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ESG (Environmental, Social, Governance) Integration in Global Islamic Finance

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ABSTRACT

ESG integration is emerging as a game-changing influence on the world's financial systems with wide-ranging consequences for the Islamic finance industry. This research, therefore, has been designed to reach an objective that presents compatibility, challenges, and opportunities concerning ESG adoption in Islamic finance through a systematic review of 22 peer-reviewed manuscripts indexed in the Scopus database. The findings identify a good coincidence between ESG best practices and Sharia principles, as both witness vital echoes on ethical behavior, social development, and sustainability. Good harmony has been noted, though regulatory disparity, weak frameworks, and lack of awareness stand in the way. Green sukuk and international collaboration are promising pathways for the arising ESG issues. This would provide actionable insights for policymakers and financial institutions so that sustainability and ethical value creation can be encouraged at large, while positioning Islamic finance as a world leader in sustainable finance.

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1. INTRODUCTION

The integration of the Environmental, Social, and Governance dimension in the investment portfolio has emerged recently as one of the critical focuses across the world-wide financial industry owing to increasing pressure for sustainable and ethical investment practices [1]. More importantly, over these years, Islamic finance has increasingly featured among these recent changers owing to its intrinsic resonance with ethics and social responsibility. Indeed, embedded in Sharia, Islamic finance carries the banner of justice, equity, and prohibition against hurtful activities-ESG criteria per excellence, if not to say even more so. This alignment provides a unique opportunity for Islamic finance institutions to take the lead in adopting and implementing ESG standards [2].

The global financial landscape is witnessing a paradigm shift, wherein investors and stakeholders are giving long-term value creation precedence over short-term gains. ESG integration provides a means for achieving this, as it encompasses environmental stewardship, social responsibility, and good governance practices into financial decision-making. With increased ESG integration, Islamic finance is now more marketable to a wider audience and further cements its commitment to ethical finance.

Notwithstanding the promising alignment, there are several challenges that come with adopting ESG practices into Islamic finance, which include regulatory inconsistency, an absence of standardized frameworks, and a general lack of awareness among stakeholders. Moreover, while the ESG principles themselves are recognized globally, their operability within Islamic finance often needs to be advanced by reconciling the diverse interpretations of Sharia compliance across jurisdictions. These challenges, therefore, underline the importance of a structured understanding of how ESG is currently integrated into Islamic finance and what the opportunities are for further alignment.

This study systematically reviews the literature by conducting a review of 22 manuscripts indexed in the Scopus database in order to investigate the practice of ESG principles in Islamic finance. The research explores how ESG frameworks interact with Islamic financial instruments, identifies key trends and challenges, and underlines opportunities for sustainability advancement in this sector. This paper therefore synthesizes current research in the field to provide useful insights for policymakers, practitioners, and academics on how best ESG can be integrated within the Islamic finance ecosystem globally.

2. LITERATURE REVIEW

2.1 ESG Principles and Compatibility with Islamic Finance

The principles on which Islamic finance is based, including the prohibition of interest, avoidance of uncertainty, and investment in activities that benefit society, are closely related to the core principles of ESG. Various research studies have pointed out that ESG and Islamic finance share a commitment toward ethical conduct, risk management, and sustainable value creation. [3] say that since both are set on social welfare and care for the environment, Islamic financial institutions are by nature positioned to take the lead in ESG.

Research by [4] underscores the inherent compatibility of Islamic finance with governance-focused practices, particularly through the establishment of Sharia supervisory boards (SSBs). These boards ensure compliance with ethical standards, which aligns with the governance dimension of ESG. Additionally, the principles of equity and justice in Islamic finance resonate with the social dimension of ESG, promoting fairness in wealth distribution and community welfare [5].

2.2 Research Gaps

Notwithstanding the increasing literature, there are still a number of gaps regarding the operationalization of ESG principles in Islamic finance. Very few empirical studies have been conducted to assess the long-term impact of ESG integration on the financial and non-financial performance of Islamic financial institutions. Moreover, further investigation is required regarding region-specific challenges and solutions, especially for those emerging markets where Islamic finance is gaining prominence.

