

# STUDIES OF ENVIRONMENT, SOCIAL AND GOVERNANCE DISCLOSURE BY ISLAMIC FINANCIAL INSTITUTIONS (IFIS) IN CONNECTION WITH MAQASID AL-SYARIAH

Syaryanti Hussin<sup>i</sup> Muhammad Najib Abdullah<sup>ii</sup> & Nabilah Yusof<sup>iii</sup> Fadhlina Alias<sup>iv</sup>  
Hasnizam Hashim<sup>v</sup> & Muhammad Nizam Awang<sup>vi</sup>

<sup>i</sup> (*Syaryanti Husin*). Senior Lecturer, Faculty of Syariah and Law (FSU), Universiti Sains Islam  
Malaysia, email@email.com

<sup>ii</sup> Designation, Institution. email@email.com

<sup>iii</sup> Designation, Institution. email@email.com

## Abstract

*Over the last three decades, the Islamic finance industry has grown at an exponential rate, with current market sizes ranging from USD1.66 trillion to USD2.1 trillion. It is predicted to grow to furthermore than USD4 trillion by the end of 2025 (Islamic Commercial Law Report 2018). This rapid progress should be accompanied by IFIs' financial and non-financial disclosure to shareholders, existing and potential investors, and capital providers of the institution's economic resources, claims on those resources, and any transactions or events that may affect them. Disclosure is one method of disseminating information to investors in order to be transparent, which can aid them in making better investment decisions. This study investigates the significance of Islamic Financial Institutions' (IFIs') Environment, Social, and Governance (ESG) disclosure and its relevance in the eyes of Maqasid al-Syariah. It is maintained that, while the environment, social, and governance components of business highlighted in ESG disclosure are within the scope of Islamic law, they are not prioritised by IFIs. This is demonstrated by IFIs' weak ESG disclosure, as well as a lack of awareness and voluntariness in the topic. As a result, this article demonstrates the good motivations and effects of ESG disclosure for IFIs.*

**Keywords:** *Environment, Social and Governance (ESG) Disclosure, IFIs, Maqasid al Shariah.*

## INTRODUCTION

The Environment, Social and Governance (ESG) Disclosure is an initiative to inculcate and encourage corporate social responsibility and sustainability in corporate practice. This is due to the demands from value driven investors which form today's trend in business (Crifo and Forget, 2013). In responding to this demand, there are global initiatives to set systematic reporting guides such as the Global Reporting Initiatives and the United Nations Global Impact.

While other corporate sectors are following this trend, the Islamic Financial Institutions are still seen lagging behind, with poor reporting and disclosure (Belal, 2014). To date, the referred ESG related standard in Islamic Finance is the Governance Standard for Islamic Financial Institutions No.7, 'Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions' by the

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). However, such disclosure requires voluntary adoption by IFIs.

A research on the Malaysian IFI's performance in ESG elements reveals that ESG disclosure is unsatisfactory (Hussein S. 2018). One logical explanation to this, apart from it being voluntary, is the belief that there is no legitimacy impact on its performance. Legitimacy theory is important in understanding the behaviour of IFIs. Legitimacy theory sets the assumption that the actions of an entity are desirable, proper, or appropriate in the societal norm, monitored by public-policy rather than the market place (Patten, 2005). The linkage between IFIs and the larger social system should be felt in order for the IFIs to emerge in the need of ESG disclosure as part of societal responsibility. Exertion of effort in ESG disclosure is also an additional feature, and to some IFIs may seem as deviation from their profit making objective. This may only be true in the short run with the lack of futures analysis that could convince IFIs otherwise. On a more positive note, ESG disclosure is the way forward with the increasingly value driven new generation of investors and customers.

The connection of ESG disclosure to the societal needs and justice is very much in line with the Islamic teachings. The underlying concepts of ESG such as environmental protection, social wealth distribution, human rights and health and safety can be seen in the Quranic texts and Prophetic traditions as early as 1400 years ago. As will be discussed in this paper on the Islamic sources on ESG, it is inaccurate to regard ESG elements as an innovation which has no religious value. The focal discussion of this paper is to promote ESG to IFIs and to show that ESG disclosure is part of religious responsibility under the Maqasidi analysis of the ultimate objectives of Shariah in commercial transactions.

