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THE IMPACT OF ESG COMPLIANCE ON ISLAMIC FINANCE: A HOLISTIC APPROACH TO THE SUSTAINABLE DEVELOPMENT GOALS

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Abstract. This study examines the effects of ESG principles on the Islamic finance system within the context of the Sustainable Development Goals (SDGs). ESG represents a sustainability framework encompassing environmental, social and governance criteria, whereas Islamic finance is built upon principles such as the prohibition of interest (riba), risk-sharing, asset-backed transactions, ethical investment and social welfare. Therefore, there exists a natural alignment between ESG and Islamic finance. However, this alignment is not only theoretical but also observable in practice through institutional governance, green sukuk, social finance, financial inclusion and sustainable investment instruments. The primary objective of this study is to analyze how ESG compliance affects the sustainability performance of Islamic financial institutions and to demonstrate its contribution to the SDGs. Studies conducted by the World Bank on Islamic finance and SDGs emphasize that Islamic financial institutions can contribute to sustainable development through financial inclusion, risk-sharing, social finance and economic resilience. Within this framework, the article also explores the relationship between ESG principles and Maqasid al-Shariah, arguing that Islamic finance should be developed not merely as a profit-oriented system but as a model grounded in environmental and social responsibility.

Keywords: ESG, Islamic finance, sustainable development, SDGs, Maqasid al-Shariah, green sukuk, ethical finance.

ESG UYĞUNLUĞUNUN İSLAM MALİYYƏSİNƏ TƏSİRİ: DAYANIQLI İNKİŞAF MƏQSƏDLƏRİNƏ HOLİSTİK YANAŞMA

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Xülasə. Məqalədə ESG prinsiplərinin İslam maliyyə sisteminə Dayanıqlı İnkişaf Məqsədləri (SDGs) çərçivəsində təsirini araşdırılmışdır. ESG ətraf mühit, sosial və idarəetmə meyarlarını əhatə edən dayanıqlılıq çərçivəsini ifadə edir, İslam maliyyəsi isə faiz qadağası (riba), riskin bölüşdürülməsi, aktiv əsaslı əməliyyatlar, etik investisiya və sosial rifah kimi prinsiplərə əsaslanır. Buna görə də ESG ilə İslam maliyyəsi arasında təbii uyğunluq mövcuddur. Lakin bu uyğunluq yalnız nəzəri deyil, həm də institusional idarəetmə, yaşıl sukuk, sosial maliyyə, maliyyə inklüzivliyi və dayanıqlı investisiya alətləri vasitəsilə praktikada da müşahidə olunur. Tədqiqatın əsas məqsədi ESG uyğunluğunun İslam maliyyə institutlarının dayanıqlılıq göstəricilərinə təsirini təhlil etmək və onun SDG-lərə verdiyi töhfəni nümayiş etdirməkdir. Dünya Bankının İslam maliyyəsi və SDG-lərlə bağlı apardığı araşdırmalar vurğulayır ki, İslam maliyyə institutları maliyyə inklüzivliyi, risk bölgüsü, sosial maliyyə və iqtisadi dayanıqlılıq vasitəsilə dayanıqlı inkişafa töhfə verə bilər. Bu çərçivədə məqalədə ESG prinsipləri ilə Məqasid əş-Şəriə arasındakı əlaqə də araşdırılmış və İslam maliyyəsinin yalnız mənfəət yönümlü sistem kimi deyil, ətraf mühit və sosial məsuliyyətə əsaslanan model kimi inkişaf etdirilməsinin vacibliyi irəli sürülmüşdür.
Açar sözlər: ESG, İslam maliyyəsi, dayanıqlı inkişaf, SDGs, Məqasid əş-Şəriə, yaşıl sukuk, etik maliyyə.