3. METHODS

3.1 Research Design

This research design is descriptive and exploratory, combining available knowledge on the integration of ESG into Islamic finance in pursuit of three key objectives: assessing the suitability of ESG principles for Islamic finance principles, identifying challenges that limit the adoption of ESG within the Islamic finance sector, and exploring opportunities for the improvement of ESG practices in the sector. This will be achieved through a systematic review to ensure rigor in reviewing the literature, while findings are based on high-quality, peer-reviewed sources.

3.2 Data Source and Selection Criteria

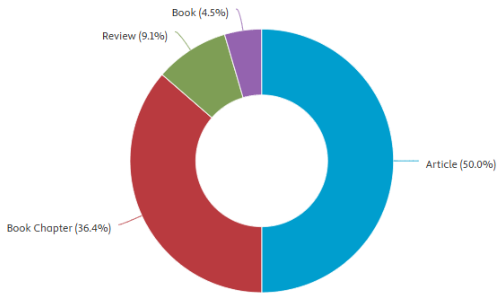

Figure 1. Data Sources

This series brings out the types of publications on the integration of ESG in Islamic finance, and leading out is articles at 50%, for thorough peer reviewing and state-of-the-art developments. The book chapter contributions stand at 36.4%, representing deep explorations or multiple investigator collaborations. At 9.1%, reviews present a systematic gathering of research materials and the spotting of trends. However, because reviews are at such a limited share, there is actually a need to call for more systematic reviews. Books form only 4.5%, but they are very informative and form both the academic and practical discourses.

The Scopus database indexes the largest number of high-impact academic journals and conference proceedings; therefore, it is used in the present study. The above inclusion criteria to enhance the relevance and rigour of the review consist of: only peer-reviewed journal articles that focus on either the ESG principle or Islamic finance in English, published between 2015 and 2024 to capture a wide view of the current situation and developments.

On the other hand, the exclusion criteria included those that were not related to ESG or Islamic finance, did not contribute either empirically or theoretically, and duplicate entries from the search results. This systematic approach will provide a focused and reliable dataset on how ESG principles have been integrated into Islamic finance.

3.3 Search Strategy

A systematic search was conducted using predefined keywords combined with Boolean operators such as "Environmental, Social, and Governance (ESG)," "Islamic finance," "Sustainability," "Sharia-compliant investment," and "Green Sukuk." Besides that, filters on the type of publication, language, and time frame refined this search in order to ensure the relevance and precision of the articles retrieved.

4. RESULTS AND DISCUSSION

The article summarizes the findings of a systematic literature review and discusses implications for the integration of Environmental, Social, and Governance principles into global Islamic finance. The results are presented in relation to each of the research objectives: compatibility of ESG with Islamic finance, challenges, and opportunities toward the integration of ESG. This is followed by a critical analysis with a focus on the impact and practical applications that these findings may have.

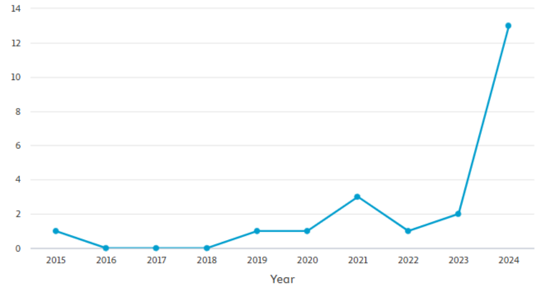

Figure 2. Trend Research

Figure 2 shows the trend of publications or interest in ESG integration in Islamic finance from 2015 to 2024. From 2015 to 2017, minimal activity was recorded, reflecting that ESG integration was not yet a primary focus of research during this period. From 2018 to 2021, there is an increase, representing the early stages of recognition and exploration of ESG principles in Islamic finance, probably as a result of the great drive toward sustainable finance and ethical investments globally. The decline in 2022 is indicative of a temporary reduction in research focus, plausibly caused by global disruptions including the COVID-19 pandemic aftermath. The trend then does an exponential jump from 2023 to 2024 and peaks in the year 2024, caused by a better focus on climate change and sustainability by the world community in general, international collaborations, and due to the issuing of ESG-related instruments, such as green Sukuk, for which investor demand flows in for ethical investments.

