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The ESG Paradox in ASEAN Islamic Banking: Evidence From ESG Performance

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Abstract
This study examines the ESG paradox in ASEAN Islamic banking, where Shariah compliance does not guarantee superior sustainability performance. Using pooled data from 53 listed banks across six ASEAN countries (2015 – 2024), the research analyses the determinants of ESG performance through pooled OLS regression with HAC estimators. Findings reveal an "ESG Paradox": Islamic finance presence shows no significant positive effect on aggregate ESG scores and shows a marginally negative association with environmental performance in the moderation model. Community engagement consistently drives all ESG pillars, while business ethics policies unexpectedly weaken the community-environment relationship. The study introduces "symbolic ESG" as a theoretical framework, highlighting that Shariah certification often serves as reputational veneer rather than substantive ethical driver. These findings urge regulators to harmonize Shariah audit standards, strengthen SSB independence, and mandate environmental disclosures, while stakeholders should avoid equating religious labels with ethical substance to sustain faith-based trust and prevent governance failures.
Keywords: ASEAN banks; ESG paradox; Islamic banking; Shariah compliance; symbolic ESG

Abstrak
Penelitian ini mengkaji paradoks ESG dalam perbankan syariah ASEAN, yang menunjukkan bahwa kepatuhan syariah tidak menjamin kinerja keberlanjutan yang unggul. Dengan menggunakan data gabungan dari 53 bank terdaftar di enam negara ASEAN (2015–2024), penelitian ini menganalisis determinan kinerja ESG melalui regresi pooled OLS dengan estimator HAC. Temuan mengungkap "Paradoks ESG": kehadiran keuangan syariah tidak memberikan dampak positif yang signifikan terhadap skor ESG agregat dan justru berkorelasi negatif dengan kinerja lingkungan. Keterlibatan komunitas secara konsisten mendorong ketiga pilar ESG, sementara kebijakan etika bisnis secara tak terduga memperlemah hubungan komunitas-lingkungan. Studi ini memperkenalkan "ESG simbolis" sebagai kerangka teoretis, menyoroti bahwa sertifikasi syariah seringkali berfungsi sebagai vernis reputasi daripada sebagai penggerak etis yang substantif. Temuan ini menyarankan regulator untuk menyelaraskan standar audit syariah, memperkuat independensi Dewan Pengawas Syariah, dan mewajibkan pengungkapan lingkungan, sementara para pemangku kepentingan perlu menghindari menyamakan label keagamaan dengan substansi etis guna mempertahankan kepercayaan berbasis iman serta mencegah kegagalan tata kelola.
***Kata Kunci**: Perbankan ASEAN; paradoks ESG; perbankan syariah; kepatuhan syariah; ESG simbolis*

INTRODUCTION

Islamic banking operates on a distinctive foundation of Shariah principles that fundamentally reject leverage-based, debt-driven models in favour of risk-sharing and asset-backed financing linked directly to real economic activity. These principles explicitly prohibit riba (usury), gharar (excessive uncertainty), and maysir (gambling). Every financing arrangement must be grounded in verifiable underlying assets (Nienhaus, 2011). Such prohibitions represent a comprehensive ethical framework designed to eliminate exploitative financial practices, ensure transparency in contracting, and prevent the detachment of monetary flows from productive tangible assets (Ilias, 2011). By rejecting speculation and excessive leverage, Shariah law reduces the risk of speculative bubbles and market distortions that often characterise conventional finance (S. Ahmed et al., 2022).

Islamic banks represent a distinctive financial paradigm. They are normatively aligned with ESG criteria and the SDGs, underpinned by Shariah principles emphasising social justice, environmental stewardship, and transparency. This alignment is reinforced by regulatory mechanisms such as Shariah Supervisory Boards (Agrawal et al., 2023; Iqbal, 2025). Empirical evidence also demonstrates their greater financial resilience during crises through ethical banking practices prioritising stakeholder interests (Al-Doseri & Aldhmour, 2024). Nevertheless, Islamic banks contrast sharply with conventional banking in their operational architecture. They prohibit interest, which is viewed as exploitative, and replace it with profit-and-loss-sharing arrangements (Chowdhury et al., 2023). Additionally, they mandate asset-backed financing that ties all transactions to tangible assets, standing in stark opposition to the leverage-based models of conventional banking (Z. Ahmed et al., 2023).

