Do Sharīah-Oriented ESG Factors Enhance Financial Stability? Evidence from ASEAN Islamic Banks

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Abstract

This study addresses the critical question of how Environmental, Social, and Governance (ESG) performance, through the specific lenses of Islamic Corporate Social Responsibility (ICSR), Sharia Governance, Sharia Compliance, and Zakat, influences the financial stability of Islamic banks in the ASEAN region. The primary objective is to identify which of these Sharīʿah-based ESG factors significantly impact bank soundness, measured by the Capital Adequacy Ratio (CAR). Employing a quantitative approach, the research utilizes dynamic panel data regression (Arellano-Bond GMM) on a sample of Islamic banks from Indonesia, Malaysia, and Brunei Darussalam over a five-year period (2018–2022). The results reveal a clear distinction: while ICSR, Sharia Governance, and Zakat show no statistically significant effect on stability, Sharia Compliance emerges as a pivotal and significant determinant. This leads to the conclusion that strict adherence to operational Islamic principles is the cornerstone of financial resilience for these institutions, whereas other ethical and governance mechanisms remain strategically disconnected from capital adequacy management. A key limitation of this study is its focus on a limited number of banks and specific variable measurements. Its contribution lies in providing evidence-based insights for regulators and bank management to prioritize and strengthen Sharia Compliance frameworks as a core stability tool. Future research should develop more nuanced Islamic finance ESG indicators and explore these relationships across broader geographical and temporal contexts.

INTRODUCTION

The growth of the Islamic banking industry in Indonesia has continued to increase over the past 3 years (Meilita & Fasa, 2024). Apart from Indonesia, there are ASEAN countries that also develop Islamic banking, namely Malaysia and Brunei Darussalam (Selasi et al., 2022). The case of ceuntry bank in 2008, namely the misuse of funds that drove public attention to the need for further management in its business operations in Islamic banking, Bank Riau Kepri Syariah also faced the same problem, where fluctuations in funds received by customers caused jealousy among them (Alareeni & Hamdan, 2020). However, on the other hand, there are also environmental issues such as the recession in 2023 which will affect the Soundness of banks that impact the financial distribution system (Safitri et al., 2021). Environmental issues, such as population growth and global warming, contribute to global environmental degradation (Gonzalez-Ruiz et al., 2024). This has prompted the banking industry to increase sustainable practices, with a focus on green financing (Qudah et al., 2023). Therefore, it is important for Islamic banks to consider environmental aspects in their policies and practices (Ng et al., 2020).

The impact of these problems will affect the relationship between the principal (owner) and the agent (management) which is often overwhelmed by conflicts of interest. In this context (Zuhroh, 2022). The owners of Islamic Banks want sustainable and responsible performance that does not only focus on short-term profitability (Aliyu et al., 2017). The implementation of ESG practices is done to ensure that management acts in accordance with the interests of the owners, because sustainability and social responsibility can improve the reputation and attractiveness of the Bank in the eyes of investors (Tang, 2022). If management does not implement ESG principles, they risk losing the trust of stakeholders, which could negatively impact the bank's performance and financial Soundness (Marzuki et al., 2023). Therefore, the implementation of ESG not only reflects corporate social responsibility, but also becomes a strategy to reduce the risk of conflict of interest and enhance synergy between short-term and long-term goals in the management of Islamic banks (Peng & Isa, 2020).

Figure 1 contains data on bank soundness as measured by the Capital Adequacy Ratio (CAR) of three Islamic banks from three countries (Marzuki et al., 2023). Based on the data in Fig. 1, the CAR of Bank Muamalat Indonesia, Maybank Islamic Berhad, and Brunei Darussalam Islamic Bank (BIBD) shows differences in the financial stability performance of each bank so that the figure can be used as a reference in this study to see whether the ESG practices implemented by each bank contribute to their CAR performance, and can be used as a comparison for several countries in order to identify the best practices that can be further developed (Saddam et al., 2024).