### **ESG: The New Paradigm for IFIs**

It is pertinent that IFIs should shift from business-as-usual to a more sustainable future. Environmental, social and governance issues should be factored into financial decisions. These changes in public awareness could actually create new needs and opportunities for IFIs. Among the needs and opportunities are:

#### **a. The Need to Tap Global Sustainable Responsible and Impactful Investments (SRIs)**

The IFIs should embrace the new paradigm in seeing investments as agents of positive societal impacts. This new global trend in disclosing SRI related information is in line with ESG disclosure which considers environmental, social and corporate governance criteria to generate long-term competitive financial returns and sustainable economic and social growth. In the world of SRI markets, the US

market alone showed an increase of 33% of total asset amounting to USD 8.72 million in 2016 from USD 6.57 in year 2014 (US SIF Foundation, Biennial Report, 2016). Malaysia was the largest SRI market in the Asian market in 2014 with 30 % more total asset, after Hong Kong 26% (Global Sustainable Investment Alliance (GSIA) 2014). GSIA is an international collaboration of membership-based sustainable investment organization which aims at deepening the impact and visibility of sustainable investment organisations at the global level. In the GSIA's report, GSIA highlights the increasing utilisation of ESG integration strategy all over the world from US, Australia and New Zealand and Asia excluding Japan (GSIA, 2015)

#### b. The growth of Islamic funds in the local Malaysian market

The growth of Islamic funds in the local Malaysian market increases the demands towards ESG disclosure. An obvious example of this is the Employees Provident Fund (EPF), the Malaysian biggest private pension fund, which launched its Shariah saving fund in August, 2016 (EPF, 2016). This step by EPF was motivated by the continuous requests from its members for Shariah-compliant funds. The anticipated accumulation of fund amounting to RM25 billion is a huge opportunity to be tapped by IFIs, and this can be met by providing business strategies that incorporate the new ESG paradigm. Furthermore, ESG compliance is recommended by the Malaysian Code of Corporate Governance 2012 (MCCG, 2012). The importance of the matter can also be seen from the recommendations by 75% of CEOs in a survey by KPMG on CEOs on the matter. (PwC, 2013).

#### c. Emergence of Organisation of Islamic Cooperation (OIC) Market for ESG Strategy

In prior studies, the emerging and OIC markets are still struggling in their effort towards environmental, social business practices and financing decisions, as compared to developed markets. The Islamic finance industry in particular, which operates in the emerging market and OIC markets, suffers this general lack of awareness and preparation in managing environmental and social risks or optimising environmental and social opportunities (Dijk et al., 2012). Ironically, there are more ESG-related business opportunities in emerging economic countries than the developed countries in areas such as energy efficiency or environmental protection projects financing and micro-financing (WWF, 2014). Quick action is required for the IFIs to acknowledge this new development and the need to adopt ESG disclosure to ensure its relevance in the future.

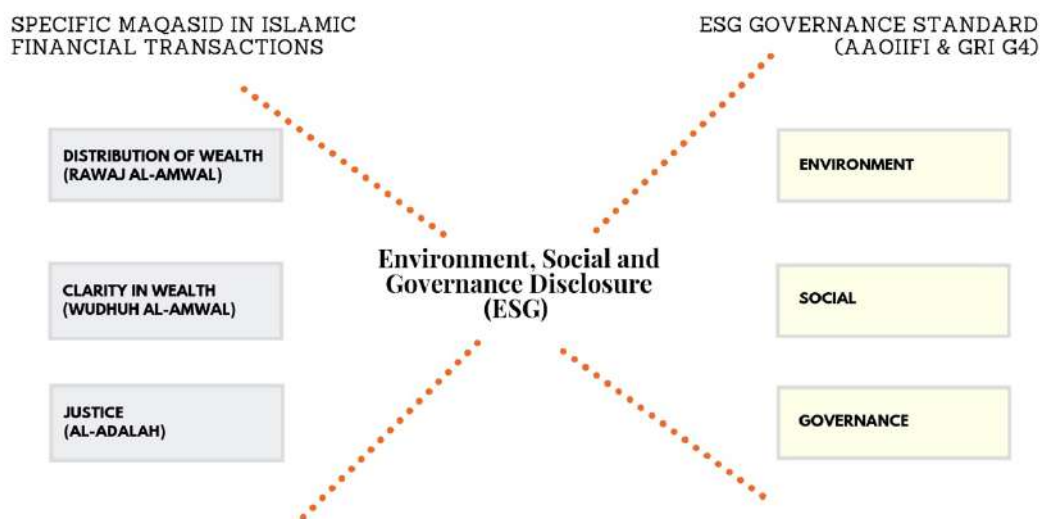
Despite encouraging Islamic principles in promoting the preservation of the environment, society and governance, the current Islamic finance industry does not significantly contribute to ESG disclosure. The focus has been on ensuring Shariah-compliant sectors and financial screening ratios with little concern in addressing real risks faced by the global investors such as climate change, food shortage, extreme

poverty, youth education, financial literacy and other important issues (Haneef, 2015). Therefore, an in-depth research on ESG matter for IFIs is a good initiative to assist the Islamic finance market players to expand their future potential market. (Ahmed, H.,2015).