1. Introduction

In recent years, the concept of sustainability has become increasingly central to the global financial system. Climate change, income inequality, resource depletion, environmental degradation and corporate governance crises have revealed the inadequacy of evaluating financial institutions solely based on profitability. Consequently, investors, regulators and international organizations have begun to consider companies' environmental, social and governance performance as well. The concept of ESG has emerged as a response to this need and has become one of the key criteria in sustainable investment decision-making. Islamic finance, on the other hand, has historically been grounded in principles of ethics, justice, transparency, social welfare and real economic activity. Principles such as the prohibition of interest, avoidance of excessive uncertainty (gharar), limitation of speculation and risk-sharing distinguish Islamic finance from conventional financial systems. These constitute the fundamental elements. In this respect, Islamic finance has a structure that largely overlaps with ESG principles. In particular, the principles of environmental responsibility, social justice and good governance are aligned with the core objectives of Islamic finance. The Sustainable Development Goals (SDGs) represent the global development agenda established by the United Nations for the 2015-2030 period. In a study conducted by the World Bank on Islamic finance and SDGs, it is emphasized that significant resource mobilization is required to finance sustainable development and that Islamic finance can play an important role in this process through financial inclusion, social finance instruments and capital markets [14].

In this context, examining the impact of ESG compliance on Islamic finance is important from both academic and practical perspectives.The main research question of this article is as follows: How can the integration of ESG principles into the Islamic finance system contribute to achieving the Sustainable Development Goals? To answer this question, the study focuses on the following sub-questions: 1. What is the relationship between ESG principles and Islamic finance principles? 2. How does ESG compliance affect the environmental and social performance of Islamic financial institutions? 3. How do green sukuk and Islamic social finance instruments contribute to sustainable development goals? 4. What opportunities and challenges does ESG integration create for Islamic finance?

2. Conceptual framework

The concept of ESG: ESG consists of three main dimensions: environmental, social and governance. The environmental dimension includes issues such as climate change, carbon emissions, energy efficiency, the use of renewable energy, waste management and the conservation of natural resources. The social dimension covers areas such as employee rights, customer satisfaction, supply chain ethics, human rights, social contribution and financial inclusion. The governance dimension focuses on corporate governance elements such as transparency, accountability, auditing, ethical management, anti-corruption measures and stakeholder rights. The primary objective of ESG is to ensure that companies and financial institutions not only generate short-term financial returns but also create long-term environmental and social value. Therefore, ESG is considered one of the most important tools of sustainable finance.

The concept of Islamic finance: Islamic finance is a financial system that operates in accordance with Sharia principles. In this system, interest (riba) is prohibited. Additionally, excessive uncertainty (gharar) and transactions involving gambling or speculation (maysir) are not permitted. Islamic financial transactions are generally based on real assets and are structured around the principle of risk-sharing between parties [7].

One of the fundamental objectives of Islamic finance is to ensure that economic activities are conducted within an ethical framework. Therefore, sectors such as alcohol, gambling, interest-based activities, speculative transactions, harmful products and industries that negatively impact society are considered non-compliant with Islamic investment principles. This structure is directly related to the social and governance dimensions of ESG. The contribution of Islamic finance to sustainable development is not limited to banking products alone. Instruments such as zakat, waqf, qard al-hasan, microfinance and sukuk provide significant opportunities for enhancing social welfare and supporting development. According to studies by the World Bank, Islamic financial institutions, capital markets and the social finance sector can contribute to sustainable development in terms of growth, financial inclusion, reducing the vulnerability of the poor and ensuring financial stability.

Theoretical compatibility between ESG principles and Islamic finance: The relationship between ESG and Islamic finance should be evaluated not merely as a contemporary financial trend but also as a deeper area of ethical and institutional alignment. The environmental, social and governance dimensions of ESG demonstrate strong similarities with the fundamental objectives of Islamic finance, known as Maqasid al-Shariah. Maqasid al-Shariah refers to the primary objectives of Islamic law, generally defined as the protection of religion, life, intellect, lineage and wealth. In modern interpretations, these objectives are associated with human dignity, social justice, economic balance, environmental responsibility and societal welfare [2]. The environmental dimension of ESG aligns with the Islamic principle of avoiding harm to nature and preserving resources for future generations. Similarly, the social dimension corresponds to Islamic principles of justice, equality, charity and poverty reduction. Governance principles such as transparency, accountability, ethical conduct and anti-corruption measures are also central components of Islamic financial ethics. A study published in 2024 emphasizes that integrating ESG principles in alignment with Maqasid al-Shariah can provide a strategic roadmap for sustainable operations, particularly in the field of takaful (Islamic insurance). The study argues that ESG integration strengthens institutional resilience, enhances stakeholder trust and improves long-term sustainability performance in Islamic financial institutions [11].