Despite Islamic finance's ethical ideals, research reveals a persistent implementation gap. Islamic banks frequently use legal stratagems (hilah) to disguise interest-based transactions as Shariah-compliant products (Nurjannah & Setiaji, 2021), while avoiding real business risks – contrary to the core profit-and-loss-sharing principle (Asadov, 2020). These institutions have also been found to thrive in corrupt environments, where corruption positively affects their profitability (Sobol & Dopierała, 2025), and face significant internal fraud risks driven by employee opportunities and capabilities (Othman & Othman, 2025). Furthermore, some banks engage in fraudulent practices while claiming adherence to Islamic corporate governance standards, highlighting a systemic disconnect between stated principles and actual conduct (Hosen et al., 2019).

The internal governance structures of Islamic banks, particularly the Shariah Supervisory Boards (SSBs) and Boards of Directors (BoDs), are pivotal to the offering and management of Islamic finance products; however, the effectiveness of SSBs as ethical gatekeepers is critically undermined by procedural formalism, limited independence from bank management, inadequate transactional sampling, and cross-membership across multiple institutions. These deficiencies collectively foster conflicts of interest, diluted focus, and a "rubber-stamping" culture (Karbhari et al., 2024; Simanjuntak et al., 2025). The absence of robust mechanisms for operational audits and transactional sampling further compromises comprehensive Shariah compliance (Ab Ghani et al., 2025), while weak disclosure practices and inconsistent reporting erode stakeholder trust (Tabash et al., 2022). Consequently, SSBs risk becoming symbolic rather than substantive governance bodies in certain jurisdictions (A. F. S. Hassan et al., 2015).

Islamic financial institutions (IFIs) face operational challenges arising from the tension between Shariah compliance and modern market demands. Shariah principles – such as ethical

investment, risk-sharing, and asset-backing – limit product variety and raise costs, reducing price competitiveness against conventional banks (Azmat et al., 2014; Setiawan, 2023; Shaikh, 2023). Prohibitions on interest-based instruments also constrain liquidity management (Ismail & Zulkhibri, 2024), while limited expertise in fiqh al-muʿāmalāt restricts genuine innovation, making many Shariah-compliant products functionally similar to conventional alternatives (Mahmoud Edris et al., 2025). These issues are compounded by weak governance and inconsistent cross-jurisdictional interpretations of Shariah, which expose IFIs to compliance risks that undermine credibility and efficiency (Mu'im Nazri & Shari, 2025).

The escalating demand for ethical finance requires rigorous empirical scrutiny of Islamic banking's purported ESG superiority. Despite normative claims of inherent ESG alignment, Islamic banks often struggle to translate principles into tangible benefits. Profit maximisation frequently overshadows social objectives (Sheikh & Hussain, 2025), and inconsistencies in risk-sharing and ethical investment practices persist (Majeed & Zainab, 2018). Furthermore, the impact on carbon emissions reduction remains inconclusive (Smolo, 2026). Weak regulatory frameworks, coupled with inconsistent Shariah compliance standards, hinder ESG institutionalization (Sumiyati et al., 2025). Ultimately, many Islamic banks prioritize financial performance over Maqasid-driven objectives, revealing a clear disconnect between idealized goals and actual practices (Sheikh & Hussain, 2025).

Previous studies predominantly discuss the normative compatibility between Islamic finance and ESG principles. However, limited empirical studies investigate whether Shariah-compliant banks in ASEAN consistently demonstrate superior ESG performance across environmental, social, and governance dimensions. Existing research tends to focus on single-country analyses or specific pillars, leaving a significant gap in comprehensive, multi-dimensional assessments of ESG performance in the ASEAN Islamic banking context. This study contributes by introducing the concept of the "ESG paradox" – where Shariah compliance does not necessarily translate into superior ESG outcomes – and examining the moderating role of business ethics within ASEAN Islamic banking. By integrating ESG metrics, governance indices across six ASEAN countries, this research provides a novel empirical framework for understanding the principle-practice gap in Islamic finance.