### Maqasid Framework Approach towards ESG Disclosure

Environment, social and governance elements as contained in the ESG disclosure are promoted in Islam. They constitute the necessary elements to achieve the higher objectives of the Shariah (Maqasid al-Shariah) that governs all dealings of human transactions. The relation between Maqasid and ESG disclosure can be seen in the following diagram:

Diagram 1: Relation between Maqasid and ESG Disclosure



The corpus of knowledge of Maqasid al-Shariah which underlies Islamic finance is comprehensive. It covers every aspect of financial transactions, with its main objective to achieve excellence (السعادة) in human life (Ibn Ashur, 2001, p.251). The comprehensiveness of Maqasid al-Shariah in Islamic finance covers questions of legalities in its products as well as the overall operations. Thus, where problems occur in the current practice of Islamic finance that affects human wellbeing and universal sustainability, it would constitute a big concern in Shariah and has its own redress under its ambit. The IFIs have great responsibilities to ensure that their operations meet well the Maqasid al-Shariah and realign themselves in cases of deficiencies to its right purpose (Muhammad Najib, 2018, p66).

Mohamad Akram Laldin stated that the objective of offering Islamic banking services by IFIs must be in line with the Maqasid al-Syariah from the beginning of its establishment. This is to ensure that the spirit of the Shariah and its compliance in each financial activity is preserved. These objectives could be achieved if all the operations are carried out with superior underlying principles of justice and transparency. This marks the importance of the implementation of the financial system which is based on Maqasid al-Shariah, ethics and values. With this, Islamic financial services will become more integrated in its form and essence. (Mohamad Akram, 2014, p.78).

### **Specific Maqasid in Islamic Financial Transaction**

With reference to the main source in Maqasidic studies by Ibn Ashur (Ibn Ashur, 2001, p.254), the objectives of the Shariah in Islamic financial transaction are divided into general principles and specific rules, the latter being the focal point of discussion in this paper. The elements of ESG and their disclosure are contained in the specific objectives namely, distribution of wealth (رواج الأموال) clarity in wealth (وضوح الأموال) and justice (العدالة). Clarity entails further honesty and transparency (ثبوت الأموال) and clear evidence of wealth/ documentation (الصدق والبيان).

The illustration of the specific objectives and its relevance to ESG elements and disclosure is as below:

a) Distribution of Wealth (رواج الأموال)

Islam promotes growth of wealth by way of Shariah- compliant transactions. This constitute the core operation of contemporary financial activities of IFIs. However, in Islam, the promotion of wealth accumulation does not end at the parties, neither is it is concentrated and confined to limited hands of a few members of the community. Wealth accumulation activities must involve the exchange of wealth among the groups of society. Wealth should revolve around all sectors of the economy with the aim of upgrading the qualities of human life. Wealth circulation in the society is very crucial, as it will significantly contribute to the development of resources and economic activities at a general level. Locking money within certain groups or individuals will lead to imbalance in the economy. This objective is clearly manifested in the obligation of almsgiving (zakat) by affording members of the society, according to the guidelines of the Shariah. Charity (sadaqah) and benevolent money lending (qard al-hasan) are also encouraged to those in need. Islam also provides guidelines on inheritance, pricing mechanisms for governments and prohibition of usury (riba), stagnation and monopoly. The Quranic injunction is clear on the prohibition of circulation (دَوْلَةً) of wealth among the rich (Al-Quran, Surah Al-Hashr: 7). Islam made the allocation of the wealth for the portion of 'Al-Fai', last it

remain a food that is overcome by the rich, and they will act in it by the desires, and they will not divert anything from it to the poor (Ibn Kathir, 1419H, p.97).

Distribution of wealth includes allocations for earth preservation and promotion of environmental control. This can be realized by IFIs in their commitment to environmental disclosure and support towards green energy financing.

b) Clarity in Wealth (وضوح الأموال)

Islam has laid a clear principle on the general permissibility of transactions. The origin of rulings for financial and commercial transactions is permissibility (ibahah/ Mubah), but they must be restricted by the constraints of justice, equity and morality. This is in line with the ultimate intention of transactions, that is to be kept away from destruction, harm and dispute as much as possible. All contracts between the parties should be free from those elements and should be respected and enforced. The application of Shariah in financial practices should not generally lead to dispute, damage or hardship to individuals or groups. The Shariah urges a creation of positive atmosphere that is suitable for financial transactions, based on fraternity, cooperation and mutual benefit for all parties.

The principles to achieve the purpose of clarity in wealth are:

i. Honesty and Transparency (الصدق والبيان).