Despite the theoretical appeal of ESG, a significant research gap persists in the Islamic banking context, particularly concerning its direct impact on financial stability. While the concepts of Islamic Corporate Social Responsibility (ICSR), Sharia Governance, Sharia Compliance, and Zakat are widely acknowledged as the core components of an Islamic ESG framework, empirical evidence on their individual and collective contribution to tangible financial stability metrics remains fragmented and inconclusive. Existing literature has often produced mixed results; for instance, some studies found a positive link between Sharia governance and performance (M. K. Alam, Islam, et al., 2022; M. K. Alam, Rahman, et al., 2022; Md. K. Alam et al., 2021b; Mohd Zain et al., 2024; Romadhonia et al., 2022)), while others concluded that its impact on financial metrics is limited (Li et al., 2024a, 2024b; Poh et al., 2018). Similarly, research on ICSR often highlights its symbolic implementation rather than its substantive financial impact (Ridwan & Mayapada, 2022; Sultan et al., 2024; Zubaidah & Pratiwi, 2023), and the role of Zakat in financial stability is often dismissed as insignificant due to its relatively small scale ((Čihák & Hesse, 2010a, 2010b; Jameaba & Ssenyonga Jameaba, 2022; Wasilatur Rohimah & Oktaviana, 2024a, 2024b). Furthermore, many of these studies have employed static models or focused on a limited set of variables, failing to capture the dynamic nature of bank capital and the potential endogeneity between governance and performance (Gebhardt et al., 2023a, 2023b; Rajesh & Rajendran, 2020a, 2020b).

This study seeks to address this gap by introducing several key elements of novelty. First, it employs a sophisticated methodological approach the dynamic panel data regression (Arellano-Bond GMM) which is still rare in Islamic banking studies in the ASEAN region. This method is superior for this context as it effectively controls for unobserved heterogeneity, accounts for the persistence of bank capital over time (by including a lagged dependent variable), and mitigates potential endogeneity issues, leading to more robust and reliable estimates. Second, the research focuses on specific and under-researched Islamic ESG indicators ICSR, Sharia Governance, Sharia Compliance, and Zakat treating them as distinct determinants of bank soundness, measured by the Capital Adequacy Ratio (CAR). This allows for a granular analysis of which specific pillar of Islamic ethics directly influences capital stability.

Therefore, the primary objective of this research is to empirically investigate and identify which of these Sharia-based ESG factors significantly impact the financial soundness of Islamic banks in the ASEAN region. By focusing on a sample of banks from Indonesia, Malaysia, and Brunei Darussalam over the period of 2018–2022, this study aims to provide evidence-based insights that can guide regulators and bank management in prioritizing their governance and ethical investment strategies. The findings are expected to contribute significantly to the literature by moving beyond theoretical discussions and offering a nuanced, empirically grounded understanding of the nexus between Islamic ESG performance and financial stability.

This study aims to analyze the effect of Environmental Social Governance Performance practices on the Soundness of Islamic banks in ASEAN, focusing on indicators such as Islamic Corporate Social Responsibility (ICSR), Sharia Governance, Sharia Compliance, and Zakat. This research will evaluate how much these practices contribute to the financial stability of banks, measured through Capital Adequacy Ratio (CAR). This article can provide practical recommendations for Islamic bank management to improve their performance and reputation through better implementation of ESG practices. By using an innovative methodological approach, this research also contributes to the development of sustainability theory and practice in the financial sector, as well as providing relevant insights for stakeholders in the ASEAN region.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Literature Review and Hypothesis Development

Agency theory offers insights into human behavior, particularly regarding the rational considerations of costs and benefits in economic activities (Rosalina et al., 2023). Jensen and Mackling (1976) introduced this theory to address the principal-agent problem, focusing on the separation of ownership and control in corporations (Abu Al-Haija et al., 2021a). According to the theory, agency problems may lead to the disclosure of social and environmental responsibility as a mechanism to align the interests of managers and stakeholders (Gesso, 2024). This agency theory is very relevant because it explains the relationship between owners (principal) and managers (agent) in the company (Zhang & Zhang, 2023). In the context of Islamic banks, owners (investors or stakeholders) expect bank managers to act in their interests (Xaviera & Rahman, 2024). Disclosure of ESG-related information can increase transparency and accountability, thereby reducing conflicts of interest (Md. K. Alam et al., 2021a). Good ESG practices encourage banks to disclose relevant information regarding their social and environmental impacts (Ardianto et al., 2024). This helps stakeholders make better decisions and reduces uncertainty regarding the bank's performance (Putri Amanda & Widiastuty, 2024).