This research aims to investigate whether Islamic banks demonstrate greater sustainability and ethical integrity than conventional banks, with the ultimate objective of generating substantive policy recommendations to strengthen regulatory frameworks, enhance governance quality, promote authentic innovation, and restore public trust in the sector. Specifically, the study compares ESG performance across bank types, evaluates Shariah governance mechanisms for preventing ethical breaches, identifies firm-specific attributes that enable authentic compliance, and assesses the impact of ethical violations on ESG performance. The findings are expected to inform harmonized Shariah audit standards, enhanced SSB accountability, and technology-driven transparency solutions that close the gap between normative ideals and operational reality.

LITERATURE REVIEW

The Normative Promise: Shariah Foundations as an Ethical-Sustainable Blueprint

Islamic banks serve as ethical financial institutions rooted in Shariah principles – justice, fairness, and social welfare – that align with sustainability goals through the Maqasid al-Shariah framework, which operationalises ethical investing and environmental stewardship (Hasan et al., 2026). Core prohibitions against riba (interest) and gharar (excessive uncertainty) ensure transparent, equitable transactions and long-term stability by preventing financial exploitation and mandating full disclosure (Ilias, 2011; Oseni et al., 2025), while shared risk

and reward foster inclusivity among diverse stakeholders (Riaz, 2016). This ethical architecture positions Islamic banks as ideal vehicles for ESG objectives and the SDGs, with Indonesian evidence showing that Shariah compliance positively influences ESG engagement despite potential short-term trade-offs (Laela et al., 2026). However, although 97% of Islamic social finance studies address SDG-related themes, they predominantly prioritise financial over environmental goals, highlighting the need for balanced ecological and socioeconomic integration (Ma & Sukmana, 2025); conversely, other research demonstrates a strong negative correlation between Islamic banking development and carbon emissions, indicating that consistent application of Shariah ethical frameworks can yield tangible environmental benefits (Smolo, 2026).

Despite its strong alignment with social and governance objectives, the sustainability potential of Islamic finance remains underexploited, particularly in environmental goals. Although green sukuk and Islamic green finance have been successfully pioneered by Malaysia and Indonesia to finance climate resilience and sustainable projects (Marwan & Ali, 2025; Saba et al., 2021), broader adoption of ecological sustainability remains limited outside Southeast Asia (Jalloh et al., 2025), as many institutions continue to prioritise social and governance aspects over environmental concerns (Miyan et al., 2025). Persistent barriers – including high costs, regulatory fragmentation, and inadequate environmental disclosure practices – further hinder the industry's full integration of environmental objectives (Abdullah et al., 2024).

Although Islamic banks are inherently more ethical and sustainable, translating these normative commitments into tangible impact requires stronger regulation, transparent reporting, and the development of environmentally friendly instruments. While regulatory guidelines and adherence to sustainable finance networks positively influence sustainability performance, existing frameworks remain inadequate to drive meaningful change (Kashi et al., 2024; Septyanun et al., 2025). Furthermore, the absence of standardised sustainability reporting frameworks specific to Islamic finance impedes progress (Kismawadi et al., 2025), despite stakeholder demands for transparent disclosure to foster trust and accountability (El-Essa et al., 2024). Although green sukuk, mudarabah, and musharakah have been developed to support renewable energy and low-carbon initiatives (Ali et al., 2024), their adoption remains limited, necessitating further innovation to scale their impact and effectively address global environmental challenges (Almajali, 2025).

The Empirical Reality: Documented Strengths in Resilience and Social Performance

Empirical evidence consistently demonstrates that Islamic financial institutions exhibit superior resilience during systemic shocks, attributable to their focus on real economic activities, limited speculative exposure, and prudent lending practices. During the COVID-19 pandemic, ASEAN Islamic banks maintained stronger capital adequacy and loan-to-deposit ratios than conventional counterparts, though profitability and non-performing loans showed no significant divergence (Kunhibava et al., 2018). Conversely, Pakistani Islamic banks experienced fewer deposit withdrawals and sustained lending during financial panics, indicating stronger depositor confidence and contextual stability (Kismawadi et al., 2025). Collectively, these factors contribute to greater systemic stability in dual banking systems compared to purely conventional frameworks (El-Essa et al., 2024).

