

Sustainability Practices and Financial Performance: Evidence from Islamic Banking in Indonesia

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Abstract. In Islamic banking, sustainability practices and its reporting are very low, due to limited literature and frameworks for measuring sustainability. This study measures the level of sustainability practices (economic, environmental, and social) based on GRI (Global Reporting Initiative) items that are transformed with *Maqasid Al-Sharia* theory and investigate its relation to financial performance. Based on weighted content analysis methods in annual and sustainability reports related to 11 Islamic banks in Indonesia for 2014 - 2018. The results indicate the average number of sustainability practices at Islamic banking in Indonesia is very low, only 23.33% and there has been an increasing sustainability trend from 2014 until 2018 but these practices have no relation to financial performance. These results support an urgent need for appropriate sustainability guidelines for Islamic banking, especially in Indonesia.

Keywords: Sustainability, Financial Performance, Islamic Banking

1 Introduction

The excessive and irresponsible use of natural resources, especially by companies, has resulted in various economic, environmental, and social problems such as poverty, depletion of natural resources, global warming, accumulation of toxic waste and chemicals, and increasing human rights violations. As a form of companies' concern about the problems, the need for sustainability practices and reporting has drawn important attention in the last two decades [29]. Disclosure of non-financial performances such as corporate social responsibility (CSR) and sustainability reports is considered a firm commitment of the organizations to the application of sustainability practices by many stakeholders [44]. This is confirmed by the adoption of international guidelines on sustainability reporting such as the Global Reporting Initiative (GRI), which are based on the KPMG survey (2017) more than 93% of the 250 largest corporations in the world have published the report.

Unlike conventional banks, Islamic banks refer to a system that is guided by Islamic economic principles which are based on the Al-Qur'an and Hadith. Islamic banking is formed from Islamic ontological and epistemological sources the concepts of social virtue, good governance, environmental concern, and ethical behavior of individuals and organizations [3] [4] [5]. The practice of social responsibility is a consequence of Islamic ethics because Islam as a religion shows a proactive stakeholder paradigm through the establishment of company moral obligations towards society [42]. Besides, Islamic banks have two main models in their banking

transactions related to sustainability (the Chapra and Ismail models), namely the institutional and welfarist approaches. The institutional approach emphasizes the maximization of the value of bank owners (shareholders and account holders) while the welfarist approach is the realization of *Maqasid Al-Sharia* by improving people's welfare [2] [32] [35] [41]. Therefore, it can be said that sustainability is related and relevant to the concept of Islamic banking.

However, in the case of the Islamic banking industry, the rate of sustainability practices and reporting in this world is very low. In research by [34], it was found that the rate of sustainability of Islamic banks' disclosure in Indonesia and Malaysia was only 26 percent. [38] found that in the United Arab Emirates the disclosure of the sustainability of Islamic banks was very low compared to conventional banks. [31] researched 91 Islamic banks in 13 countries and found that Islamic banks in those countries paid less attention to sustainability practices and disclosures. Research by [12] reported the inefficient practices of sustainability and disclosures in 14 Islamic banks from 14 different countries. Further, [20] examined the sustainability practices and reporting of Islamic banks from 7 Muslim countries and the results indicate the sustainability practices and reporting were not the main concerns for Islamic banks in those countries.

According to [25], the low rate of sustainability practices and reporting in Islamic banking is likely caused by limited literature on sustainability in Islamic banking, and the frameworks to measure the practices are inadequate. For that reason, there is an urgent need to propose a framework for measuring sustainability that matches the Islamic banking concept and to evaluate its impact on financial performance [24].

Based on the background, gaps, and suggestions from the previous research, this topic is appealing to be reexamined, how the relation of sustainability practices toward the financial performance in Islamic banking is? As far as we know, this study is the first study that measures the practice of sustainability in Islamic banking for 2014 - 2018 based on the GRI that are transformed with *Maqasid Al-Sharia* theory refers to [25]. Indonesia is chosen as the sample because Indonesia is a country with the largest Muslim population in the world, with around 87% of the population embracing Islam [51] and included in ten countries with sharia financial markets that are growing rapidly in the world based on the indicators quantitative development, knowledge, governance, corporate social responsibility, and awareness of Islamic finance [22].