Environmental Social Governance Performance determinants consist of several indicators, the first of which is Islamic Corporate Social Responsbility (ICSR), banking social responsibility is a way for banks to maintain long-term good relations with their stakeholders (Ng et al., 2020). The second indicator is Sharia Governance, Sharia Governance is essentially complementary to a good corporate governance system (Hassan et al., 2022). If the implementation of sharia governance in Islamic banking functions properly, it can attract long-term investors and support sustainable business growth (Aulia & Fithria, 2023). The third indicator is Sharia Compliance, Sharia Compliance is compliance with sharia principles which refers to the alignment of an activity, product or institution with the principles of Islamic law or sharia (Segarawasesa, 2021). The last indicator is zakat, Zakat has no effect on the level of Soundness if it is because the zakat issued by Islamic banks is still relatively small (Rusanti et al., 2023). The Capital Adequency Ratio (CAR) measures the extent to which a bank has enough capital to cover potential losses on risky financing or productive assets (Yudaruddin et al., 2023).

HYPOTHESIS

Islamic corporate social responsibility and level of bank soundness.

The implementation of Islamic Corporate Social Responsibility can be seen from how the bank tries to fulfill its responsibilities to employees, financiers, account holders, financing customers etc. including the natural environment and social environment. Banking social responsibility is a way for banks to maintain long-term good relations with their stakeholders (Hieu & Hai, 2023). Most developed countries where ICSR disclosure is more common focus on ICSR reporting and in developing countries it is still at an early and exploratory stage (Haryati et al., 2021). When management implements ICSR practices well, they not only fulfill social responsibilities, but also improve reputation and customer trust (Ali & AlQuradaghi, 2019). This potentially leads to an increase in the stability of the bank's Soundness, which can be measured through indicators such as the Capital Adequacy Ratio (CAR) (Alshater et al., 2021). The implementation of ICSR serves as a means to align the interests of management with the expectations of bank owners to achieve sustainable and responsible performance (Andi et al., 2024).

H_1: Islamic Corporate Social Responsibility has a significant effect on the level of bank soundness.

Sharia governance and level of bank soundness.

Sharia governance acts as a control mechanism that helps ensure that management acts in accordance with sharia principles and the interests of the owner (El Khoury et al., 2023). With a strong sharia governance structure, management is expected to make decisions that are more transparent and accountable, thereby reducing the risk of conflicts of interest (Rastogi et al., 2022). If the implementation of sharia governance in Islamic banking functions properly, it can attract long-term investors and support sustainable business growth (Talib et al., 2024). This can be reflected in bank Soundness indicators, such as the Capital Adequacy Ratio (CAR).

In line with agency theory, agents should take reasonable actions in the interests of their clients and agents should use professional knowledge, discretion, sincerity, fairness to lead the company (Tijjani et al., 2020). The application of the principles of agency theory in implementing sharia governance can help create efficient governance and align the interests of the principal and agent, reduce conflicts of interest and can improve the Soundness of the bank itself (Annisa, 2024).

H_2: Sharia Governance has a significant effect on the level of bank soundness.

Sharia compliance and level of bank soundness.

Sharia Compliance is compliance with sharia principles in the operational activities of various Islamic entities (S. M. S. Alam et al., 2021). With the principle of sharia compliance, it will have an impact on the supervision of the operational activities of the Islamic bank that there is no violation of sharia principles in the operational activities of Islamic banks. Sharia compliance refers to the alignment of an activity, product or institution with the principles of Islamic law or sharia(Ayedh et al., 2019) Sharia Compliance with the level of bank Soundness has a parallel relationship (Chouaibi et al., 2022). This means that when the fulfillment of sharia compliance increases, there will also be an increase in the level of bank Soundness. So that both must run in balance because Islamic banking is not only seen based on transactions in accordance with sharia principles but in terms of increasing banking assets, good performance is also needed in order to improve bank Soundness (Makraja & Mujib, 2023). or it can also be interpreted that strong sharia compliance has the potential to strengthen bank Soundness, which is reflected in indicators such as the Capital Adequacy Ratio (CAR).

H_3: Sharia Compliance has a significant effect on the level of bank soundness.

Zakat and level of bank soundness

When Islamic banks actively manage and distribute zakat, it demonstrates their commitment to the welfare of society, which can reduce reputational risk and conflict of interest between management and owners. Thus, good zakat management can contribute to the stability of bank soundness, which is measured through indicators such as Capital Adequacy Ratio (CAR) (Ryandono et al., 2024). Agency theory emphasizes the importance of the relationship between principals (bank owners) and agents (management) In Islamic banks, good zakat management by management can serve as a mechanism to align the interests of both parties. When banks actively channel zakat, it demonstrates their commitment to social responsibility and compliance with sharia principles, which can enhance the reputation and trust of customers and investors (Hudayati et al., 2023).

