental score (3 subdimensions), Social score (four

<sup>124</sup> “Environmental, Social and Governance Score from Refinitiv” Refinitiv, May 2022, [https://www.refinitiv.com/content/dam/marketing/en\\_us/documents/methodology/refinitiv-esg-scores-methodology.pdf](https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/refinitiv-esg-scores-methodology.pdf).

<sup>125</sup> *Ibid*

<sup>126</sup> *Ibid*

subdimensions), and Governance score (3 subdimensions). The review of the total ESG score and its three main dimensions can be seen in Table 5. ESG data with its ten subdimensions used in this study are detailed in Table 6. These dimensions are resource use, emission, environmental innovation, workforce, human rights, community involvement, product responsibility, management, shareholder, and CSR strategy. The results provide a comprehensive analysis of the current ESG practices by the Islamic banks regarding the ESG issues.

Table 5: List of Islamic Banks and Countries

No	Country	Islamic Banks
1	Saudi Arabia	Al Rajhi Bank
2		Alinma Bank
3		Bank Albilad
4		Bank Aljazira
5	UAE	Dubai Islamic Bank
6		Abu Dhabi Islamic Bank
7		Ajman Bank
8	Qatar	Qatar Islamic Bank
9		Qatar International Islamic Bank
10		Masraf Al Rayan
11	Kuwait	Boubyan Bank
12		Kuwait International Bank

Source: Refinitiv Eikon

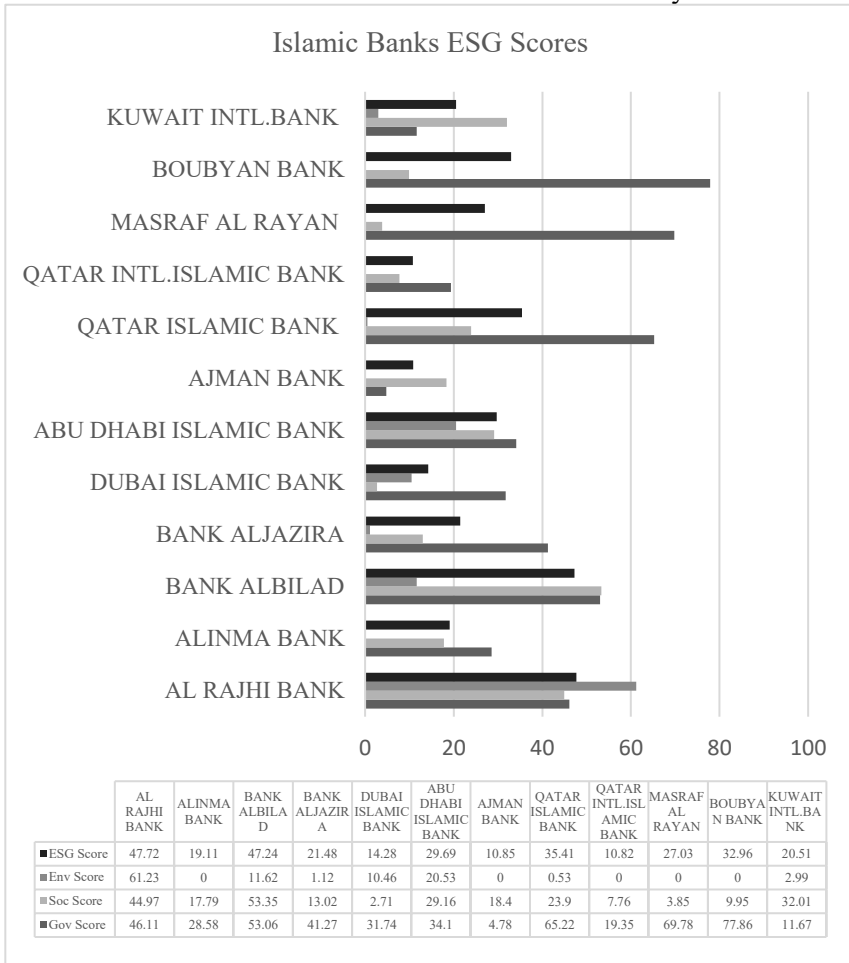
As per Table 6, overall, the three ESG dimensions scores tend to align with total ESG scores for the Islamic banks. However, some nuances are visible in the ESG pillars among the different Islamic

banks. Al Rajhi Bank (Saudi Arabia) displays the highest Environmental score (61.23%), Bank Albilad (Saudi Arabia) the highest social score (53.35%), and Boubayan Bank (Kuwait) the highest governance score (77.86%). As for the aggregate or total score, Al Rajhi Bank displays the highest score (47.72%), while Qatar International Islamic bank falls short of its peers among this group of Islamic banks not only concerning the overall ESG score but also for the scores in each of the three dimensions. While some banks show relatively good ESG performance (scores between 50% - 75%) on the social and governance dimensions, most Islamic banks in this study performed poorly in the environmental dimension. This is the category of ESG where Islamic banks need to demonstrate significant improvements. According to Refinitiv, companies that score between 0% to 8.33% indicate poor relative ESG performance and insufficient transparency in reporting material ESG data to the public.