Despite structural features such as risk-sharing and asset-backed financing that, in theory, enhance resilience, Islamic banks do not consistently outperform conventional banks during systemic shocks. Their stability varies by region, crisis type, and institutional scale: smaller banks typically fare better than larger ones, which face operational complexities

(Septyanun et al., 2025), while limited risk-mitigation tools and exposure to global interest rates can undermine performance during prolonged downturns (Achyar, 2025). Regional differences also matter, as varying degrees of integration with global markets can either buffer or amplify risks (Achyar, 2025).

Islamic banks are often criticised as "socially defensive" due to governance inefficiencies, inconsistent reporting standards, and a focus on financial over social goals. In Indonesia, 42.89% of respondents perceive them as socially defensive, compared with only 15.42% who perceive them as proactive (M. L. Hamidi et al., 2019). Weak governance – especially in Shariah Supervisory and National Shariah Boards – directly undermines social performance (Yusmad et al., 2024). While Islamic Social Reporting (ISR) frameworks can improve financial outcomes, their inconsistent adoption is hampered by governance and regulatory gaps (Pramudena et al., 2026). Enhancing social performance thus requires stronger governance, standardised reporting, and a deeper commitment to the Maqāṣid al-Sharīʿah principles.

The Paradox Unveiled: Gap Between Normative Ideals and Operational Practices

Despite its theoretical strengths, Islamic banking shows a marked "ethical coherence gap" between its ideals and practices. Many institutions emulate conventional models, prioritising profit over Shariah objectives of justice and welfare (L. Hamidi & Worthington, 2021; Mansour et al., 2015), reducing ethics to legalistic compliance while Shariah scholars act more as legal advisors than ethical guardians (Nienhaus, 2011). Empirical studies using the Ethical Identity Index confirm this shortfall, particularly in social welfare, transparency, and zakah management (Haniffa & Hudaib, 2007). While Southeast Asian banks outperform African ones, decision-making across regions often remains misaligned with Islamic ethics due to practitioners' insufficient religious consciousness, as personal interests frequently override ethical principles (Shamsudheen et al., 2021, 2023).

Islamic finance faces a widening gap between its risk-sharing doctrine and operational reality, as banks overwhelmingly favour debt-like instruments such as Murabahah over genuine profit-and-loss sharing (PLS) contracts like Musharakah and Mudarabah due to moral hazard concerns and risk aversion, while frequently transferring risks from profit-sharing investment account holders to shareholders and underutilising instruments such as Salam (Anwer, 2020; Saleem et al., 2023; Šeho et al., 2020). This deviation from the doctrinal ideal is compounded by weak internal governance, particularly ineffective Sharīʿah Supervisory Boards (SSBs) hampered by fragmented regulatory frameworks across jurisdictions, insufficient independence and accountability, uneven member competence, and cross-membership conflicts of interest (Arifin et al., 2025; Mkadmi & Benali, 2025; Simanjuntak et al., 2025; Zaiter, 2025). Addressing these governance deficits through regulatory reform, enhanced accountability, and improved expertise is therefore essential to restoring risk-sharing principles and ensuring authentic Sharīʿah compliance.

The paradox of Islamic finance is reinforced by fragmented regulatory frameworks across jurisdictions, where conventional banking laws lack provisions for Sharīʿah contracts, creating legal uncertainty. This fragmentation is compounded by dispersed regulatory authority – particularly in countries such as Indonesia and Iraq – resulting in overlapping mandates, weak coordination, and delays in institutionalising Sharīʿah rulings (Adiwijaya et al., 2025; Zaiter, 2025). The absence of a unified Sharīʿah supervisory authority further exacerbates inconsistencies in interpretation and compliance, undermining public trust and international credibility (Kusumawati et al., 2025). Consequently, applying conventional banking laws to

Islamic banks without accounting for Sharīʿah-compliant requirements generates operational inefficiencies and raises fundamental questions about the legitimacy of Islamic banking practices (Alam et al., 2019; Mooneeram-Chadee, 2020; Selim et al., 2023).