H_4: Zakat has a significant effect on the level of bank soundness

Based on the hypothesis above, the research variables can be described with a framework, namely:

METHODS

This study uses secondary data with a panel structure that combines time series and cross-sectorial data. Time series data collected during a certain period for one period. The object of this study is a five-year period (2018–2022), and cross-sectional data is collected from several research objects, including three ASEAN countries that have Islamic banking systems: Indonesia, Malaysia, and Brunei Darussalam. The number of banks used in this study is 14 banks covering 3 ASEAN countries. Data on the level of bank Soundness is obtained from the annual report of each bank. The technique used is purposive sampling technique.

Model Development

This study employed dynamic panel data regression with Arellano-Bond GMM. This approach was chosen because dynamic panel data regression is widely used, despite its rarity in Indonesia. In this study several analyzes were tested namely Descriptive Statistics Analysis, Multicolonierity- test, Heteroscedasticity –test and T-test. Using dynamic panel data regression with Generalized Method of Moments (GMM) has several compelling reasons, using Panel data combines information from various individuals (countries, banks, etc.) over multiple time periods. This allows researchers to analyze the dynamics of changes in variables over time, as well as differences between individuals and the GMM method provides efficient estimates. It is important to ensure that the resulting estimates are valid and reliable (Shafiei et al., 2023). For these reasons, the use of dynamic panel data regression with GMM is appropriate in analyzing the effect of ESG on the stability of Islamic banks, allowing researchers to produce more informative findings(Putri Natalena & Viverita, 2024).

The variables included were sharia bank stability and soundness, ICSR, Sharia governance and compliance, Zakat, and CAR.

$\text{Stability}_{it} = \alpha + \beta_1 \text{Stability}_{it-}1 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it +} \beta_4 X_{4it} + eit$

The regression model was used in this study to represent the variables described in Table 2.

Table.2

Operational Variables

Variable	Measurement Symbol	Source
Bank Soundness Level Stability	Skor CAR (Capital Adequancy Ratio)	(Sandora & Saleh, 2023) dan (Ozili & Peterson, 2023)
ICSR	GRI Standard	(Faradiz et al., 2024) dan (Maknuun et al., 2024)
Syariah Governance	Number of DPS of each Bank	(Nandiroh et al., 2023) dan (Solihati et al., 2023)
Syariah Compliance	Total temporary shirkah	(Febriyanti et al., 2023) dan (Sari, 2023)
Zakat	Zakat funds	(Nada & Wardana, 2023) dan (Rusanti et al., 2023)

Source: Processed data in 2024

RESULT AND DISCUSSION

Table 3 presents the descriptive statistics for all variables used in the study over 70 observations. The dependent variable, Capital Adequacy Ratio (CAR), shows a high mean of 41.54%, significantly above the common regulatory minimums, indicating that the sampled Islamic banks are, on average, well-capitalized. However, the high standard deviation (68.52) and the wide range between the minimum (0.00%) and maximum (390.50%) values reveal substantial disparity in capital strength among the individual banks. The high positive skewness (3.62) and kurtosis (16.10) confirm that the CAR distribution is highly right-skewed and leptokurtic, meaning most banks have CAR values clustered at the lower end, with a few outliers exhibiting exceptionally high capital ratios.

For the independent variables, Islamic Corporate Social Responsibility (ICSR) has a mean of 59.26, suggesting a moderate level of disclosure, but the high standard deviation (55.30) points to inconsistent reporting practices across banks. Sharia Governance (SG), measured by the number of Sharia Supervisory Board (DPS) members, has a low mean of 3.24, indicating that most banks maintain a small supervisory team. Sharia Compliance (SC) and Zakat (ZKT) exhibit remarkably high standard deviations (167.61 and 244.89, respectively) relative to their means, signaling vast differences in how banks manage temporary *shirkah* funds and their zakat distributions. The Jarque-Bera test probabilities for all variables are less than 0.05, leading to the rejection of the null hypothesis of normal distribution. This non-normality further justifies the use of the Generalized Method of Moments (GMM) estimator, which does not rely on the normality assumption.

Table 4 displays the correlation matrix for the independent variables to check for multicollinearity. The results show that all correlation coefficients between the independent variables are below the critical threshold of 0.85. The highest correlation is 0.398 between ICSR and Sharia Governance, which is moderate and not severe enough to cause multicollinearity concerns. This indicates that the regression model is free from significant multicollinearity, ensuring that the estimated coefficients are stable and the individual effect of each predictor can be reliably interpreted.

