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Measuring Sustainable Performance of Islamic Banks: Integrating the principles of Environmental, Social and Governance (ESG) and *Maqasid Shari'ah*

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Abstract. To fulfil the *Maqasid Shari'ah* of Islamic banks in promoting the welfare of society, Islamic banks are expected to consciously align their performance measurement according to the principles of Islamic banks that are derived from Islamic economic philosophy. In the meantime, in light of the agenda of Sustainable Development Goals (SDG) 2030, the principle of environment, social and governance (ESG) has become part of the sustainability reporting and become a central concern of the investors. The tenets of ESG and Islamic finance basically intersect and share similar principles of responsibility, accountability, and stewardship in providing protection and benefits to the environment and humankind as a whole which is in line with the principle of Maslahah in the *Maqasid Shari'ah*. Hence, there is ample room for the ESG element to be harmonized with the *Maqasid Shari'ah* elements in a holistic performance measurement index of Islamic banks. Therefore, the performance of Islamic banks can be measured in a more holistic approach by combining financial and non-financial performance with the ultimate objective of Islamic banks being sought as the primary reference, and the sustainability issue can be well addressed. This paper reviews the previous literature on the performance of Islamic banks, ESG principles in the context of Islamic banks and the *Maqasid Shari'ah* performance index that has been developed by previous researchers. Fulfilling *Maqasid Shari'ah* and sustainability agenda in the performance measurement index would further strengthen the performance of Islamic banks in the effort to maintain Malaysia as the leader in the regional and world Islamic financial hub.

1. Introduction
The Islamic financial system underlies the principles of *Shari'ah* and the transactions of Islamic finance basically advocate the principles of equity and justice. Islamic finance has been growing tremendously globally through Islamic banking, takaful, capital and money market activities. With a growing population of Muslims worldwide, Islamic banks continue to grow and cater to the needs for *Shari'ah*-compliant financial products, especially in Asia and the Middle East markets. Despite the pandemic of COVID-19, 81% of Islamic banks still report net income as of 2020. The Islamic banking industry continues to lead the contribution to the Islamic finance industry in which it contributes about 70% of the Islamic finance total assets distribution or USD 2,349 billion of the global Islamic finance industry with annual growth of 14%, consisting of 527 Islamic banks, including windows, in 72 countries across the world [1].

Along with the agenda of sustainable development goals (SDG) 2030, there is concern about the need to engage and align the SDG agenda with the principles of Islamic finance. Islamic finance and SDG basically share similar principles in which the objectives of *Shari'ah* to bring benefits to the whole of humankind and prevent harm or maslahah, as well ensuring the sustainability of life, are inherent in the philosophies of Islamic finance. Few concentrated efforts on the SDGs agenda have been made, including SDG funding by Islamic Development Bank. Various instruments have been developed to align with the sustainability agenda including Social Responsible Instrument, Value-based Intermediation (VBI), and environmental, social and governance (ESG). ESG has emerged as a critical investment screening tool in fulfilling the sustainability interest of the investors. This also applies to Islamic finance, where the demand for *Shari'ah*-compliant investment keeps increasing. For example, the government of Malaysia and Indonesia have continued issuing ESG-linked Sukuk throughout 2020 and 2021 while Saudi Arabia has raised green Sukuk to fund the Saudi Electricity Co and Abu Dhabi with their Etihad Airways has issued the first-ever transition Sukuk that was designed to manage the airline's shift towards a decarbonized economy [1].

ESG instrument and *Maqasid Shari'ah* basically share many similarities in terms of principles. They are complementary in applauding the stewardship and accountability of humankind, welfare of society and preservation of the environment. Islamic economic concept drawn from Shari'ah which has its sources divine revealations from the Quran and Sunnah, serves as a foundation for Islamic banking principles. Thus, the vision and mission of Islamic banks' business activities should be aligned toward attaining the objectives of *Shari'ah* [2]. The fulfilment of *Shari'ah*'s higher goals requires proper behavior and moral conduct in all transactions, as well as charity in the distribution of wealth. The players in the Islamic banking industry, particularly those responsible for managing and approving *Shari'ah* compliance products and services should strive to establish the *Maqasid Shari'ah* with the highest level of integrity [3]. The realization of the *Maqasid Shari'ah* is the cornerstone and essence of all contracts that govern all the Islamic operations in Islamic banking [4].

