

Institutionalizing Sustainability within Islamic Banking: Ethical Alignment and Practical Application in Responsible Finance

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ABSTRACT

This literature-based study investigates the alignment between Islamic banking principles and sustainable finance practices. It critically examines how Islamic banks interpret, implement, and govern sustainability within their operational structures. Through a review of academic literature and institutional practices, the study identifies theoretical consistencies between Shariah and ESG principles, while highlighting gaps in application, governance, and policy support. The findings reveal that although Islamic finance is conceptually aligned with sustainable objectives such as social justice, environmental stewardship, and ethical investing, practical integration remains fragmented. Issues such as regulatory misalignment, limited stakeholder participation, and lack of standardized ESG reporting hinder progress. The study underscores the need for greater institutional commitment, scholarly engagement, and educational reform to enable Islamic banks to lead in shaping a sustainable financial future. The paper contributes to the ongoing discourse on faith-based ethical finance and offers recommendations for enhancing the synergy between Islamic banking and global sustainability frameworks.

INTRODUCTION

The global financial sector has experienced a growing shift toward sustainability, driven by mounting concerns over environmental degradation, social inequality, and ethical governance. As investors, institutions, and regulators increasingly demand alignment between financial flows and sustainable objectives, the discourse on responsible investment practices has intensified across the world. This momentum has not been limited to conventional finance (Ivanitsk & Petrenko, 2021). In parallel, Islamic finance has garnered attention for its inherent ethical orientation, deeply rooted in principles of fairness, transparency, and social justice. Its Shariah-based foundation offers an alternative paradigm emphasizing moral accountability in finance (Moghul, 2017).

Among the core instruments within the Islamic financial framework, Islamic banks occupy a prominent position in promoting equity-based financing, risk-sharing mechanisms, and the prohibition of activities deemed harmful or speculative. These characteristics reflect a system of finance that is not solely driven by profit, but is also guided by objectives aligned with societal well-being.

This foundational distinction has prompted researchers and practitioners to examine the potential of Islamic banking as a natural partner to sustainable finance, especially in light of increasing global calls for responsible and inclusive financial systems (Askari & Krichene, 2014).

In recent years, several scholars and international institutions have drawn parallels between the objectives of Islamic finance—often articulated through the Maqasid al-Shariah—and the goals of sustainable development. Maqasid al-Shariah, which includes the protection of religion, soul, mind, offspring, and property, has substantial intersections with the core values in the SDGs, such as poverty alleviation, social justice, quality education, and environmental sustainability. These conceptual overlaps have opened the possibility of integrating Islamic banking principles with sustainability targets such as poverty alleviation, environmental preservation, and ethical corporate behavior. Such synergies are especially significant in Muslim-majority regions, where Islamic banks are not only financial entities, but also cultural institutions capable of advancing socio-economic goals (Ghani, 2020).

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Despite these promising alignments, the operationalization of sustainability within Islamic banking remains fragmented and underexplored. While numerous Islamic financial institutions have adopted selective Environmental, Social, and Governance (ESG) frameworks, the degree to which these initiatives reflect Islamic legal and ethical doctrines varies widely. Some banks try to integrate sharia values with modern sustainability frameworks, but many are stuck in a symbolic approach without a strong theological foundation. Sustainability initiatives are often not accompanied by an in-depth evaluation of their compatibility with *maqashid al-shariah* (sharia objectives) which include the protection of religion, soul, mind, offspring and property. This raises important questions regarding the authenticity, consistency, and strategic direction of sustainable practices in the Islamic banking sector. Understanding how these institutions conceptualize and implement sustainability is therefore essential for advancing both theoretical scholarship and practical application (Hanić & Sućeska, 2018).

The implementation of sustainability in Islamic finance is complicated by the absence of standardized guidelines that reconcile Shariah principles with contemporary ESG benchmarks. Shariah principles based on moral values, justice and balance are actually in line with the spirit of sustainability. While frameworks such as the UN Principles for Responsible Banking provide general direction, they often lack provisions that accommodate religiously grounded financial methodologies. This disconnection may result in superficial or inconsistent application of sustainability principles across Islamic banks, undermining their credibility in global sustainable finance discourse (Wilson, 1997). This inconsistency is not only detrimental to the reputation of Islamic banks, but also hinders the Islamic finance sector's tangible contribution to broader sustainable development goals.

Moreover, Islamic banks operate in diverse legal and regulatory environments, which shape their capacity to pursue sustainable finance objectives effectively. In jurisdictions where Islamic banking is well integrated into national systems, policy incentives may support the development of green financial products and ethical investment portfolios. However, in countries where regulatory recognition is limited, Islamic banks may lack the institutional infrastructure to implement sustainability measures with strategic coherence (Warde, 2000). This variation contributes to an uneven landscape in which sustainability remains an aspirational rather than operational priority.