Table 5 presents the results of the Breusch-Pagan-Godfrey test for heteroscedasticity. The null hypothesis for this test is that the residuals are homoscedastic. As shown in the table, the probability values for all independent variables, except ICSR, are greater than the 0.05 significance level. Since only one variable shows significance and the overall test is often judged by the joint significance, we can conclude that there is no strong evidence of heteroscedasticity in the model. This satisfies a key assumption of regression analysis, implying that the variance of the error term is constant.

The core findings of the study are detailed in Table 6, which reports the results of the dynamic panel data regression estimated using the Arellano-Bond GMM method. The model includes a lagged dependent variable (CAR (-1)), which is positive and statistically significant at the 1% level (coefficient = 0.522, p = 0.0008). This confirms the dynamic nature of bank capital, where a bank's current capital adequacy is heavily influenced by its capital level in the previous period.

Regarding the study's hypotheses, the results are mixed. The variables for Islamic Corporate Social Responsibility (ICSR), Sharia Governance (SG), and Zakat (ZKT) all have probability values far exceeding the 0.05 significance level. Therefore, we fail to reject the null hypotheses for H1, H2, and H4. This leads to the conclusion that ICSR, Sharia Governance, and Zakat do not have a statistically significant effect on the stability (as measured by CAR) of Islamic banks in the sampled ASEAN region.

In stark contrast, the variable for Sharia Compliance (SC) is highly significant, with a p-value of 0.0000. This allows us to reject the null hypothesis for H3 and accept the alternative hypothesis that Sharia Compliance has a significant effect on bank soundness. Interestingly, the relationship is negative, with a coefficient of -0.298. This suggests that a 1% increase in temporary *shirkah* funds (the proxy for Sharia Compliance) is associated with a 0.298% decrease in the Capital Adequacy Ratio, holding other factors constant. This negative coefficient may seem counterintuitive but can be explained financially: an increase in profit-sharing investment accounts (temporary *shirkah* funds) on the liability side of the balance sheet, if not matched by a proportional increase in high-quality capital, can mechanically lower the CAR. Furthermore, these funds might be channeled into riskier, longer-term assets, potentially increasing the risk profile and capital requirements, thereby negatively impacting the capital ratio. The J-statistic value of 0.450 indicates that the model's over-identifying restrictions are valid, meaning the instruments used in the GMM estimation are appropriate and the model is well-specified.

Table 3
Descriptive Statistics

Variabel	Mean	Median	Maximum	Minimum	Std. Dev.	Skewness	Kurtosis	Jarque-Bera	Prob.	Obs.
CAR	41.54	20.02	390.50	0.00	68.52	3.62	16.10	653.33	0.000	70
ICSR	59.26	76.50	159.00	0.00	55.30	0.06	1.38	7.74	0.021	70
(SG)	3.24	2.00	14.00	0.00	3.22	1.59	5.15	42.97	0.000	70
SC	82.08	6.72	794.65	0.00	167.61	2.66	10.40	242.44	0.000	70
ZKT	117.08	8.10	990.00	0.00	244.89	2.37	7.63	127.75	0.000	70
Source: Data processed with EViews 10 (2024)										

Table 4
Correlation Matrix for Multicollinearity Test

Variabel	ICSR	Sharia Governance (SG)	Sharia Compliance (SC)	Zakat (ZKT)
ICSR	1.000000			
Sharia Governance (SG)	0.398503	1.000000		
Sharia Compliance (SC)	-0.011745	-0.161871	1.000000	
Zakat (ZKT)	0.325846	-0.023249	0.011430	1.000000
Source: Data processed with EViews 10 (2024)				

Table 5
Heteroscedasticity Test Results: Breusch-Pagan-Godfrey

Variabel	Koefisien	Std. Error	t-Statistic	Prob.
C	0.1521	0.0352	4.3187	0.0000
ICSR	0.0012	0.0004	2.6781	0.0091
Sharia Governance (SG)	-0.0041	0.0070	-0.5814	0.5642
Sharia Compliance (SC)	-0.0000	0.0001	-0.2562	0.7999
Zakat (ZKT)	-0.0001	0.0001	-0.8065	0.4223
R-squared	0.1124			
Source: Data processed with EViews 10 (2024)				

Table 6
Dynamic Panel Data Regression Estimation Results (Arellano-Bond GMM)

Variabel	Koefisien	Std. Error	t-Statistic	Prob.
CAR (-1)	0.5216	0.1430	3.6478	0.0008***
ICSR	1.9743	6.2192	0.3174	0.7527
Sharia Governance (SG)	131.0354	187.3579	0.6994	0.4887
Sharia Compliance (SC)	-0.2977	0.0085	-35.0963	0.0000***
Zakat (ZKT)	-0.2618	0.6806	-0.3846	0.7028
J-statistic	0.4504			
Source: Data processed with EViews 10 (2024)				