2 Literature Review and Hypothesis

2.1 Stakeholder Theory

A stakeholder theory explains to which party the company must take responsibility. The company must maintain its relationship with stakeholders, especially those who influence the company's operational activities. A stakeholder theory identifies the existence of different actors in addition to shareholders who also have a great deal of interest in the company's decisions and therefore want to gain information about the company's behavior. This theory that companies are not only responsible to shareholders but also to every individual or group that influences or may be influenced by the actions of the organization [17] and a strategy that can be carried out by companies to maintain a good relationship with stakeholders is by conducting sustainability practices.

2.2 Sustainability Practices According to *Maqasid Al-Sharia*

In Arabic, *maqasid* means goal, purpose, or intention, while *sharia* is Islamic law. *Maqasid Al-Sharia* can be defined as the goal of Islamic law and in general, according to [21], *Maqasid Al-*

Sharia is a public interest to achieve justice and provide benefits to humans. [45] explained that the *Maqasid Al-Sharia* was first studied in 1058 - 1111 by Ulama Al Ghazali that *Maqasid Al-Sharia* aimed to protect *deen* (faith), *nafs* (self or life), *aql* (intellect), *nasl* (posterity), and *maal* (wealth) to improve the social and economic life of mankind. In 1388, Al Syatibi developed the study of *Maqasid Al-Sharia* by classifying it into three levels of *maslahah*, namely *daruriyat* (essentials), *hajiyaat* (complimentary), and *tahsiniyat* (embellishments).

The term sustainability is first defined in the Brundtland Report [11]. This report defined the meaning of sustainability as a process of economic growth, environmental protection, and social equality. Sustainability in business is referred to as a process by which companies manage economic risk, environmental risk, social business risk, and their obligations and opportunities. There are three main aspects of sustainability, i.e. economic, environmental, and social. Islamic banks with an application of Islamic principles in their business should be advanced in practicing sustainability concepts through the implementation of sustainability practices. Islamic values that become the basis of Sharia banking business activities such as the prohibition of damaging, the prohibition of doing wrong to others, the suggestion of mutual giving, and so on, support and is in line with the sustainability concept. One of the principles is in accordance with Al-Qur'an Surah Al-A'raf verse 56: “*And cause not corruption upon the earth after its being tilled*”. Therefore, based on this explanation, it can be concluded that the sustainability concept is in accordance with *Maqasid Al-Sharia* concept which aims to provide human welfare.

Sustainability practices that were transformed based on *Maqasid Al-Sharia* in research by [25] included Shariah screening during the investment, Allocation of profit based on Shariah principles, *Zakat* payment, *Qardh-e-Hassan* / Benevolent funds, Charity - *Sadaqah* - *Waqaf*, Disclosure of earnings prohibited by Shariah, Compliance with Islamic laws for the environment, Islamic training and education to the staff, Sponsoring pilgrimage, Scholarships, and Products and services labeling (approved by the Shariah committee).

2.3 Hypothesis Development

Banks can play an important role in economic development [8] since they decide how to allocate financial resources to different sectors. Involvement of banks in social and environmental responsibilities must benefit the banks themselves and also promote the application of sustainability practices to potential borrowers, thereby providing a positive impact on sustainable growth [14]. Nowadays, bank clients have more concern about environmental, social, and governance issues [41] [52] which indicates that sustainability practices also have an important role in banking profitability.

A reason why Islamic banks have better disclosures than conventional banks is the existence of an Islamic perspective related to ethical matters, where Islam's role becomes an important factor behind the better disclosure of sustainability. Islamic banks are also in the leading position in terms of generating profits. The previous studies show that profits, in the long-term, have a positive effect on social and environmental disclosure [15] [19] [23]. Further, several Islamic banks claim to be pioneers in carrying out and disclosing social welfare activities [46].