3. The impact of ESG compliance on Islamic finance

Environmental impact: One of the most significant effects of ESG compliance on Islamic finance emerges in the area of environmental responsibility. Traditional Islamic finance practices have largely focused on the prohibition of interest, asset-backed transactions and Sharia compliance. However, the modern understanding of sustainability requires Islamic finance to also consider its environmental impact. In this context, ESG integration encourages Islamic financial institutions to finance environmentally friendly projects, such as renewable energy, energy efficiency and sustainable infrastructure. Instruments like green sukuk play a critical role in directing capital toward environmentally responsible investments, thereby aligning Islamic finance more closely with global climate goals and sustainability standards. At this point, green sukuk emerges as a key instrument. Green sukuk is a Sharia-compliant capital market instrument used to finance renewable energy, clean transportation, energy efficiency, sustainable infrastructure and environmentally friendly projects. A 2025 report prepared by the United Nations Development Programme and Kuwait Finance House highlights that green sukuk is an important tool for sustainable financing and is gaining increasing significance in terms of market dynamics and regulatory frameworks. The importance of green sukuk is not limited to financing environmentally friendly projects. Due to the asset-backed nature of Islamic finance, it also ensures that funds are directed toward specific projects. This facilitates the allocation of financial resources to areas that genuinely generate environmental benefits. Thus, ESG compliance can make the environmental performance of Islamic financial institutions more measurable and reportable.

Social impact: One of the strongest intersections between Islamic finance and ESG lies in the area of social impact. Islamic finance aims not only to generate financial transactions but also to contribute to social welfare. Instruments such as zakat, sadaqah, waqf and qard al-hasan play a significant role in strengthening social justice. Within the framework of the Sustainable Development Goals, targets such as poverty reduction, zero hunger, quality education, gender equality, decent work and economic growth are emphasized. Islamic social finance instruments have the capacity to contribute to many of these objectives. A systematic literature review published in 2023 examined the relationship between Islamic finance, Islamic law and SDGs, analyzing 65 studies selected from the **Scopus** database and evaluating the areas in which Islamic finance can contribute to sustainable development. ESG compliance can make the social impact performance of Islamic financial institutions more institutionalized and measurable. For instance, an Islamic bank should not only offer interest-free products but also enhance financial inclusion, support small and medium-sized enterprises, promote women’s entrepreneurship and provide accessible financing to low-income groups. In this way, Islamic finance can transform its theoretical ethical claims into tangible social impact.

Governance impact: The third dimension of ESG - governance - is critically important for Islamic finance. Islamic financial institutions are required to comply not only with conventional corporate governance rules but also with Sharia governance principles. This creates a dual layer of responsibility. On one hand, compliance with banking regulations, financial reporting standards and risk management frameworks is necessary. On the other hand, the effectiveness of Sharia boards, transparency in fatwa processes, genuine Sharia compliance of financial products and accurate disclosure to customers are essential. ESG integration can establish stronger accountability mechanisms in this area. In particular, practices such as sustainability reporting, impact measurement, independent auditing, stakeholder engagement and corporate transparency can significantly enhance the credibility and trustworthiness of Islamic financial institutions. In this way, Islamic financial institutions can move beyond merely being “Sharia-compliant” and evolve into institutions that are also “sustainability-compliant” and “social impact-oriented”.