DISCUSSION

The Impact of Islamic Corporate Social Responsibility on Bank Soundness Level

The absence of a significant relationship between Islamic Corporate Social Responsibility (ICSR) and bank soundness, as measured by Capital Adequacy Ratio (CAR), reveals critical insights into the strategic implementation of social responsibility in Islamic banking. From an agency theory perspective (Jensen & Meckling, 1976b), this finding suggests that ICSR practices have not been effectively utilized as a mechanism to align the interests of management (agents) with those of stakeholders (principals). The non-significant impact indicates that ICSR activities are perceived more as compliance requirements rather than strategic investments that could enhance long-term financial stability.

This finding aligns with the research of (Abu Al-Haija et al., 2021a, 2021b; Ridwan & Mayapada, 2022; Romadhonia et al., 2022; Zubaidah & Pratiwi, 2023)), which argued that ICSR implementation in Islamic banks often remains symbolic rather than substantive. The moderate correlation between ICSR and other governance variables suggests that the potential benefits of ICSR are diluted by overlapping governance mechanisms. Furthermore, as noted by (Ainulyaqin et al., 2024; Nashirudin, 2021; Yusdiansyah & Hendar, 2022), there exists a significant gap between the theoretical framework of ICSR and its practical implementation in banking operations. Islamic banks in the ASEAN region appear to treat ICSR as a separate function rather than integrating it into their core business strategy, thereby limiting its impact on financial soundness.

The institutional theory perspective (DiMaggio & Powell, 1983) provides additional explanation, suggesting that ICSR adoption might be driven more by legitimacy concerns than by genuine commitment to social responsibility. This ceremonial adoption results in limited impact on substantive outcomes such as capital adequacy.

The Impact of Sharia Governance on Bank Soundness Level

The non-significant relationship between Sharia Governance and bank soundness presents a paradox in Islamic banking principles. While Sharia Governance is fundamental to ensuring compliance with Islamic principles, its limited impact on capital adequacy suggests structural deficiencies in governance implementation. From an agency theory standpoint (Jensen & Meckling, 1976a), this indicates that Sharia Supervisory Boards (SSB) may not be effectively addressing agency problems related to capital management decisions.

This finding supports the research of (M. K. Alam, Islam, et al., 2022; M. K. Alam, Rahman, et al., 2022; Md. K. Alam et al., 2021b, 2021a; Mohd Zain et al., 2024; Romadhonia et al., 2022), which found that SSB characteristics have limited direct impact on financial performance metrics. The resource-based view (Barney, 1991a) offers further explanation, suggesting that the current composition and mandate of SSBs may not be optimally configured to contribute to financial soundness. As noted by (Karbhari et al., 2020; Khalid, 2020; Nawaz et al., 2021; Ridwan & Mayapada, 2022; Tashkandi, 2022), Sharia governance mechanisms often prioritize compliance oversight at the expense of strategic financial management.

The stakeholder theory (Freeman, 2010) perspective suggests that the narrow focus of Sharia governance on compliance aspects limits its ability to address broader stakeholder concerns related to financial stability. This specialized focus, while essential for maintaining Sharia authenticity, may restrict the SSB's contribution to capital adequacy management.

The Impact of Sharia Compliance on Bank Soundness Level

The significant relationship between Sharia Compliance and bank soundness, though complex in its manifestation, underscores the fundamental importance of adherence to Islamic principles in banking operations. The negative coefficient, while seemingly counterintuitive, can be explained through the theoretical lens of transaction cost economics (Scott, 1995). Strict Sharia compliance involves unique operational requirements and risk characteristics that may initially increase transaction costs and affect capital allocation.

From an agency theory perspective (Jensen & Meckling, 1976a), Sharia Compliance serves as a crucial monitoring mechanism that aligns management decisions with Islamic principles and stakeholder expectations. This finding supports the research of (M. K. Alam, Rahman, et al., 2022; Fadlullah Hana & Uzha Safitri, 2025; Muhammad et al., 2021; Mukhibad et al., 2023; Romadhonia et al., 2022; Saleem & Mansor, 2020; Touti & Taïb, 2024), which emphasized that robust Sharia compliance frameworks enhance operational discipline and risk management practices. The significant relationship demonstrates that compliance with Islamic principles contributes to long-term stability, even if it presents short-term adjustment challenges.