The most significant ethical aspect in Islamic banking and financial Institution, is that it should be conducted based on honesty, clarity and transparency throughout its entire processes and procedures. Islam promotes honesty and transparency in dealings with the aim to avoid harm resulted from lies and concealment which would lead to conflicts and disputes. In avoidance of these negative effects, the IFIs are to take all the necessary procedures to clarify matters relating to the contracts and its nature to the parties, including clear descriptions of compensation, reports, terms, obligations, rights and duties.

The evidence that indicate this objective is a hadith from the Prophet SAW :

البيعان بالخيار ما لم يتفرقا، فإن صدقا وبيّنا بورك لهما في بيعهما وإن كذبا وكتما محقت بركة بيعهما

“The sale is based on the option until they get separated, if they practice honesty and clarity they are blessed, if they lie and conceal, the blessing of their selling will be destroyed”.

Islam prohibits all kinds of lying and concealment including tricks in transactions (hiyal) that could lead to prohibition (haram) of the transaction. Ibn Qudamah held a special chapter in his book on the prohibition of hiyal which states: “Any transaction based on hiyal (tricks) are all haram and not permissible in any aspect of the religion, it is to show a permissible contract that is actually prohibited, deceptive and begging

to do what God has forbidden and to expropriate his prohibitions". (Ibn Qudamah, 1968, p.43 ).

Among the important mechanism in governance disclosure by IFIs is the Shariah report, endorsed by the Shariah Committee and are generally published in the institution's annual report. The Shariah report normally contains the activities carried out by the Shariah Committee throughout the year in ensuring that the institution's activities comply with the Shariah principles. However, it is suggested that in line with the principle of transparency, the Shariah report should also contain disclosure of information if there are non-Shariah compliant earnings and expenditure. It is suggested also to the IFIs to report the aggregate descriptions, amounts, account classification (revenue, expense, liability or asset) and reasons for undertaking those types of transactions. The IFIs must also explain how they plan to dispose incomes from such source. A notable example of governance disclosure is by OCBC al Amin Bank which reported non-compliant events in its Shariah Report with detailed financial report of the said activities in their Financial Result Disclosures (OCBC al Amin Bank Financial Annual Report, 2017).

ii. Clear evidence of wealth/ Documentation (ثبوت الأموال).

Wealth accumulation activities should be recorded. This includes records of compliance, whether it comes from permissible or impermissible business transactions or factors. The requirements are:

a. The validity of the property (صحة الملكية): It shall be ascertained that the owner of the wealth has the right and the validity of the contracts, and the necessity thereof, also the fulfillment of the conditions and others.

b. Freedom of property (حرية الملكية): The owner has freedom to act on his property in a legitimate way and not bring harm to others.

c. Protection of property (وقاية الملكية): It not permissible to take money from the owner without his consent, unless it is related to the right of others. Islam urge to respect and protect the property of others, whether it is a public or private property.

This is taken from a hadith of the Prophet:

"إنه لا يحل مال امرئ إلا بطيب نفس منه"

"Wealth is not permissible unless he gives it willingly."

c) Justice (العدالة).

Islam regards justice in muamalat between individuals as a medium to achieve a just system in society. Justice in wealth means that the way the wealth is obtained is in a rightful manner, either by obtaining it through acquired work, by making transactions with the owner or by gift or inheritance (Al-Fauzan, 2014, p.49). Islam

strongly emphasizes on the realization of justice in financial transactions because of its vulnerability to abuse in gaining wealth by doing injustice to others (Ibn Taymiyyah, 1995, p.469).

Justice and fairness in dealings are the hallmark of commercial contracts. Justice is a higher objective in financial transactions which must be preserved and given priority; particularly in determining Shariah compliant contracts. This is so to the extent that when there is element of injustice among the contracting parties, the contract must be revoked immediately. This was enunciated by Ibn Taymiyyah as he stated: “the origin of these transactions and exchange is the equalization of the two sides, if one of them included gharar or riba whose income is inequity, Allah SWT forbade it, which forbade injustice to itself, and made it prohibited for its slaves”. (Ibn Taymiyyah, 1995, p.107).

## CONCLUSION

The IFIs should recognize ESG Disclosure as an effort towards achieving the Maqasid al-Shariah. This paper has illustrated that the legitimate shariah objective in financial practices is to achieve distribution of wealth (رواج الأموال), clarity in wealth (وضوح الأموال) and justice (العدالة) to the parties and the society. These objectives are key features of sustainable financial dealings that are ethically balanced and could give positive impact on the society and universe. In the fast-growing awareness of ESG Disclosure among customers, corporates and conventional banking, the IFIs should adopt it as a new paradigm and a healthy step towards transparency and best practice. It is an opportunity for the IFIs to play an exemplary role in promoting ESG as a mechanism to achieve the higher objectives of Maqasid al-Shariah for a more sustainable economy.

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