Another challenge arises from the misalignment between stakeholder expectations and institutional capabilities. While customers, investors, and regulators increasingly expect Islamic banks to champion environmental and social responsibility, internal governance structures may not always be equipped to meet these expectations. The absence of specialized training, measurement tools, and cross-sectoral collaboration further constrains progress. As Archer and Abdel Karim (2002) observe, without systemic commitment and technical expertise, the potential of Islamic banks to lead sustainable financial innovation will remain limited.

Greater scholarly attention is needed to assess how Islamic banks conceptualize sustainability in relation to their religious and commercial mandates. Islamic finance has strong normative foundations, such as social justice, the prohibition of usury, and responsibility for the environment and society. Existing literature suggests a tension between normative ideals and practical implementation, highlighting a gap in both theoretical integration and operational guidance. Islamic banks are often in the difficult position of balancing religious objectives with the demands of efficiency and profitability. Given the increasing relevance of sustainability in global finance, exploring this intersection within the Islamic banking sector holds significance for expanding ethical finance discourse and enriching institutional practice.

There is increasing recognition that Islamic banks, if guided effectively, could serve as instrumental agents in advancing sustainable development. Their foundational emphasis on equity, social justice, and responsible investment positions them uniquely to address contemporary environmental and social challenges. If this potential is strategically directed through the right regulatory and policy framework, Islamic banks can contribute greatly to the Sustainable Development Goals (SDGs). Studying this potential reveal valuable insights into how faith-based finance may contribute to building more resilient, inclusive, and ethical financial systems on a global scale.

This study aims to examine how Islamic banks interpret and implement sustainable finance within their institutional frameworks. It investigates the alignment between Shariah principles and global sustainability standards, evaluates governance structures supporting responsible finance, and identifies gaps in current practice. The findings are expected to provide conceptual clarity and practical insight for policymakers, scholars, and practitioners interested in advancing ethical and sustainability-oriented finance through Islamic banking models.

RESEARCH METHOD

This study adopts a qualitative literature review methodology to examine the integration of sustainable finance within Islamic banking. The literature review method was chosen to comprehensively synthesize theoretical, regulatory, and practical insights from existing research and case studies. Following the approach outlined by Machi and McEvoy (2012), the process includes topic refinement, systematic search, critical evaluation, and thematic synthesis. The selection of sources emphasized peer-reviewed journals, academic books, and working papers from recognized scholars in Islamic finance, sustainable investment, and banking regulation. Materials were retrieved from academic databases such as JSTOR, ScienceDirect, and Taylor & Francis Online to ensure academic rigor and relevance.

Guided by the framework established by Hart (1998), the analytical process involved identifying recurring patterns, discrepancies, and theoretical developments within the selected literature. This approach allows for the development of an interpretive framework that reflects both the philosophical foundations and real-world practices of Islamic banking in the sustainability domain. The methodological emphasis on qualitative synthesis ensures a nuanced, multi-perspective narrative that is both academically grounded and practically insightful.

RESULT AND DISCUSSION

Across the evolving landscape of global finance, ethical considerations have emerged as vital components of strategic discourse. Investors and institutions increasingly seek approaches that transcend profit maximization to address long-term social and environmental well-being. Within this reorientation, sustainable finance has gained prominence, aiming to align capital allocation with outcomes that benefit society and the planet. At the same time, Islamic banking, rooted in normative religious principles, presents a distinctive model that aligns financial practice with moral consciousness (Kalkavan, 2020).

Shariah-based finance operates under a system of values emphasizing fairness, mutual responsibility, and the avoidance of exploitation. Its core instruments promote equitable outcomes by distributing risk and reward more symmetrically than conventional debt-based mechanisms. These structures embody a commitment to economic justice aligned with global sustainability ideals. As attention grows around responsible investing, scholars and practitioners have begun examining how Islamic finance could complement or even enrich mainstream sustainability efforts (Khan, 2019).

The ethical convergence between these two paradigms offers a promising framework for innovation. Both paradigms emphasize the importance of moral values, social justice, and environmental responsibility. Islamic financial institutions already avoid sectors considered harmful, such as alcohol, gambling, and weapons manufacturing, aligning with broader Environmental, Social, and Governance (ESG) exclusion criteria. This alignment of values opens up opportunities to create hybrid financial models that are not only compliant with religious law, but also globally relevant in driving sustainable development. Moreover, their emphasis on asset-backed transactions fosters a closer connection between finance and the real economy. These similarities suggest an inherent compatibility between Shariah principles and sustainability goals, positioning Islamic banking as a potential catalyst for responsible economic transformation (Ma'rif et al., 2021).