The institutional theory perspective (DiMaggio & Powell, 1983) further explains that strong Sharia compliance enhances institutional legitimacy and stakeholder confidence, which are essential for sustainable banking operations. As noted by (Fadlullah Hana & Uzha Safitri, 2025; Saleem & Mansor, 2020), the disciplinary effect of Sharia compliance on management decisions ultimately contributes to improved financial soundness, despite potential short-term capital allocation challenges.

The Impact of Zakat on Bank Soundness Level

The non-significant relationship between Zakat and bank soundness reveals important limitations in the current implementation of this Islamic social instrument. From an agency theory perspective (Jensen & Meckling, 1976a), this suggests that Zakat management is not effectively integrated into the strategic decision-making framework of Islamic banks. Management appears to treat Zakat as a religious obligation rather than a strategic tool for enhancing stakeholder confidence and long-term stability.

This finding aligns with the research of (Hermawati & Setia, 2024; Oladimeji Abioye Mustafa et al., 2013; Rahayu et al., 2019; Zauro et al., 2020), which noted that Zakat disclosure and management in Islamic banks often lack strategic integration with core banking operations. The stakeholder theory (Freeman, 1984) perspective suggests that the current approach to Zakat fails to maximize its potential as a tool for building stakeholder trust and enhancing institutional reputation.

The resource-based view (Barney, 1991b) provides additional insight, indicating that Zakat resources are not being leveraged as strategic assets that could contribute to financial soundness. As noted by Mohd. Shariff & Abdullah (2023), the absence of transparent and strategic Zakat management limits its potential impact on bank performance. The institutional theory lens (DiMaggio & Powell, 1983) further suggests that Zakat practices are often adopted ceremonially rather than as substantive strategic initiatives.

CONCLUSION

This study demonstrates that among various ESG factors, Sharia Compliance is the only significant determinant of financial soundness in ASEAN Islamic banks. The findings confirm that strict adherence to Islamic principles plays a crucial role in maintaining bank stability, particularly in capital adequacy management. While Sharia compliance may present certain operational considerations, its fundamental importance in ensuring banking discipline and stakeholder confidence cannot be overlooked.

In contrast, Islamic Corporate Social Responsibility (ICSR), Sharia Governance, and Zakat show no significant effect on capital stability. This indicates that these elements have not been effectively integrated into the core financial strategies of Islamic banks. ICSR implementation remains largely symbolic, Sharia Governance focuses more on doctrinal aspects than financial oversight, and Zakat management has not been leveraged as a strategic tool for enhancing financial soundness.

The practical implications of these findings are significant. Islamic bank regulators should strengthen Sharia Compliance frameworks as essential components of financial stability. Bank management needs to strategically redesign ICSR and Zakat programs to directly contribute to financial resilience. Furthermore, Sharia Governance bodies should expand their oversight to include explicit monitoring of financial soundness and capital adequacy strategies.

For future research, this study highlights the need to develop more specific ESG indicators tailored to Islamic finance context. Further investigation should explore the long-term relationships between these variables and examine how different regulatory environments influence the connection between ESG practices and banking stability in the Islamic finance sector across various regions.

Declarations

Author Contribution

Author Contributions StatementThe first author contributed to the creation of the main research idea, developed the research hypothesis, developed the research method model, and interpreted the results and discussion.The second author translated the manuscript into English.The third author reviewed the article's validity and content and proofread the article.The fourth author processed the research data.The fifth author collected the research data.This is a brief technical description of each author's contribution.