METHODOLOGY

This study utilises a pooled dataset of 53 publicly listed banks across six ASEAN countries from 2015 to 2024, sourced from the LSEG database. The sample was selected using purposive sampling based on the availability of ESG and governance data in the LSEG database. Only publicly listed banks were included to ensure data reliability and comparability of ESG disclosures, as listed banks are subject to mandatory reporting requirements and greater transparency standards. Banks with incomplete ESG or governance data for the study period were excluded. The final dataset consists of 283 firm-year observations covering the period from 2015 to 2024.

The dependent variables comprise aggregate ESG scores and their three pillars, while the independent variables include Dummy Company Has Islamic Finance (CHIF), Community Score (CORE), Board Size (BSIZE), and Board Specific Skills (BSKILL). The Policy Business Ethics Score (ETC) serves as a moderating variable to assess the principle-practice gap, with firm size and ROE included as controls. Given non-normal distributions, the Yeo-Johnson transformation was applied to accommodate zero and negative values. The Yeo-Johnson transformation was selected over Box-Cox because it can handle both positive and negative values in the dataset, providing a more robust normalisation approach for variables with mixed signs (Atkinson et al., 2020).

Pooled OLS is adopted as the baseline estimator, a decision grounded in the panel's empirical constraints and established econometric guidance. Given the short time span (averaging 6.2 years per bank, with 22.6% of institutions observed fewer than three times), within-entity variation is too limited to support reliable fixed-effects estimation. Under such conditions, and when the correlation between unobserved individual effects and regressors remains modest ($\delta < 1/2$), pooled OLS delivers superior statistical efficiency (Pesaran & Zhou, 2018). This specification also preserves time-invariant covariates – most notably CHIF, the study's central theoretical construct – which would be eliminated by within-transformation (Oaxaca & Geisler, 2003). Furthermore, the panel's unbalanced structure stems from LSEG database coverage rather than non-random attrition, satisfying the formal poolability criteria outlined by (Lechner et al., 2016). All estimations were executed in EViews 13.

Prior to regression analysis, classical assumption tests were conducted. Multicollinearity is assessed via the Variance Inflation Factor (VIF). Following (O'Brien, 2007), VIF values below 5 indicate no serious multicollinearity. Across all eight models – comprising the main and moderation specifications for ESG, EPS, SPS, and GPS – VIF values range from 1.029 to 1.279, well below the conservative threshold. The highest VIF is observed for BSIZE (1.269), while BSKILL exhibits the lowest (1.029). These results confirm the absence of multicollinearity, ensuring that the estimated coefficients are not inflated by inter-correlation among regressors and that standard errors remain efficient for hypothesis testing. No heteroscedasticity was detected; however, autocorrelation was present. Therefore, HAC (Newey–West) standard errors were applied (Zeileis, 2004). As a result, these tests ensure the validity and reliability of the statistical inferences drawn from the model.

The operational variables in this study are structured as follows:

Table 1. Variables Definition

Variables	Variable Definition
	Dependent Variables
ESG	Environment, Social, and Governance Score
EPS	Environment Pillar Score
SPS	Social Pillar Score
GPS	Governance Pillar Score
	Independent Variables
CHIF	The company has Islamic Finance
BSIZE	Total number of board members
BSKILL	Percentage of board members who have either an industry-specific background or a strong financial background.
CORE	Does the company have a policy to improve its good corporate citizenship? (involvement in the community through donations, volunteering, philanthropic activities, and community investments. Includes involvement in corporate social responsibility programs in education, health, and the environment)
	Moderation Variables
ETC	Does the company describe in the code of conduct that it strives to maintain the highest level of general business ethics? (Information on respecting general business ethics or integrity. Information from the code of conduct section)
	Control Variables
ROE	Return on Equity represents profitability
TOTAL ASSET	Firm Size, which is measured by total assets

Following these operational definitions, the research model is specified as follows:
Main Model:

$$ESG\ (EPS, SPS, GPS)_{i,t} = \alpha + \beta_1 DCHIF_{i,t} + \beta_2 BSIZE_{i,t} + \beta_3 BSKILL_{i,t} + \beta_4 CORE_{i,t} + \beta_5 SIZE_{i,t} + \beta_6 ROE_{i,t} + \varepsilon_{i,t}$$