Islamic banking which is a part of the Islamic financial industry entails more than just offering financial products and services that are *Shari'ah* compliant; instead, it must be designated to be capable of promoting the public good in which it must recognize the importance of emphasizing on the public interest ahead of self-interest and profit maximization and take both the negative and positive effects of transactions into account [5]. Therefore, Islamic banks need a sustainable performance measurement that depicts Islamic banks' true performance in achieving their mission and vision since Islamic banks have different concepts and practices from conventional banks [6]. Islamic banks need a sustainable performance measurement that could cater to the sustainability agenda by integrating both shareholder and stakeholder interest in the forms of financial and non-financial ratios while maintaining the *Maqasid Shari'ah* since the debate on the ideal measurement of Islamic banks' performance has been prolonging for many years. Therefore, with the apparent relation between *Maqasid Shari'ah*, ESG and Islamic banks, this study reviews the application of these elements explicitly relating to the development of performance measurements of Islamic banks.

2. *Maqasid Shari'ah* and Islamic Banks

The basic sources of *Shari'ah* are the Qur'an and the Sunnah (sayings and doings of Prophet Muhammad SAW). Based on these sources, *Maqasid Shari'ah* was developed throughout time by Islamic scholars who sought to safeguard community members by setting essential moral standards and approving all necessary behaviours for the preservation and advancement of a moral society. The phrase Maqasid is a plural form of the singular word maqsad, which denotes purpose, goal, or objective. Therefore, the *Maqasid Shari'ah* refers to *Shari'ah*'s purposes, goals, and objectives. The goal of *Shari'ah*, according to Al-Ghazali, is to protect these five cores encompassing faith (din), self (nafs), intellect ('aql), posterity (nasl), and money (mal), which are deemed primary (al-asliyyah) while the rest are referred to as corollaries (tabi'ah) [2]. The absence of these five cores will harm society. The primary meaning of maslahah, according to Al-Ghazali, is the preservation of *Maqasid Shari'ah* [7]. Al- Shatibi went on to classify Al-work Ghazali's into three categories which are essential (daruriyat), complementary (hajiyat), and embellishment (tahsiniyat). Faith, life, intellect, posterity, and riches are the five basic aspects under essential that are considered necessary for the effective functioning of people's religious and daily concerns. The complementary complements the essential part whereby it is required to alleviate the hardship, and the embellishment refers to all the process of enhancing and refining people's behaviors and customs at all levels of achievement [8].

According to Ibn Ashur, *Maqasid Shari'ah* is based on two general elements: the promotion of welfare (jalb al-masalih) and the evasion of evil (dar'a al-mafasid), which clearly encompasses fostering welfare, combating corruption, using natural resources responsibly, and the enhancement of Islamic way of life[8]. Abu Zahra broadens *Maqasid Shari'ah* by integrating elements of education and justice, and divides it into three major categories: educating the individual (Tahdhib al-Fard), upholding justice (Iqamah al- Adli), and fostering the public interest (al-Maslahah) [27, 28, 29]. The promotion of public interest covers the components of complementary (hajiyat), necessity or essential (daruriyat) and embellishment (tahsiniyat) [9, 10]. In a nutshell, *Maqasid Shari'ah* or *Shari'ah*'s objectives are seen as essential for individuals' existence and spiritual well-being in a way that their violation and neglection would ruin the normal operation of society [11].

With regard to Islamic banking as a major component of Islamic finance, it is basically more than just offering *Shari'ah* compliance financial products and services; it must be designated to be capable of promoting the public good by recognizing the importance of emphasizing on the public good ahead of self-interest and profit maximization and take into account both the negative and positive consequences of transactions [5]. Without all these components, Islamic banking transactions will be perceived as a paper exercise with a similar goal to its conventional counterparts [12]. The operation of the Islamic banking system must be consistent with *Maqasid Shari'ah*. The realization of *Maqasid Shari'ah* in Islamic banking needs collaborative awareness and commitment to moral obligations from those representing stakeholders particularly management and *Shari'ah* scholars in promoting permissible transactions for the public good [13].

3. The Principles of ESG, *Maqasid Shari'ah* and Islamic Banks

ESG issue emerges as important in fulfilling the sustainability interest of the investors. Responsible investing is a growing trend among financial organizations, emphasizing ESG factors and ESG integration in the investment process [14]. ESG variables are a collection of issues that are not generally considered in financial analysis but could have financial implications including the business response to climate change, the efficiency of water management, the effectiveness of health and safety policies in preventing accidents, management of supply chains, employee's treatment and the adoption of corporate culture that fosters trust and innovation [15]. Despite the COVID-19-induced market instability, equity products contributed US$20 billion, the largest amount to the global ESG flows, to the inflow of US$36 billion into ESG funds globally in the first quarter of 2020, and the second-highest quarterly flow amount over the previous ten years [16].

Islamic finance is based on the same fundamental concepts as sustainable finance which comprises of the issues of financial stability and expansion of economic, poverty reduction and wealth distribution, financial and social inclusion, and environmental protection [16]. As a result of these parallels, Islamic finance has developed into a natural vehicle for disseminating components of green financing. Islamic finance and ESG investing are complementary capital-raising and investment strategies that share a number of shared principles, including being accountable to society and the environment, despite the fact that both principles were established in different historical and cultural settings. Both provide products that appeal to both Muslim and non-Muslim investors and have top-notch procedures and rules that they can both benefit from.

