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From ESG Disclosure to Financing Resilience: A Conceptual Framework for Indonesian Islamic Banks

Selvia Khusnul Khatimah*[1]
[1]Department of Accounting, Faculty of Economics and Business, Universitas Muhammadiyah Jember, Indonesia

***Correspondence**: selviakhusnul7@gmail.com

ABSTRACT

Study's aims: This study aims to develop a conceptual framework analyzing the partial impact of Environmental, Social, and Governance (ESG) disclosures on Non-Performing Financing (NPF) in Indonesian Islamic commercial banks during the 2020-2024 period. **Design/Methodology/Approach:** As a conceptual paper, this study employs a literature review integrating Agency Theory and *Maqashid Sharia* to construct research hypotheses and a structural research model. **Findings:** Based on the literature, the proposed conceptual model hypothesizes that environmental, social, and governance disclosures individually exert a negative influence on NPF, positioning ESG as a strategic mitigation tool against financing risks rather than a mere regulatory compliance. **Theoretical contribution/Originality:** This study deconstructs the aggregate ESG score into distinct pillars within the context of Islamic banking, merging Sharia objectives (*hifdz al-maal*) with modern agency conflict resolution.

Keywords: ESG Disclosure; Non-Performing Financing; Islamic Banking; Maqashid Sharia; Risk Mitigation

Introduction

The dynamics of the global financial sector are no longer solely profit-driven; they have shifted significantly toward sustainability. In this context, Environmental, Social, and Governance (ESG) criteria play a crucial role—no longer merely a supplementary aspect of reporting, but rather the banking sector's primary tool for mitigating systemic risk (Borowiec & Heryszek, 2025). Specifically for Islamic banking, the essence of ESG is actually very much in line with the foundations of Maqashid Sharia. The application of these principles directly contributes to efforts to protect assets (*hifdz al-maal*) while also realizing the broader public interest (Siregar, 2025). In Indonesia, the Financial Services Authority (OJK) has also become increasingly firm in mandating transparency in sustainability reporting. This serves as a clear signal that the management of non-financial risks within Indonesian financial institutions can no longer be overlooked (Prihandini, 2024).

However, the period from 2020 to 2024 posed severe challenges to the stability of the national Islamic banking industry. The economic shocks caused by the COVID-19 pandemic, which severely impacted the economy, had a massive effect on the quality of bank assets, most notably evident in fluctuations in the Non-Performing Financing (NPF) (Aziz & Fianto, 2024). The worsening risk of default during the crisis demonstrates that NPF fluctuations are highly vulnerable to external shocks if banks lack a holistic risk management framework (Silaban et al., 2025). Empirically, a bank's risk profile can also be analyzed using tail dependence, with ESG scores proven to be a valid tool for capturing information about a company's risk level, particularly under extreme pressures such as a financial crisis (Bax et al., 2021). Conceptually, Islamic banks are indeed endowed with moral resilience. However, empirically in practice, the high risk of NPF remains a major threat

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that requires intervention beyond reliance on conventional financial ratios. This is where a commitment to ESG governance is believed to act as a "shield." High-quality ESG disclosure has a highly significant negative correlation with various banking risks, making it a crucial element in safeguarding the financing portfolio (Ahmed, 2026). This aligns with empirical evidence from other emerging-market banking sectors, where ESG disclosure serves as a key catalyst for financial performance and long-term stability (Loan et al., 2024). Disciplined ESG practices encourage banks to operate more prudently and selectively in extending financing, thereby minimizing the potential for customer defaults (Kiran et al., 2025).

Based on a review of the existing literature, several research gaps remain regarding the interaction between ESG and banking risk. First, most researchers still use ESG scores in aggregate or combined form (Aziz & Fianto, 2024; Faizulayev, 2026). However, averaging these scores can obscure the reality on the ground. Each pillar of ESG carries very distinct operational risk characteristics and customer profiles (Alghafes et al., 2024). Furthermore, the limitations of previous studies often stem from limited sample diversity, making a new approach that examines the effects of each ESG pillar separately essential for strengthening explanatory depth and external validity (Salem et al., 2025). Second, the conclusions drawn from various studies remain conflicting (mixed results). Some studies demonstrate that ESG successfully mitigates risk, but many others find that the operational costs associated with ESG implementation risk eroding bank efficiency if not managed properly (Prasetyo & Musmini, 2025). Third, quantitative research that examines the impact of each ESG pillar on NPF separately—particularly during the crisis and recovery phases (2020–2024)—within the Indonesian Islamic banking sector, which operates under a dual supervisory structure, remains extremely scarce (Hilman & Aslamah, 2025).