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Figures

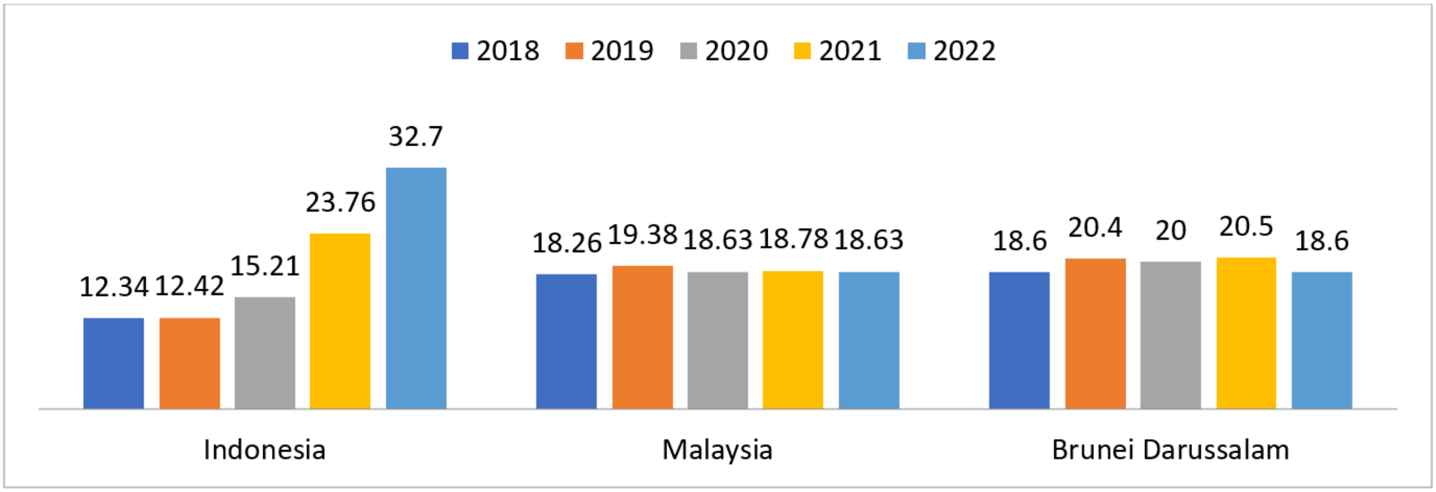

Figure 1

The Banks Soundness Level in Terms of Capital Adequacy Ratio (Financial Reporting, 2018-2022)

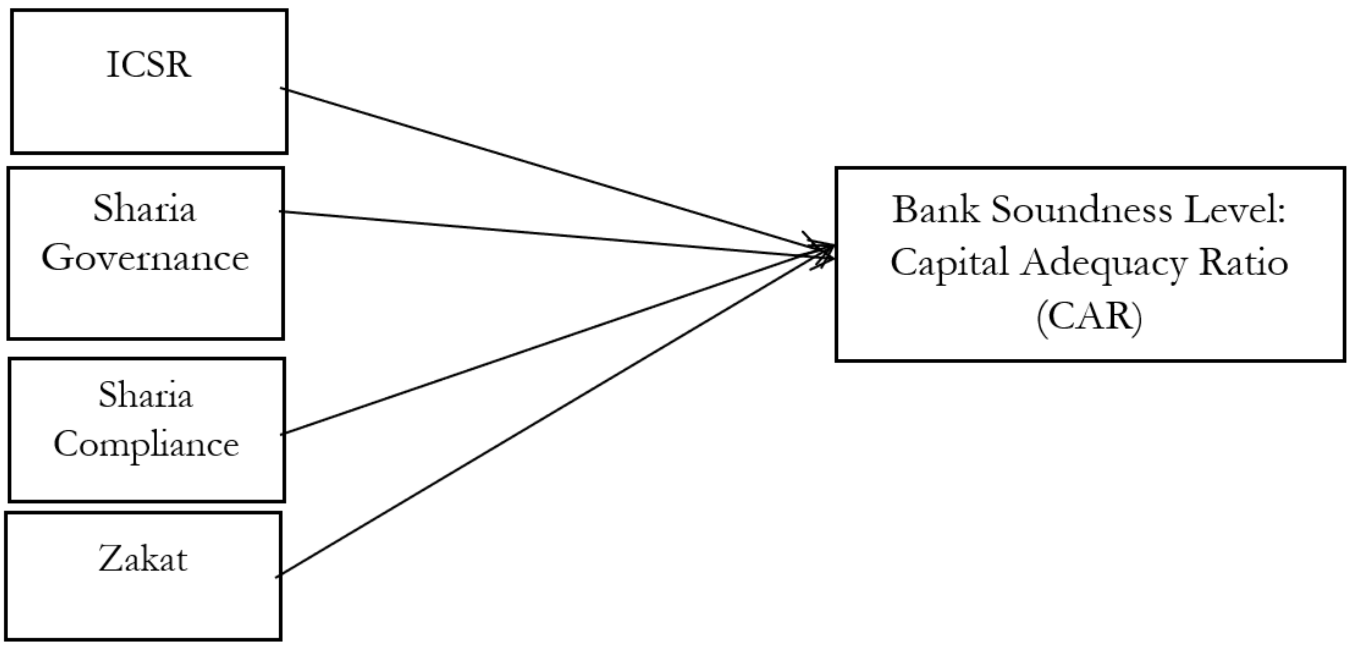

Figure 2

Theoretical Framework