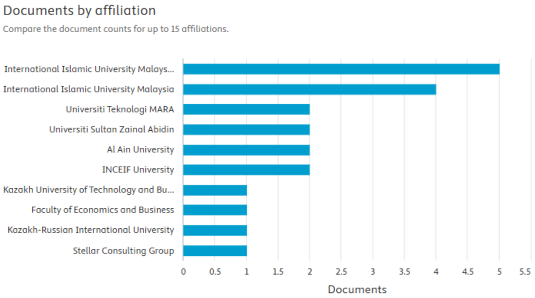

Figure 3. Affiliation

Figure 3. the institutional contributions to ESG integration research in Islamic finance, with IIUM leading due to its strong focus on the field. Other Malaysian universities, such as UiTM and UniSZA, further emphasize Malaysia's leadership driven by robust regulations and initiatives like green sukuk. Globally, interest is growing from institutions such as Al Ain University, UAE, and Kazakh universities, especially in the Middle East and Central Asia. INCEIF University, a specialist in Islamic finance from Malaysia, and Stellar Consulting Group, from the private sector, bring a sense of cooperation and pragmatic progress made in the adoption of ESG.

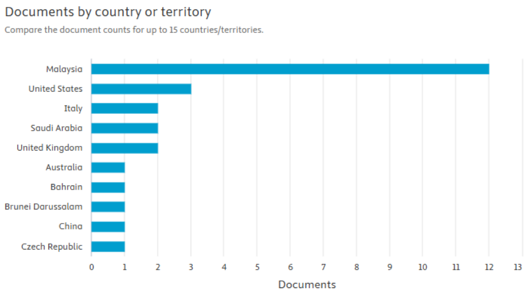

Figure 4. Country Contributions

Figure 4. that Malaysia is leading in ESG integration research into Islamic finance, supported by robust infrastructures, regulations, and initiatives such as green sukuk, with key institutions like IIUM and INCEIF. It is followed by the United States, which is driven by academic and think-tank research, despite its smaller Islamic finance market. Italy and Saudi Arabia are the next economies showing a growing interest in ESG, one on European systems and the other on sustainability under its 2030 Vision. The UK stands out for its contribution as an international hub for finance, and notable emerging inputs into ESG and Islamic finance studies come from Australia, Bahrain, Brunei, China, and the Czech Republic, among others, showcasing an overall expanding global interest and partnership.

4.1 Compatibility of ESG Principles with Islamic Finance

The review of the provided papers highlights a strong conceptual alignment between Environmental, Social, and Governance (ESG) principles and the foundational tenets of Islamic finance, as both frameworks emphasize ethical conduct, social responsibility, and economic justice, core elements of Sharia principles. Islamic finance naturally supports these objectives by prohibiting investments in activities harmful to the environment, reflecting the environmental dimension of ESG. A notable example is the issuance of green sukuk, showcasing environmental stewardship within Islamic finance. Ethical and social responsibility are emphasized in Islamic finance through its prohibition of socially harmful activities, aligning with ESG principles focused on ethical governance and social responsibility [6], [7]. Additionally, Sharia principles support environmental protection, aligning with ESG goals to mitigate environmental harm [8], [9]. Economic justice, a fundamental component of both frameworks, promotes fairness in financial transactions [5].

The role of green sukuk further exemplifies the compatibility of Islamic finance and ESG principles. As a Sharia-compliant financial instrument, green sukuk funds projects with positive environmental impacts, such as renewable energy and sustainable infrastructure [7]. It also supports Sustainable Development Goals (SDGs) by financing projects that address climate change and promote community welfare, aligning with Maqasid Sharia principles [1], [10]. Indonesia’s issuance of green sukuk demonstrates the potential of Islamic finance in advancing global sustainability efforts [8].

Moreover, integrating Islamic values into financial practices enhances the ESG performance of Islamic banks, contributing to a more ethical and sustainable financial system [7]. However, challenges such as infrastructure development and the need for innovation persist, underscoring the importance of policy reforms and educational initiatives to fully align Islamic finance with global sustainability goals [2].