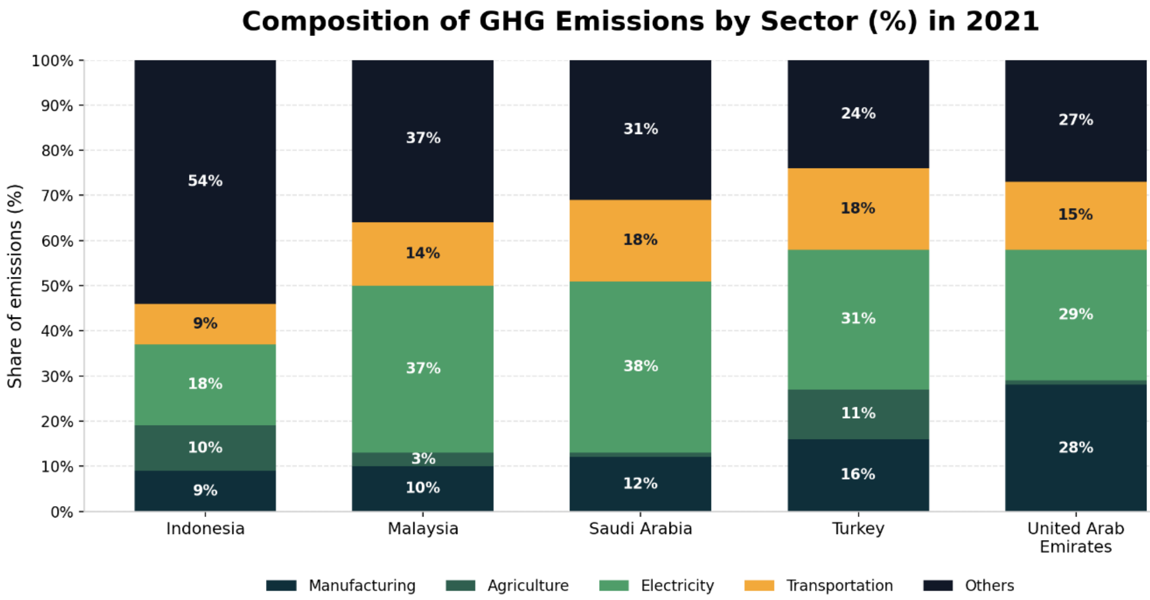

Figure 1. Composition of GHG emissions by sector (percentage) in 2021

The Organisation of Islamic Cooperation (OIC) represents one of the most vulnerable groups of countries globally due to their high exposure to climate change and low adaptive capacity. According to modeling results, some of the highest temperature increases are expected to occur in arid and semi-arid regions, particularly in Sub-Saharan Africa (SSA), the Middle East and North Africa (MENA) and Central Asia. Since many OIC member countries are located in these regions, they face significant physical risks (Intergovernmental Panel on Climate Change, 2014a). According to the 2022 Notre Dame Global Adaptation Initiative (ND-GAIN) Index, the average vulnerability score of OIC countries is estimated at 0.46, while their readiness level is 0.36. In contrast, the global average for both vulnerability and readiness is reported at 0.43. This indicates that OIC countries are generally more vulnerable and less prepared for the impacts of climate change compared to many other regions worldwide. At the country level, more than half of OIC countries (32 countries) are more vulnerable than the global average and approximately 75% have readiness levels below the global average. In Indonesia, the largest share of emissions comes from other sectors (54%), followed by electricity (18%), agriculture (10%) and manufacturing and transport (9%). In Malaysia, emissions are equally dominated by electricity (37%) and other sectors (37%), highlighting the significant role of energy production.In Saudi Arabia, the electricity sector accounts for the largest share (38%), followed by transport (18%), manufacturing (12%) and other sectors (31%), while agriculture has a minimal share (1%). In Türkiye, the primary source of emissions is the electricity sector (31%), followed by other sectors (24%), transport (18%), manufacturing (16%) and agriculture (11%), indicating a relatively balanced distribution. In the United Arab Emirates, manufacturing holds the largest share (28%), closely followed by electricity (29%), with other sectors at 27%, transport at 15% and agriculture at 1%. Overall, the data indicate that electricity generation is one of the most significant sources of greenhouse gas emissions across these countries. Particularly in Malaysia, Saudi Arabia and Türkiye, the electricity sector plays a dominant role. Therefore, transitioning to renewable energy, improving energy efficiency and investing in clean technologies are critical for sustainable development.