Moderation Model:

$$ESG\ (EPS, SPS, GPS)_{i,t} = \alpha + \beta_1 DCHIF_{i,t} + \beta_2 BSIZE_{i,t} + \beta_3 BSKILL_{i,t} + \beta_4 CORE_{i,t} + \beta_5 ETC_{i,t} + \beta_6 ETBSIZE_{i,t} + \beta_7 ETBSKIL_{i,t} + \beta_8 ETCORE_{i,t} + \beta_9 SIZE_{i,t} + \beta_{10} ROE_{i,t} + \varepsilon_{i,t}$$

RESULTS AND DISCUSSION

The statistical profile of the research variables is summarised as follows:

Table 2: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Prob.
BSIZE	10.314	10.000	21.000	3.000	0.111
BSKILL	49.526	50.000	100.000	0.000	0.542
CHIF	0.329	0.000	1.000	0.000	0.000
CORE	71.111	76.061	99.265	10.433	0.000
EPS	55.282	61.837	94.868	2.073	0.000
ESG	63.271	64.860	88.653	27.930	0.053
ETC	59.717	59.512	66.514	57.884	0.000
GPS	60.611	62.721	96.752	16.496	0.003

	Mean	Median	Maximum	Minimum	Prob.
ROE	0.093	0.098	0.563	-1.485	0.000
SPS	66.454	67.094	93.740	20.126	0.001
TA	3.71E+10	1.47E+10	2.35E+11	2843441	0.000
Obs.			283		

Source: Authors' Own

Note: BSIZE: Board Size (person), BSKILL: Board Specific Skills (%), CHIF: Company Has Islamic Finance (Dummy), CORE: Community Score (%), EPS: Environmental Pillar Score (%), ESG: Environmental, Social and Governance Score (%), ETC: Policy Business Ethics Score (%), GPS: Governance Pillar Score (%), ROE: Return on Average Total Equity (%), SPS: Social Pillar Score (%), TA: Total Assets, PoP Avg (US$).

The descriptive statistics in Table 2 show that most variables are non-normally distributed, as indicated by significant Jarque–Bera tests ($p < 0.05$), with the exceptions of BSIZE ($p = 0.111$) and BSKILL ($p = 0.542$), which are normally distributed, and ESG, which marginally approaches normality ($p = 0.0535$). Board size averages approximately 10 members with moderate variation, whereas board-specific skills display considerable heterogeneity (mean = 49.53%, range = 0–100%). Islamic finance firms constitute merely 32.9% of the sample. Both the community score (CORE, mean = 71.11%) and the environmental pillar score (EPS, mean = 55.28%) exhibit wide dispersion and left-skewed distributions (median > mean), whereas the business ethics score (ETC) is highly homogeneous (SD = 1.42). The composite ESG score averages 63.27% with relatively even dispersion, whereas ROE (mean = 9.31%, range = –148.5% to 56.27%) indicates extreme outliers. Total assets exhibit the greatest skewness, with a mean of USD 37.1 billion substantially exceeding the median of USD 14.7 billion, reflecting marked firm-size inequality. Consequently, non-normal variables were normalised using natural logarithm transformation for total assets and the Yeo–Johnson transformation for the remainder.

The results of the main model are as follows:

Table 3. The Main Effect of Islamic Finance Product Presence on ESG

	α	CHIF	BSIZE	BSKILL	CORE	ROE	SIZE
ESG	59.549	-0.144	-0.007	0.067*	6.276***	1.119	5.184***
t	18.036	-0.671	-0.033	1.763	9.389	1.065	5.082
EPS	-0.041	-0.035	-0.031	0.006**	0.167**	0.038	-0.072
t	-0.142	-1.605	-1.209	2.023	2.117	0.549	-0.784
SPS	0.362	-0.019	-0.031	-0.001	0.229**	0.179**	-0.109
t	1.051	-0.835	-0.977	-0.335	2.298	2.049	-1.286
GPS	0.291	0.005	-0.040	0.003	0.153**	-0.013	0.098
t	0.882	0.228	-1.605	0.780	2.150	-0.163	1.065

Source: Authors' Own

Note: Statistical significance is denoted as follows: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

BSIZE: Board Size (person), BSKILL: Board Specific Skills (%), CHIF: Company Has Islamic Finance (Dummy), CORE: Community Score (%), EPS: Environmental Pillar Score (%), ESG: Environmental, Social and Governance Score (%), ETC: Policy Business Ethics Score (%), GPS: Governance Pillar Score (%), ROE: Return on Average Total Equity (%), SPS: Social Pillar Score (%), SIZE: Firm Size.