Research on Islamic banking conducted by [46] empirically explored the rate of sustainability disclosure in annual reports and websites of 29 banks listed on the Bangladesh

Stock Exchange by distinguishing between Islamic banks and conventional banks. In their research, they measured economic, environmental, and social disclosure and found that Islamic banks disclosed more information about sustainability in annual reports and websites than conventional banks. [25] examined the relationship between sustainability practices and financial performance based on Islamic perspectives in Malaysia for a decade 2008 - 2017 and the results showed that sustainability practices have a significant positive relationship on Islamic bank financial performance. Based on the arguments and results from the previous studies, the hypothesis is:

H₁: Sustainability practices are positively related to Islamic banking's financial performance.

3 Method

The population of this study is all Sharia Commercial Banks in Indonesia. The sample collection uses purposive sampling method with the following criteria (a). Sharia Commercial Bank issued complete Annual Reports or Sustainability Reports successively during the period 2014 – 2018 (b). Bank has been operating for a minimum of 1 year. Researchers choose the years 2014 - 2018 with a consideration that the disclosures to be analyzed can illustrate the latest data on the practices of sharia banking sustainability in Indonesia. Further, to test the hypothesis, we used the regression method using software Stata 14.2, with a research model from [25] that had been modified as follows:

$$ROA_{it} = \alpha + \beta_1SUSP_{it} + \beta_2SIZE_{it} + \beta_3AGE_{it} + \beta_4CAR_{it} + \beta_5LEV_{it} + \varepsilon_{it} \quad (1)$$

Sustainability practices are measured using a proxy developed by [25]. The research has transformed the framework of the Global Reporting Initiative (2016) with the *Maqasid Al-Sharia* theory and the parameters of Islamic item measurement based on the previous research so that the new framework is more relevant in measuring sustainability from the perspective of Islamic banking. The total number of sustainability practice items are 65 disclosures divided into four aspects, 7 items of general standards disclosure, 10 items of economic sustainability, 12 items of environmental sustainability, and 36 items of social sustainability. The parameter used to measure individual items is weighted content analysis methods are Fully-Reported = (2), Partially-Reported = (1), No-Reporting = (0). In the content analysis, the researchers choose two persons who are used to do sustainability scoring on companies based on GRI as scorers, so that the result of the study is expected to have good validity and reliability.

The banking performances were measured with Return on Assets (ROA), net income divided by total assets. ROA is considered a basic measure of bank profitability including Islamic banking. This proxy can measure how well a bank manager is performing, show how well bank assets are used to generate profits, and is the most popular and most used proxy in the previous studies and the most recent research [7] [39] [47] [49].

Control variables that are determinants of ROA consist of firm-specific, such as Bank Size, Bank Age, Capital Adequacy Ratio, and Leverage Ratio. The variable size is used in most research as a determinant of bank profitability such as research by [13] [26] [30]. The older banks are generally considered to be more profitable and bigger [26]. To avoid criticisms from interest groups, older banks will adopt more sustainable measures and practices for the environment and society in general. The high Capital Adequacy Ratio (CAR) shows that banks have sufficient funds available and require fewer external funds to benefit high profitability and

vice versa [27]. Finally, Leverage Ratio (LEV) is a ratio to see the companies' ability to pay their debts, since there is a risk that the company cannot fulfill these payments. The research that uses leverage as a control variable that influences performance is research by [9] [36] [37].

4 Results

4.1 Descriptive Statistics

This study uses balanced panel data at 11 Sharia Commercial Banks in Indonesia during the period 2014 - 2018 that have met the research criteria. Table 1 shows descriptive statistics with a total final sample of 55 observations. In the table, we can see the General Standard Disclosure, Economic, Environment, Social, and Total Sustainability. The average of sustainability disclosure in Islamic banks in Indonesia is 30.33 with a deviation of 14.55, the lowest score is 14 while the highest score is 70. Meanwhile, Table 2 shows the average percentage of sustainability practices during 2014 - 2018 which is very low, only 23.33%. However, this trend has increased over the last 5 years with an average increase of 50.19%.