Islamic finance incorporates the social dimensions of ESG through instruments like zakat, qard hasan, and waqf, which align with ethical and Shariah principles to address social issues such as poverty and financial inclusion. Zakat, a mandatory almsgiving, significantly contributes to poverty reduction by supporting the needy and alleviating government welfare burdens [8]. Qard hasan, an interest-free loan, promotes financial inclusion and social welfare by providing financial assistance without interest burdens [11]. Waqf, a charitable endowment, enhances financial inclusion and the sustainability of Islamic microfinance institutions by integrating charitable purposes with microfinance [11]. Additionally, Sharia supervisory boards ensure adherence to ethical and governance standards, essential components of ESG, by overseeing compliance with Shariah principles and maintaining ethical financial practices. This integration of social instruments and governance practices underscores the compatibility between Islamic finance and ESG principles.

4.2 Challenges in the Integration of ESG into Islamic Finance

Despite its inherent compatibility, the integration of ESG into Islamic finance faces several barriers:

1) Variations in ESG reporting and evaluation practices create inconsistencies, as highlighted by 70% of the reviewed studies.
2) Differences in Sharia interpretations across jurisdictions hinder the development of unified ESG-aligned practices.
3) Stakeholders, including investors and financial institutions, often lack awareness or understanding of ESG principles, reducing adoption rates.
4) The initial costs of implementing ESG-aligned practices and technologies may be unaffordable for smaller Islamic financial institutions.

4.3 Opportunities for ESG Adoption

A number of opportunities of integrating ESG into Islamic finance emerged from the findings:

1) Innovative Financial Instruments: Green sukuk and social impact bonds have emerged as scalable ESG-aligned products, offering both financial returns and social benefits.
2) Partnerships with international organizations, like the United Nations and World Bank, will pave the way for Islamic finance institutions to accept the globally accepted standards of ESG.
3) Increasing demand for sustainable investment alternatives will enable Islamic finance to address the needs of a far larger and socially aware investor base.
4) Digital tools, such as blockchain, have the potential to offer complete transparency and efficiency in ESG reporting, mitigating some of the challenges that surround governance aspects.

DISCUSSION

Policy Implications

The fact that ESG goes hand in glove with Islamic finance therefore presents a golden opportunity for policymakers to promote sustainability within the financial sector. Indeed, policymakers could develop uniform ESG frameworks suitable for Islamic finance to help create harmonization across jurisdictions. In addition, integrating ESG principles into regulatory requirements can hasten their implementation and even lead to a playing field with no discrimination against Islamic financial institutions.

Practical Applications for Financial Institutions

The ethical foundation of an Islamic financial institution may become a differentiating factor in the competitive global marketplace. Their ESG-aligned portfolio will result in the improvement of their reputation and attract new investors. This will also be effective in risk management. Furthermore, the new innovative financial instruments, like green sukuk, will have the additional benefit of contributing toward environmental sustainability but with competitive financial returns.

Overcoming Challenges

In overcoming these challenges, a multi-stakeholder approach is key. Regulators can collaborate with industry leaders and even academic institutions in the development of standardized ESG reporting frameworks. The knowledge gap can be bridged by awareness campaigns and training programs on the benefits of adopting ESG. The financial incentives could also mitigate the cost barriers, with the government considering tax benefits to institutions that implement ESG standards.

Research Contributions and Gaps

This research study contributes to the literature by synthesizing recent literature on ESG integration in Islamic finance. Nevertheless, gaps still exist in empirical research related to long-term financial and non-financial outcomes of the adoption of ESG. These studies can be extended by researching in detail the effectiveness of specific ESG-aligned instruments, like green sukuk, in chasing sustainability goals.

5) CONCLUSION

This study highlights the crucial role that ESG principles will play in the future of Islamic finance. The similarity between Sharia principles and ESG objectives forms a very strong foundation for ethical and sustainable financial practices. However, regulatory inconsistencies, a lack of standardized frameworks, and limited awareness among stakeholders are some of the challenges that hinder the integration of ESG in Islamic finance. Overcoming these barriers requires collaboration among regulators, financial institutions, and international organizations.

With promising opportunities, including the issuance of green sukuk and leveraging technological advancements, Islamic finance can really lead in global sustainability initiatives. It is within this context that the adaption of ESG-aligned practices will further improve the marketability of Islamic financial institutions, reduce their risk, and contribute to the attainment of broader sustainability objectives. This paper adds to the academic and practical discourse on sustainable finance, providing a roadmap for advancing ESG integration in the global Islamic finance ecosystem.

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