Table 7 summarizes the score of the 10 ESG subdimension. For the environmental innovation subdimension, only Al Rajhi bank indicates good relative ESG performance (79.8%) in reporting material ESG data, while the other 11 Islamic banks' scores were zero. However, the other two environmental subdimensions (resource use and emissions) also show an average score of ESG laggards (score less than 25%). As for the social pillar of the ESG, the product responsibility dimension has the highest average score compared to the other three subdimensions. This suggests that customers of Islamic banks care about a bank's product responsibility and thus purchase products and services from institutions that are providing products consistent with the Shari'ah. Islamic banks that do not abide by Shari'ah may lose customer confidence in the products. For the shareholder subdimension in the governance pillar, four Islamic banks score above 90%, which indicates excellent relative ESG performance in reporting material ESG data to the public.



Table 6: ESG Scores of Listed Islamic Banks for the year 2020



Source: Refinitiv Eikon

Table 7: ESG Sub Scores of Listed Islamic Banks for the year 2020

No	Country	Islamic Banks	ESG Pillars									
			Environmental			Social				Governance		
			Resource	Emissions	Env	Workforce	Human	Community	Product	Management	Shareholder	CSR
1	Saudi Arabia	Al Rajhi Bank	45.1	3.2	79.8	72.3	0	15.8	74.3	38.8	46.3	82.7
2		Alinma Bank	0	0	0	25.5	0	11.0	29.6	23.8	63.8	0
3		Bank Albilad	43.9	25.8	0	53.3	26.7	59.4	74.3	43.8	90.0	44.2
4		Bank Aljazira	67	0	0	12.7	0	11.7	29.6	33.8	90	5.8
5	UAE	Dubai Islamic Bank	30.4	32.3	0	44	0	42	0	19.6	93.5	0
6		Abu Dhabi Islamic Bank	74.1	49.1	0	60.7	0	23.3	0	31.0	95	86.7

7		Ajman Bank	0	0	0	0.9	0	10.1	88.0	6.5	2.2	0
8		Qatar Islamic Bank	0	3.2	0	17.7	0	48.8	29.6	64.1	70.7	62.5
9	Qatar	Qatar Intl. Islamic Bank	0	0	0	3.8	0	4.2	29.6	9.8	64.1	0
10		Masraf Al Rayan	0	0	0	3.84	0	9.77	0	75	98.9	0
11	Kuwait	Boubyan Bank	0	0	0	9.48	0	4.24	29.6	96.43	67.9	0
12		Kuwait Intl. Bank	0	18.0	0	18.3	0	81.3	29.6	3.57	46.4	0

Source: Author's own source

## CONCLUSION

Literature on ESG and bank efficiency is minimal.<sup>127</sup> Prior studies mainly focus on the impact of ESG on various aspects of bank performance. Furthermore, the result of ESG on the efficiency of Islamic banks is still an empirical issue. Growing academic scrutiny involves ESG and Islamic finance, with the latter being expected to be more sensitive to sustainability due to its peculiar founding

<sup>127</sup> Mashiyat Tasnia, Syed Musa Alhabshi and Romzie Rosman, "Corporate Social Responsibility and Islamic and Conventional Banks Performance: A Systematic Review and Future Research Agenda," *Journal of Sustainable Finance and Investment*, (2021): 1-21, <https://doi.org/10.1080/20430795.2021.1922063>

principles.<sup>128</sup> However, this field is even more inconclusive, with results concentrated primarily on the beneficial role of corporate ethics attributable to Shari'ah supervisory boards.

This study uses a small sample of 12 listed Islamic banks from four MENA countries: Saudi Arabia, UAE, Qatar, and Kuwait. The study finds that in 2020, the aggregate ESG score for all our samples indicates poor and satisfactory relative ESG performance. To remain competitive and relevant to conventional banks, it is urged that Islamic banks raise their understanding of the benefits of ESG practices and focus on improving their overall and subdimensions of ESG scores.

This study encounters several limitations. First, since the primary purpose is to analyse the ESG practices of Islamic banks, the study had a small sample size that only focused on the listed Islamic banks in the MENA countries. Secondly, the ESG scores for this study are only from 2020, the latest available data on the Refinitiv.

Based on the analysis related to Islamic banks in this paper, it is assumed that they lack sufficient investment in ESG-friendly activities, which is evident in their overall and subdimensions ESG scores. Therefore, the study recommends that Islamic banks pay greater attention to the benefits of ESG practices for the survival of the institutions. This finding supports the studies that found conventional banks perform better than Islamic banks in ESG practices.<sup>129</sup>

With the growth of ESG investments across Islamic finance's various asset classes, this strategic alignment will open new long-term investment trajectories and trends for Islamic finance and ESG investors while enabling Islamic financial institutions to discover new business opportunities.

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<sup>128</sup> AndreaPaltrinieri et al., "Islamic Finance Development and Banking ESG Scores: Evidence from a Cross-Country Analysis," *Research in International Business and Finance*, no. 51 (2020): 101100, <https://doi.org/10.1016/j.ribaf.2019.101100>

<sup>129</sup> Ahmed W. Alam, Hasanul Banna and M. Kabir Hassan, "ESG Activities and Bank Efficiency: Are Islamic Banks Better?" *Journal of Islamic Monetary Economics and Finance* 8, no. 1 (2022), <https://doi.org/10.21098/jimf.v8i1.1428>.