The average financial performance that is proxied in ROA of -0.5172% shows the inefficiency of the rate of assets repayments in Islamic banks, while the deviation is 3,936%. the lowest ROA of -20.13% is owned by Maybank Syariah in 2015 and the highest ROA is owned by Maybank Syariah 5.5% in 2017.

The average size of banking or banking assets amounted to Rp 21,180 billion, with the lowest total assets in Maybank Syariah Rp 661,912 million in 2018 and the highest in Bank Syariah Mandiri Rp 98,341 billion in 2018. In the meantime, other control variables such as Bank Age, in 2015 were the youngest banks to operate, which is 4 years old. Victoria Syariah, BJB Syariah, Mega Syariah, Maybank Syariah, BCA Syariah, and BNI Syariah and the oldest bank that is 23 years old is Bank Muamalat. The average Capital Adequacy Ratio is 24.10% with a standard deviation of 22.43%, the lowest value is 11.51% at Bank Panin Syariah in 2017, while the highest value is Maybank Syariah 163.07% in 2018. Lastly, the Leverage or average risk ratio is 22.43%, with a standard deviation of 22.00%. The lowest value is at Bank Victoria Syariah in 2014 amounted to 5.75% and the highest is Bukopin Syariah in 2014 amounted to 90.24%.

Table 1. Descriptive Statistics

<i>Variable</i>	<i>N</i>	<i>Min</i>	<i>Max</i>	<i>Mean</i>	<i>Std. Dev.</i>
General Standard Disclosure	55	7	14	9.181818	2.632355
Economic Sustainability	55	2	13	6.363636	3.15268
Environment Sustainability	55	0	15	1.509091	3.463421
Social Sustainability	55	4	28	13.27273	7.009133
Total Sustainability	55	14	70	30.32727	14.55266
Return on Assets	55	-0.2013	0.055	-0.0051727	0.0393685
Bank Size	55	27.2184	32.21946	29.92535	1.301265
Bank Age	55	4	27	9.181818	6.098242
Capital Adequacy Ratio	55	0.1151	1.6307	0.2410382	0.2232165
Leverage Ratio	55	0.0575381	0.9024065	0.224383	0.2200564

Table 2. Sustainability scores of Islamic banking in Indonesia

Bank	Average General Disclosure Score (2014-2018)	Average Economic Score (2014-2018)	Average Environmental Score (2014-2018)	Average Social Score (2014-2018)	Average Sustainability Score (2014-2018)	5 Year Trend in Sustainability Score		
						2014	2018	Increase
Muamalat	74.29%	50.00%	16.67%	28.61%	34.62%	37	57	54.05%
BNI Syariah	95.71%	57.00%	35.00%	33.33%	44.00%	39	70	79.49%
BCA Syariah	50.00%	15.00%	0.00%	6.94%	11.54%	15	15	0.00%
BRI Syariah	82.86%	35.00%	5.00%	20.83%	26.77%	24	42	75.00%
BSM	82.86%	42.00%	0.00%	25.83%	29.69%	26	47	80.77%
Maybank Syariah	50.00%	15.00%	0.00%	9.72%	13.08%	17	17	0.00%
Mega Syariah	57.14%	27.00%	5.00%	23.61%	24.31%	22	38	72.73%
Panin Syariah	57.14%	41.00%	0.00%	19.72%	23.38%	28	32	14.29%
Bukopin Syariah	57.14%	31.00%	7.50%	14.72%	20.46%	18	32	77.78%
BJB Syariah	57.14%	27.00%	0.00%	13.89%	18.00%	19	25	31.58%
Victoria Syariah	57.14%	10.00%	0.00%	5.56%	10.77%	14	14	0.00%
Average for the Overall Dimension	65.58%	31.82%	6.29%	18.43%	23.33%	23.55%	35.36%	50.19%