ESG bears many parallels with Islamic finance, which is understandable given their shared roots and fundamental ideals. Both investment techniques aim to have a good impact on the environment and society and appeal to both Muslims and non-Muslims [17]. The *Maqasid Shari'ah*, are one component that connects *Shari'ah* principles to ESG and sustainability in general. According to Haq and Wahab [18], the parallels between *Maqasid Shari'ah* and the sustainability paradigm arise from the emphasis on stakeholder benefit. The researchers say that the Islamic perspective on sustainability centers on humans' duty to nature, which arises from the belief that people are just managers rather than proprietors. Iqbal and Mirakhor [19] suggest that Islamic finance is based on a stakeholder-oriented framework, which supports this idea. This is founded on Islamic beliefs of property rights and contracts. The former necessitates the inclusion of stakeholders in the process of making decision of economic actors' actions. In the case of the latter, equal focus is necessary regardless of whether the contract is explicit or implicit; standard stakeholder theory, on the other hand, has yet to discover a way to accommodate implicit contracts. The SDG are in accordance with *Shari'ah* aims, emphasizing the relationship between *Shari'ah* principles and ESG [20].

The prohibition of investing in specific businesses involving illegal (haram) products, element of uncertainty (*gharar*) and gambling (*maysir*) is a critical foundation of Islamic finance. *Shari'ah*-compliant goods are screened to exclude certain businesses, a technique that is quite similar to ESG investment. Similar to investors of *Shari'ah*-compliant products, ESG investors avoid specific activities and products to ensure that their portfolios reflect the beneficiaries' beliefs, contribute to the objective of establishing a sustainable and just society, and bring no harm to society and the environment. ESG investors take into account the financial value of ESG variables into their investment appraisal and decision-making process. In addition, active ownership activities are also incorporated into ESG strategies in order to reduce risks, boost returns, and enhance ESG firms' performance and transparency.

4. Islamic banks and Performance Measurement

4.1 Financial ratio

Evaluating the performance of the financial industry has been always an interest of scholars. Several earlier research has investigated the performance of Islamic banking institutions by employing financial ratios including ratios of profitability, efficiency, earnings, liquidity, credit risk and assets activity [21-24]. In measuring profitability, the most commonly used financial ratios are return on asset (ROA), return on equity (ROE), net profit margin (NPM) and also net interest margin (NIM). ROA is appropriate to examine the bank's ability of generating profit from the portfolio of assets. ROA is preferred above other profit measurements since it assesses a bank's efficiency in terms of banking operations [21]. Return on equity (ROE, to the contrary, indicates the effectiveness of the bank's management in using shareholder funds. The ROE of banks is affected by ROA and the financial leverage level held by the bank [24]. These performance measurements have been used by many researchers including Bukair and Abdul Rahman [25] and Almoneef and Samontaray [26] in examining the performance of Islamic banks in the context of GCC and Saudi banking industries respectively.

Another mostly used approach to determine the bank's profitability is by looking at the net profit margin (NPM). NPM assesses the success of a bank's investment decisions. NPM is also thought to be a useful indicator of a bank's cost of intermediation, as it reflects the efficiency of the intermediation of bank's funds [26]. To access liquidity, the loan-to-asset ratio (LAR) and loan-to-deposits ratio (LDR) are commonly used by past studies [27]. Loan-to-asset ratio (LAR) indicates the fraction of bank's assets that receive loan financing. On the other hand, the loan-to-deposit ratio (LDR) measures the percentage of loans the banks are offering relative to their deposits. Majeed and Zainab [27] posit that a lower ratio of LAR indicates a better liquidity position for a bank. For LDR, a lower ratio reflects a higher liquidity position of the bank and vice versa. On the other hand, several studies have used equity to liability (ELR) and equity to asset ratio (EAR) to evaluate the capital adequacy ratio [27-29]. The equity-to-asset ratio (EAR) is the proportion of a bank's total equity to its total assets. A greater EAR ratio indicates that the bank's assets are not reliant on outside sources. It refers to a bank's ability to meet its financial commitments during a period of financial distress.

4.2 Maqasid Shari'ah Index

There is still a dearth of studies investigating the elements of *Maqasid Shari'ah* in the context of performance measurement of Islamic banks. A work of Mohammed et al. [30] that was based on Abu

Zahrah's theory of *Maqasid Shari'ah* pioneered the development of *Maqasid Shari'ah*-based of performance measurement of Islamic banks. Their maqasid index (MI) was developed comprising of three objectives which are educating individuals, establishing justice, and promoting welfare. However, their MI does not consider the element of profitability and efficiency that are also imperative to measure the Islamic bank's financial performance. On the other hand, Mohammed et al. [31] develop the Maqasid-based Performance Evaluation Model (MPEM) using the Al- Ghazali theory of *Maqasid Shari'ah* and Ibnu Ashur's reinterpretation. The author adopts Ibnu Ashur s theory of maqaṣid for the interpretations and institutional elements that suit the MPEM.