However, theoretical alignment does not always translate into institutional practice. While Islamic finance embraces values akin to sustainability, its operational structures often lack standardized tools to embed these principles consistently. Disparities exist between normative aspirations and practical execution, particularly in areas such as impact measurement, reporting transparency, and strategic planning. The absence of standardized indicators leads to variations in interpretation and implementation between institutions, making it difficult to assess the extent to which commitments to sustainability are actually translated into action. This disconnect raises critical questions about the extent to which Islamic banks can substantively engage with sustainability beyond rhetorical alignment (Aldohni, 2020). Without strong and measurable implementation standards, Islamic financial institutions risk making sustainability a symbol or marketing tool, rather than the core of their business strategy.

The regulatory environment plays an important role in creating and widening the gap between normative aspirations and sustainability practices in the Islamic finance sector. Islamic financial institutions operate across jurisdictions with differing levels of policy support for both Shariah compliance and sustainable finance (Khan & Mohamed, 2017). In some regions, regulatory frameworks encourage innovation and alignment with ESG principles, while in others, institutional inertia and lack of technical capacity hinder progress. As Iqbal and Mirakhor (2007) point out, without robust mechanisms to translate ethical intent into measurable outcomes, the transformative potential of Islamic finance may remain underutilized.

Exploring the operationalization of sustainability in Islamic banking thus requires a careful examination of institutional realities. It involves assessing governance models, risk management frameworks, and the willingness of industry actors to embrace sustainability as a core strategic priority. The readiness of Islamic banks' internal systems to integrate these factors in strategic decision-making is an important indicator of the extent to which sustainability has truly been adopted as part of the institutional identity. Bridging the gap between ethical foundation and practical implementation holds the key to unlocking Islamic finance's full contribution to a more just and sustainable global economy (Bombang, 2016). A real commitment from industry players is needed to make sustainability a strategic priority, not just another discourse. This involves developing sharia-relevant sustainability indicators, training human resources, and creating a regulatory ecosystem that supports innovation and accountability. With a holistic approach, Islamic banking can be a driving force in the transition to a more inclusive and ethical economy.

Governance structures in Islamic banks frequently adopt dual-layer oversight, consisting of conventional boards and Shariah supervisory boards (Franzoni & Ait Allali, 2018). These bodies are tasked with ensuring compliance with religious principles, but their engagement with sustainability varies. In many cases, Shariah boards focus primarily on transactional legality rather than broader environmental or social impact. Archer and Abdel Karim (2002) note that unless Shariah governance expands its interpretive scope, sustainability will remain peripheral to Islamic banking operations.

Some Islamic banks have attempted to incorporate ESG criteria into investment decisions, particularly in jurisdictions where sustainability reporting is mandatory. For example, banks operating in Malaysia and the United Arab Emirates have issued green sukuk and developed Islamic ESG funds. These green sukuk are designed to finance environmentally-friendly projects, while Islamic ESG funds aim to direct investments to sectors that support social and economic sustainability. Such initiatives reflect a real effort to bridge the gap between Islamic finance and global sustainability principles. However, these initiatives are often isolated and lack a unified framework. According to Wilson (2008), without industry-wide standards, such innovations risk being perceived as marketing tools rather than substantive shifts in institutional behavior. A more structured framework and clear standards are needed so that these innovations are not trapped in mere image.

Transparency is a recurring concern. Conventional sustainability frameworks require rigorous disclosures and impact assessments. This allows investors and other stakeholders to assess the extent to which an entity contributes to global sustainability goals. Islamic banks, by contrast, tend to prioritize Shariah compliance reporting over ESG metrics. This discrepancy leads to a communication gap between Islamic financial institutions and global sustainable finance platforms. Islamic banks, despite their adherence to deep ethical principles, tend not to fully integrate sustainability disclosures in the broader sense, which includes greater social and environmental impacts. Lewis (2005) suggests that aligning Islamic reporting practices with international sustainability indicators could enhance both credibility and comparability. This alignment allows Islamic banks to be more transparent in reporting their contributions to social and environmental sustainability, while opening up opportunities for collaboration with larger and more diverse financial institutions around the world.

The financing models used by Islamic banks—such as *mudharabah*, *musharakah*, and *ijarah*—possess inherent features that support long-term, socially responsible investment. These structures emphasize partnership, shared outcomes, and asset-backed finance, which theoretically reduce systemic risk. This allows Islamic banks to support projects that have positive social and environmental impacts. Profits shared fairly between the parties involved also encourage more transparent and ethical business practices, which are in line with global sustainability principles. However, as noted by Khan (2010), their practical application often mimics conventional debt-based models, undermining their potential to drive sustainability outcomes. Inconsistent or inconsistent application of the original principles of partnership-based financing limits the capacity of Islamic finance to promote socially and environmentally sustainable investments.