To address this gap, this study introduces a novel approach that deconstructs the ESG variable into its pillars: Environmental, Social, and Governance. This approach is specifically designed to accurately identify which pillar is most effective at reducing NPF figures among Islamic commercial banks in Indonesia during the 2020–2024 period. Through this approach, the dynamics of pandemic-era risk and the digital transition era can be analyzed with greater precision. Specifically, this study aims to analyze the partial effects of disclosures regarding environmental, social, and governance aspects on NPF. To ensure the purity of the test results, internal banking factors such as the capital adequacy ratio (CAR), asset size, and return on assets (ROA) are included as control variables. In terms of contributions, this study offers the conceptual framework that is expected to enrich the literature on Islamic finance, particularly in integrating Agency Theory and Maqashid Sharia as instruments for sustainable risk mitigation.

Literature Review

Theoretical Framework

This study integrates Agency Theory with Maqashid Sharia. Jensen and Meckling (1976) emphasize that conflicts of interest often arise due to information asymmetry between management and stakeholders. To bridge this information asymmetry, ESG disclosure practices serve as a transparent channel of communication. This transparency is believed to effectively align the objectives of both parties (Kiran et al., 2025).

In addition to mitigating agency problems, adherence to these sustainability principles has also been empirically shown to unlock firm value potential more effectively through sustainable finance schemes (Puspitasari & Firmansyah, 2025). On the other hand, Islamic banking operations are closely tied to the philosophy of Maqashid Sharia. Compliance with ESG guidelines within the Sharia framework essentially goes beyond conventional regulatory requirements (Siregar, 2025). This step is a concrete manifestation of the effort to preserve the community's assets (*hifdz al-maal*) and to safeguard environmental and social welfare sustainably.

Non-Performing Financing

Asset quality in the Islamic banking industry is most easily tracked through changes in the NPF ratio. This indicator reflects the volume of problematic financing resulting from customers' failure to repay both principal obligations and profit-sharing portions (Aziz & Fianto, 2024). A high NPF rate has been shown not only to erode profitability but also to threaten the overall systemic stability of the banking sector (Hilman & Aslamah, 2025). Given this reality, today's financial institutions are required to fortify themselves through a more holistic risk analysis. They can no longer disregard customers' non-financial eligibility profiles to minimize the risk of future non-performing loans.

Environmental, Social, and Governance

A sustainability approach inherently incorporates highly specific risk mitigation measures within each of its pillars. Under the environmental pillar, a bank's policy of refusing to finance highly polluting projects will protect the institution from the risk of regulatory fines (Borowiec & Heryszek, 2025). Regarding the social pillar, the bank's involvement in community empowerment can create strong social capital and enhance the institution's reputation (Alghafes et al., 2024). Meanwhile, under the Governance pillar, strict oversight by the Sharia Supervisory Board is crucial to prevent the disbursement of financing that violates standard operating procedures (Wardiman et al., 2024). The consistent implementation of these three ESG elements has been shown to have a positive and significant impact on the recovery of profitability metrics, such as Return on Equity (ROE), across various banks in the Asian region (Hapsari et al., 2025)

Discussions

Hypotheses Development

Environmental Disclosure and Non-Performing Financing

The requirement to meet environmental criteria automatically compels Islamic banks to exercise greater caution when screening prospective borrowers. Banks that proactively avoid financing business sectors vulnerable to climate change have been shown to have healthier loan portfolios (Nocoń, 2024). Customers with environmentally friendly business models generally demonstrate greater business sustainability. Transparency regarding the disbursement of green funds is a positive signal that banks are adopting a high level of prudence (Prihandini, 2024). This is supported by findings that green financial reporting and strong environmental policies provide unique added value to the banking sector through improved operational efficiency and transparency (Chandra et al., 2024). Based on this logic, transparency in reporting on environmental conservation is believed to help curb the rate of non-performing financing.

H_1: Environmental disclosure has a negative effect on the Non-Performing Financing (NPF) rate.

Social Disclosure and Non-Performing Financing

The social pillar reflects the strength of the ethical bond between Islamic banks and the surrounding community. This is often manifested through efforts to promote financial inclusion and support programs for the SME sector. When a bank demonstrates strong social performance, it earns the trust and loyalty of its customers (Adirestuty et al., 2025). This kind of emotional closeness is psychologically capable of dampening customers' intentions to delay installment payments deliberately. Instead, they are motivated to repay their debts because they feel they have been helped and treated with humanity by the bank (Aziz & Fianto, 2024). Banks that proactively practice sustainable performance disclosure—particularly regarding social aspects—tend to demonstrate far superior resilience and operational risk mitigation in the field (Dewi et al., 2025).