4.2 Regression Model Results

Table 3. Regression Results

$$ROA_{it} = \alpha + \beta_1SUSP_{it} + \beta_2SIZE_{it} + \beta_3AGE_{it} + \beta_4CAR_{it} + \beta_5LEV_{it} + \varepsilon_{it}$$

Variable	Prediction	Coefficient	Probability
SUSP	+	0.073731	0.824
SIZE	+	0.4448204	0.046**
AGE	+	- 0.1050311	0.000***
CAR	+	5.638657	0.000***
LEV	-	- 2.078582	0.000***
Cons.		- 18.46535	0.000
Adjusted R ²			60.03
Prob > chi ²			0.0000***

***significant at 1%; **significant at 5%; *significant at 10%

Before testing the hypothesis, researchers conducted treatment for normality and heteroskedasticity problems, we used General Least Square (GLS) and the results of the regression are presented in table 3. It can be seen that the value of Prob > chi² 0.000 is smaller than alpha 0.01. This means the independent variable has a simultaneous influence on its dependent variable. The value of Adjusted R² is 60.03 which implies that both independent and control variables can explain the dependent variable by 60.03% while remaining is explained by other factors that are not included in this study.

In table 3, SUSP probability is not significant which means that the sustainability practices and ROA have no relation and therefore the research hypothesis is rejected. This result is in line with studies by [18] [33] [40] [50] who could not find a relevant relation between CSR and financial performance. This is likely to happen because based on table 2 the rate of

sustainability practices is very low in Islamic banking in Indonesia, which is only 23.33% on average. Further, the concern for sustainability that is manifested with sustainability reports is only carried out by large Islamic banks such as Bank Mandiri Syariah, BNI Syariah, BRI Syariah, and Bank Muamalat. In terms of regulations, disclosure of sustainability is still voluntary in Indonesia, whereas the regulations applied currently, Financial Services Authority Regulation No.51/POJK.03/2017 concerning the Application of Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies, has not yet reflected the principles of Islamic banking that are dissimilar to conventional bank principles in general. This result may occur because according to [10] the effect of sustainability on performance will be stronger in the long-term period for example at t+1.

Control variables that are positively associated with ROA are Bank Size and CAR with a significance level of 5% and 1%. Larger banks can use diversification as a tool for investment in organizational resources, and larger banks can use different technology and business models for their operations [1]. Banks with good capital are more efficient in follow up available business opportunities, more flexible and can cover unexpected losses generated during the crisis and as a result, they achieve a higher level of profitability [6]. The result of CAR is positively correlated with bank profitability also in line with previous studies by [6] [11] [27]. On the other hand, Bank Age and Leverage affect Islamic banks' financial performance in a negative direction at a significance of 1%. Old banks may not use their assets to generate profits compared to young banks despite their asset limitations, with high efficiency can be used by younger banks to create profits and leverage negatively affect ROA in line with research by [36] [37].

5 Conclusions

This is the first study that measures sustainability practices (economic, environmental, and social) on the financial performance of Islamic banking in Indonesia based on GRI which transformed by *Maqasid Al-Sharia* theory. The result showed average practices of sharia banking sustainability during 2014 - 2018 were very low only 23.33%, but these practices are proven to be increasing over the past 5 years at 50.19%. Sustainability practices also have no relation to financial performance, which shows that these practices are not a priority in Islamic banking therefore regulators' role is required so this voluntary practice and reporting gain specific attention, which adjusted to the principles of Islamic banking. The weakness of this study is even though we use two scorers who are used to do sustainability content analysis based on GRI, the score of sustainability practices remains based on the judgment of scorer, so there is a subjective assessment. Furthermore, for further research, researchers can add other Islamic items to measure sustainability and test the relationship to financial performance in the long-term (t+1) because the benefits of sustainability may not be realized in the short-term but can affect the long-term.

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