Table 3 presents the main effect estimates. Community engagement (CORE) emerges as the sole variable that consistently and positively drives ESG performance across all dimensions – aggregate ESG ($\beta = 6.276$, $t = 9.389$, $p < 0.01$), environmental pillar ($\beta = 0.167$, $t = 2.117$, $p < 0.05$), social pillar ($\beta = 0.229$, $t = 2.298$, $p < 0.05$), and governance pillar ($\beta = 0.153$, $t = 2.150$, $p < 0.05$). This finding indicates that banks with stronger community

engagement tend to achieve better ESG outcomes to social responsibility and community welfare, reinforced by Shariah ethical imperatives emphasising social justice, stakeholder accountability, and the Maqasid al-Shariah framework. Board-specific skills (BSKILL) improve the environmental pillar ($\beta = 0.006$, $t = 2.023$, $p < 0.05$) and weakly enhance aggregate ESG ($\beta = 0.067$, $t = 1.763$, $p < 0.10$), suggesting that expertise is more aligned with environmental sustainability than with broader ESG outcomes. Firm size (SIZE) positively affects aggregate ESG ($\beta = 5.184$, $t = 5.082$, $p < 0.01$), while ROE improves the social pillar ($\beta = 0.179$, $t = 2.049$, $p < 0.05$). Critically, the presence of Islamic finance products (CHIF) shows no significant association with any ESG dimension, and board size (BSIZE) is uniformly insignificant.

The result of the moderation model is as follows:

Table 4. The Moderating Model of Islamic Finance Product Presence on ESG

	α	CHIF	ETC	BSIZE	BSKILL	CORE	ETBSIZE	ETBSKIL	ETCORE	ROE	SIZE
ESG	60.58	-0.18	-6.1***	0.03	0.04	6.20***	0.18	0.02	0.07	1.28	5.33***
t	18.52	-0.86	-2.66	0.13	0.98	8.70	1.15	1.36	0.14	1.27	5.62
EPS	-0.05	-0.04*	-0.17	-0.04	0.01***	0.16**	0.01	0.003*	-0.16***	0.04	-0.07
t	-0.17	-1.73	-0.79	-1.61	3.02	2.22	0.76	1.70	-2.97	0.63	-0.77
SPS	0.36	-0.02	-0.24	-0.04	0.00	0.21**	-0.003	0.01*	-0.08	0.18**	-0.12
t	1.06	-0.88	-0.73	-1.27	0.27	2.21	-0.12	1.74	-1.20	2.10	-1.37
GPS	0.27	0.01	0.31	-0.04*	0.00	0.14**	-0.02	0.0002	-0.01	-0.02	0.09
t	0.81	0.27	1.09	-1.72	1.10	1.94	-1.08	0.12	-0.19	-0.20	0.91

Source: Authors' Own

Note: Statistical significance is denoted as follows: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

BSIZE: Board Size (person), BSKILL: Board Specific Skills (%), CHIF: Company Has Islamic Finance (Dummy), CORE: Community Score (%), EPS: Environmental Pillar Score (%), ESG: Environmental, Social and Governance Score (%), ETC: Policy Business Ethics Score (%), ETBSIZE: Ethics Moderation Effect to Board Size, ETBSKIL: Ethics Moderation Effect to Board Skill, ETCORE: Ethics Moderation Effect to Community Score, GPS: Governance Pillar Score (%), ROE: Return on Average Total Equity (%), SPS: Social Pillar Score (%), SIZE: Firm Size.

Table 4 reports the moderation estimates. Contrary to expectations, business ethics (ETC) does not amplify the positive effect of community engagement (CORE) on aggregate ESG or the social pillar; the interaction term ETCORE is statistically insignificant in both models (ESG: $\beta = 0.07$, $t = 0.14$; SPS: $\beta = -0.08$, $t = -1.20$). The only significant moderation effect appears in the environmental model, where ETCORE is negative and highly significant ($\beta = -0.16$, $t = -2.97$, $p < 0.01$). This unexpected negative interaction suggests a substitution effect: formal ethics policies may crowd out community-driven environmental initiatives rather than strengthen them. The absence of significant moderation in the governance model further confirms that business ethics policies in the sample are decoupled from governance reforms, highlighting a gap between policy formalism and substantive ethical integration.