H2: Social disclosure has a negative effect on the Non-Performing Financing (NPF) rate.

Governance Disclosure and Non-Performing Financing

Transparent governance has always served as the first line of defense against the abuse of authority in the disbursement of funds. In Islamic banking, dual oversight effectively ensures that every disbursement of funds has undergone a very strict eligibility screening process (Kiran et al., 2025). This comprehensive oversight practice is routinely maintained through collaboration between the board of commissioners and the Sharia Supervisory Board. The more detailed and transparent a bank's reporting on its governance commitments is, the lower the credit risk exposure it must bear (Prasetyo & Musmini, 2025). This transparency effectively reduces the potential for employee misconduct and closes loopholes in the disbursement of funds that could be influenced by nepotism.

H3: Governance disclosure has a negative effect on the Non-Performing Financing (NPF) rate.

This research model directly maps how each pillar of sustainability—Environmental, Social, and Governance—functions as an independent variable hypothesized to mitigate the risk of Non-Performing Financing. To ensure that the tested effects are pure and free from biases related to the companies' internal characteristics, this design also incorporates the Capital Adequacy Ratio (CAR), bank size, and profitability (ROA) as control variables. Visually, the paradigm and the direction of the relationships among the variables in this study are illustrated in Figure 1.

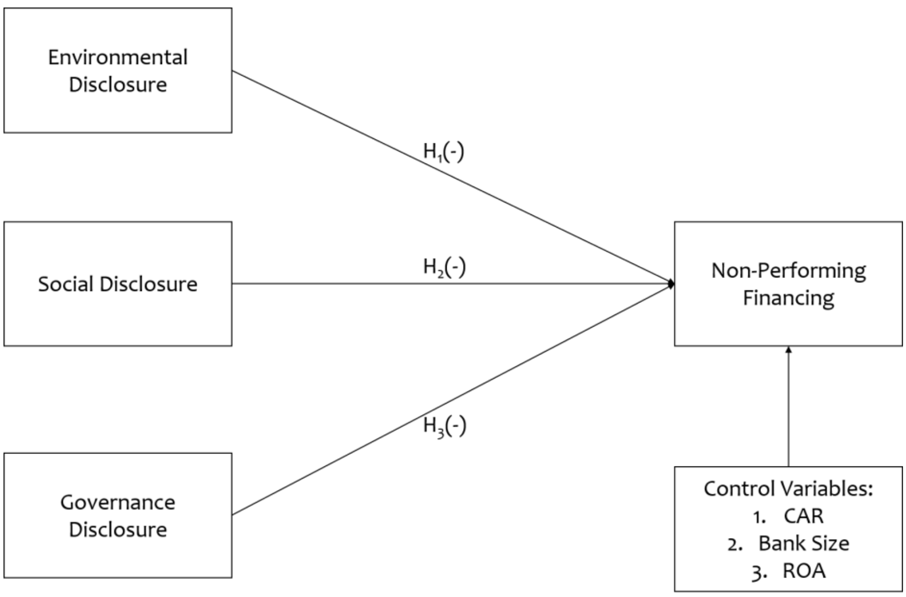

Figure 1 Conceptual Framework

Conclusion

This conceptual study formulated a framework that integrates the ESG pillars as a risk mitigation mechanism in Islamic banking in Indonesia. Through a synthesis of Agency Theory and the values of

Maqashid Sharia, this paper offers a new perspective: ESG disclosure is not merely an operational cost burden or a form of regulatory compliance. Rather, strengthening each ESG component serves as a strategic instrument with significant potential to reduce Non-Performing Financing (NPF) rates, particularly when facing economic fluctuations during periods of crisis and recovery (2020–2024).

The proposed model hypothesizes that transparency in environmental, social, and governance aspects, taken individually, will send a positive signal regarding Islamic banks' prudence in managing their financing portfolios. Theoretically, this study reinforces the argument that applying sustainability values aligned with Sharia principles can create a more robust internal defense system against default risk. In practice, this conceptual framework provides a basis for Islamic banks to prioritize the sustainability pillars most relevant to their risk characteristics. As a next step, empirical testing of this model is highly recommended to demonstrate the statistical validity of the relationships among variables, thereby making a tangible contribution to the stability of the national Islamic banking industry.

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Conflict of Interest

The authors declare no conflict of interest. The founders had no role in the design of the study, the collection, analysis, or interpretation of data, the writing of the manuscript, or the decision to publish the results.