4. Islamic finance in the context of ESG and sustainable development goals

The Sustainable Development Goals (SDGs) provide a global framework aimed at balancing economic growth with social justice and environmental protection. The contribution of Islamic finance to these goals can be evaluated through several main channels. The first channel is financial inclusion. Islamic finance can integrate individuals who avoid conventional banking systems due to interest sensitivity into the financial system. This can significantly increase financial access, particularly in countries with large Muslim populations. The second channel is social finance instruments. Tools such as zakat, waqf and qard al-hasan can be utilized in areas such as poverty alleviation, education, healthcare and social welfare. In this respect, Islamic finance holds the potential not only for commercial financing but also for generating social well-being. The third channel is green and sustainable capital market instruments. Instruments such as green sukuk, sustainable sukuk and social sukuk can be used to finance environmental and social projects. Reports by the United Nations Development Programme indicate that green sukuk is an emerging and increasingly important tool for sustainable financing, particularly as regulatory frameworks continue to evolve. The fourth channel is risk-sharing. The risk-sharing principle inherent in Islamic finance can contribute to a more balanced financial structure that may reduce the impact of financial crises. According to studies by the World Bank, Islamic finance has the potential to mitigate risks and reduce the vulnerability of low-income populations. In this context, ESG integration can make the contribution of Islamic finance to the SDGs more visible and measurable. However, this requires Islamic financial institutions to strengthen not only Sharia compliance but also environmental and social impact reporting.

5. Opportunities of ESG integration

The integration of ESG principles into the Islamic finance system presents numerous opportunities. First, ESG integration can enhance the competitiveness of Islamic finance in global financial markets. Today, international investors place increasing importance on sustainability criteria. Therefore, ESG-compliant Islamic financial products can appeal not only to Muslim investors but also to a broader investor base seeking ethical and sustainable investment opportunities. Second, ESG integration can expand product diversity. Instruments such as green sukuk, social sukuk, sustainable investment funds, Islamic ESG funds and impact investment products can be developed within this framework. These products can support both environmental and social development projects. Third, ESG compliance can strengthen corporate reputation. Islamic financial institutions can achieve a more credible market position by publishing sustainability reports, reducing their carbon footprint, investing in social impact projects and improving governance standards. Fourth, ESG integration can contribute to a more concrete implementation of Maqasid al-Shariah. Traditional Islamic finance practices are sometimes criticized for focusing primarily on formal Sharia compliance. ESG alignment, however, can make the core principles of Islamic finance - justice, welfare, environmental awareness and social responsibility - more visible and operational.

6. Challenges of ESG integration

Despite its significant opportunities, ESG integration also presents several challenges. The first challenge is the lack of standardization. Both ESG reporting and Islamic finance practices are governed by diverse standards, making comparisons across institutions difficult. The second challenge is the risk of greenwashing. Some institutions may market products with limited environmental or social impact as “green” or “sustainable”. This risk also applies to Islamic finance. If a product is labeled as green sukuk without generating genuine environmental impact, it contradicts both ESG principles and Islamic ethical values. The third challenge relates to measurement and reporting. Assessing sustainability impact is inherently complex. Indicators such as carbon reduction, social benefit, financial inclusion, employment effects and societal welfare must be measured and reported reliably. The fourth challenge is the lack of expertise. Effective ESG integration requires professionals with knowledge of both Islamic finance and sustainable finance. A shortage of such expertise can slow down implementation. The fifth challenge is regulatory alignment. Islamic finance and ESG regulations are not equally developed across countries. This makes it difficult to establish a reliable and comparable framework for international investors.

Conclusion. This study has examined the impact of ESG compliance on Islamic finance within the context of the Sustainable Development Goals (SDGs). The analysis demonstrates that there is a strong theoretical and practical alignment between ESG principles and Islamic finance principles. Environmental responsibility, social justice, financial inclusion, good governance and ethical investment constitute the shared intersection of both approaches. ESG integration can enhance the sustainability performance of Islamic financial institutions, strengthen investor confidence, expand product diversity and make contributions to the SDGs more measurable. In particular, instruments such as green sukuk, social sukuk, waqf-based financing and zakat mechanisms represent key tools that can reinforce the role of Islamic finance in sustainable development. However, challenges such as the lack of standardization, the risk of greenwashing, measurement difficulties, regulatory disparities and the shortage of expertise must be carefully addressed. Therefore, Islamic financial institutions should treat ESG integration not merely as a market trend but as a core component of their institutional strategy. In conclusion, ESG compliance represents both an opportunity and a responsibility for Islamic finance. When implemented effectively, Islamic finance can evolve beyond being merely an interest-free alternative into a comprehensive development model that supports environmental, social and economic sustainability.

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