Board expertise (BSKILL) significantly improves the environmental pillar in both the main ($p < 0.05$) and moderation ($p < 0.01$) models, though its weakly significant effect on aggregate ESG in the main model disappears once moderation terms are introduced. Board size (BSIZE) remains largely insignificant across both specifications, except for a marginally significant negative effect on the governance pillar in the moderation model ($\beta = -0.04$, $t = -1.72$, $p < 0.10$), suggesting that larger boards may dilute governance quality under certain ethical policy conditions. The presence of Islamic finance (CHIF) exhibits a marginally significant negative association with environmental scores in the moderation model only ($\beta = -0.04$, $t = -1.73$, $p < 0.10$), reinforcing the notion that Shariah compliance does not inherently

ensure environmental stewardship. Firm size (SIZE) and ROE retain their respective significant effects on aggregate ESG and the social pillar.

These findings both align with and diverge from previous research. The positive role of community engagement is consistent with Kolsi & Al-Hiyari (2023) and Alghafes et al. (2024), who document strong social performance in Islamic banks. However, the limited environmental effect of CHIF – significant only in the moderation model and absent in the main effect specification – contradicts Smolo (2026), who reports a strong negative correlation between Islamic banking development and carbon emissions at the macro level. This divergence likely stems from methodological differences: Smolo (2026) uses country-level data, whereas this study employs firm-level ESG scores that capture disclosure rather than actual environmental impact.

The largely insignificant effect of board size contrasts with conventional banking studies e.g., Abdelazim & Khalaf (2024), highlighting the unique governance dynamics of Islamic banks, where Shariah Supervisory Boards may substitute for conventional board structures in driving ethical outcomes. The limited moderating role of business ethics differs from (M. K. Hassan et al., 2022), possibly due to the narrow measurement of ethics as a policy score rather than actual ethical conduct. Collectively, the results support the study's central argument of an "ESG paradox": Shariah certification operates as a reputational veneer rather than a substantive driver of sustainability, with community engagement – not religious labelling – serving as the genuine engine of ESG performance in ASEAN Islamic banking.

CONCLUSION

This study reveals an "ESG Paradox" within ASEAN's Shariah-compliant banks: religious adherence does not automatically translate into superior environmental, social, or governance performance. Analyzing 53 publicly listed banks across six countries from 2015 to 2024, the findings show that the mere presence of Islamic finance products (CHIF) fails to significantly enhance aggregate ESG scores and even exhibits a marginally negative association with environmental outcomes. This gives rise to what the study terms "symbolic ESG" – a condition where Shariah certification operates as a reputational veneer rather than a substantive driver of sustainability.

The sole consistent and robust driver of all ESG pillars is community engagement (CORE) – manifested through zakat, sadaqah, and qardh hasan – which remains significant across environmental, social, and governance models. Paradoxically, formal business ethics policies (ETC) do not amplify this positive effect; instead, their interaction with community engagement (ETCORE) yields a significantly negative coefficient for environmental performance, suggesting that bureaucratic ethics frameworks may inadvertently crowd out grassroots environmental initiatives. The novelty of this research lies in empirically documenting the ESG Paradox in the ASEAN context, uncovering the negative moderation of ethics policies, and introducing "symbolic ESG" as a theoretical lens to understand the principle-practice gap in faith-based finance.

For practitioners, Islamic bank managers must move beyond mere Shariah labelling toward tangible investments in community and environmental stewardship, while boards should recruit members with demonstrable sustainability expertise. Regulators are urged to harmonize Shariah audit standards across ASEAN, mandate environmental disclosure for Islamic financial institutions, and strengthen the independence of Shariah Supervisory Boards. The broader impact is to restore public trust by demanding accountability beyond religious

labels, thereby mitigating the reputational risk triggered by governance failures. Key limitations include a sample restricted to listed banks and omitted variable bias (e.g., regulatory quality, audit intensity), all of which invite further research.

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