Following the similar approach of Mohamed et al. [31], Tarique et al. [32] proposed a more comprehensive *Maqasid Shari'ah* performance index by covering the component of complements and embellishment in their *Maqasid Shari'ah*-based performance measurement model for Islamic banks. Previously, Bedoui and Mansour [33] developed a *Maqasid Shari'ah* based on the Pentagon-shaped scheme performance measurement scale. Their five-pillar Pentagon-shaped *Maqasid Shari'ah* performance is based on Al-Ghazali's five cores: faith, intellect, posterity, wealth, and human self. Their performance measurement is more comprehensive because rather than focusing on profit maximization, the scale was developed comprising the objective of promoting and developing human welfare, preventing corruption, and improving social and economic stability. Enhancing the previous work of Mohammed et al. [31], Hudaefi and Noordin [34] came out with an integrated *Maqasid Shari'ah*–based performance measure (IMSPM) that combines both religious and financial aspects. The financial performance measurements that comprise non-performing loans, return on assets and operational efficiency, are included in the *Maqasid Shari'ah* element of wealth. The performance measurement index's development based on *Maqasid Shari'ah* of Hudaefi and Noordin [34], Antonio et al. [35] and Siddiqi et al. [36] are developed following the same qualitative approach. Using this approach first started with the literature review before proceeding with Sekaran's method of operationalization of the dimensions and elements. It is then followed by the finalizing and selecting the variables using the interview process with expertise and concluded with a validation of the selected variables by focus group discussion. However, the development of performance measurement based on *Maqasid Shari'ah* by these studies is still limited and only developed based on Abu Zahrah's and al-Ghazali's five components under necessity. The other two elements of *Maqasid Shari'ah*, which are complements and embellishments, are yet explored by the researchers due to the problem of operationalization of the components [34].

4.3 ESG

The proposition of the ESG principle becomes more compelling nowadays as the firm that embraces ESG-related activities gain higher valuation. The disclosure of ESG-related activity by banks conveys non-financial information of firm supposes to enhance transparency that not only mitigating information asymmetry between firm and stakeholders but also attracting the interest of the minority shareholders and investors in emerging economy as well as enhance bank valuation [37].

According to Khoury et al. [38], the relationship between ESG and performance has been extensively researched from both a theoretical and practical standpoint. However, the theoretical hypothesis is contradictory in which the social effect hypothesis shows a positive association while the trade-off hypothesis shows a negative relationship. The social effect hypothesis indicates that ESG is regarded as the source of competitive advantages in fulfilling the firm's responsibility to the society while serving the benefits to the internal and external stakeholders while the trade-off hypothesis or traditionalist view, asserts that resources expenditure relating to the accomplishment of social and environmental objectives triggers costs incremental, reduce profitability and jeopardize competitive advantage [39]. Several prior research on ESG and performance concluded conflicting findings.

The positive association showed that being socially responsible boosts profits [42-43], however, the negative relationship backed up the trade-off argument that ESG raises costs [44-45]. As the good impacts outweighed the negative consequences, the neutral relationship indicated that being socially responsible does not influence profitability [46-47]. This U-shaped or inverted U-shaped relationship conveys that the ESG and performance link is reliant on the ESG investment level [48]. Barnett and Salomon [49] established the existence of this U-shaped connection in which ESG activity has a negative impact on performance in the early stages because costs outweigh benefits, but the relationship then reverses and becomes positive later on.

5. Conclusion

Despite there being greater complementarity between ESG and *Maqasid Shari'ah*, a significant gap, as well as overlap between these approaches, exist. In addition, certain environmental and governance issues are less focused in Islamic finance. Moreover, the adoption of ESG is still low in the Islamic banking industry considering the complexity of the ESG framework to suit different industries which leads to difficulty in the assessment of ESG risks and impacts. The correlation between ESG and *Shari'ah* screening is expected to improve risk-adjusted performance in the investment and financing of Islamic banks [1]. However, there is no uniform ESG disclosure guideline or requirement that can be regarded as a reference to establish a complete ESG reporting standard for Islamic banks. Therefore this study provides insights on the integration of ESG tenet in the context of performance measurement of Islamic banking, in line with the SDG 2030 agenda in promoting sustainability through financing activity. While this study yet to provide any empirical evidence, it is recommended for the future study to tackle on the assessment of the degree of complementary and non-complementary to which ESG and *Maqasid Shari'ah* principles in the context of Islamic banks.

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