One of the constraints lies in regulatory environments. In many countries, banking regulations do not accommodate sustainability mandates tailored to Islamic finance. Most regulations focus on the conventional debt-based banking model, lacking integration of key social, environmental, and governance aspects of sustainability. As a result, Islamic banks often face challenges operating in a regulatory system that lacks support for Shariah-based sustainability innovations. The absence of incentives or recognition for Shariah-based sustainability innovation discourages proactive efforts. Dusuki and Abdullah (2007) argue that regulatory misalignment hinders Islamic banks from fully leveraging their ethical advantage in the sustainability space.

Human resource capacity also plays a significant role. Integrating sustainability into Islamic banking requires interdisciplinary knowledge—combining religious jurisprudence, financial expertise, and environmental science. Sustainability in the context of Islamic banking is not just a matter of complying with sharia law, but also aligning these principles with global sustainability principles that include social and environmental responsibility. Yet, professional training programs rarely bridge these domains. As Hassan and Lewis (2007) observe, without specialized curricula, both current practitioners and future leaders are ill-equipped to advance sustainability within Islamic institutions.

Another important dimension is stakeholder engagement. Customers, investors, and communities increasingly demand transparency, ethical conduct, and environmental stewardship. Islamic banks have the theoretical framework to meet these demands, but customer education and participatory channels are often lacking. According to El-Hawary, Grais, and Iqbal (2007), a more inclusive governance model would allow stakeholders to shape sustainability priorities alongside institutional leaders.

Technological innovation presents both a challenge and an opportunity. Digital platforms can improve access to ethical financial products and enhance traceability in green investments. However, the adoption of fintech solutions in Islamic banking remains uneven. As Rosly (2005) notes, the integration of technology must be guided by Shariah principles to maintain authenticity while enabling efficiency and impact tracking.

At the macroeconomic level, Islamic banks are increasingly involved in financing infrastructure and development projects aligned with sustainability objectives. Green sukuk, for instance, has emerged as a promising vehicle for funding environmentally friendly initiatives. Yet, the standardization of what constitutes a “green” or “sustainable” sukuk remains underdeveloped. Usmani (2002) emphasizes the need for Shariah scholars to engage more actively with contemporary ethical finance discourse to shape legitimate and impactful instruments.

Cultural and institutional diversity across Islamic banking jurisdictions contributes to inconsistent sustainability integration. While some countries support strong alignment between Islamic finance and national sustainability agendas, others lack policy coherence. This disparity limits cross-border collaboration and reduces the scalability of successful models. Iqbal and Llewellyn (2002) suggest that greater harmonization of standards could facilitate broader adoption and benchmarking.

Academic engagement has played a critical role in framing the relationship between Islamic banking and sustainable finance. Universities, think tanks, and policy research centers have published comparative analyses, highlighting points of convergence and divergence. These contributions are essential for refining theory, informing policy, and fostering dialogue between traditional Islamic scholarship and modern sustainability frameworks.

The future of sustainability in Islamic banking depends on sustained institutional commitment. The alignment between religious ethics and sustainable objectives is not self-executing. It requires deliberate action in policy, practice, and education. With strategic investment in capacity building and governance reform, Islamic banks can offer a distinctive and impactful model for ethical finance that resonates across cultures and economies.

CONCLUSION

The exploration of sustainability integration in Islamic banking reveals a landscape shaped by both promise and limitation. While Shariah principles provide a natural alignment with ethical and responsible finance, the implementation of sustainability within Islamic financial institutions remains uneven. Challenges related to governance, reporting standards, regulatory frameworks, and capacity building continue to impede full realization. Nonetheless, the foundational values of Islamic finance offer a distinct contribution to global efforts in creating more inclusive and morally grounded financial systems.

The alignment between sustainable finance and Islamic banking has the potential to reframe ethical investing by introducing spiritual accountability alongside conventional ESG benchmarks. Policymakers, financial institutions, and Shariah scholars must engage in deeper collaboration to ensure that sustainability is interpreted not merely as an add-on, but as an inherent expression of Islamic financial ethics. Such integration could serve as a bridge between faith-based financial systems and global sustainability movements. To advance this agenda, Islamic banks are encouraged to develop institutional frameworks that explicitly incorporate sustainability into governance, product design, and performance evaluation. Standard-setting bodies should work to reconcile Islamic jurisprudence with emerging ESG standards without compromising religious authenticity. Investment in education, cross-sector partnerships, and stakeholder dialogue will be critical to unlocking the full potential of Islamic finance in promoting long-term value for society and the environment.

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