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The Effect of ESG on the Financial Performance of Islamic Banks The Mediating Role of Sharia Compliance (2020–2024)

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Abstract. *This study aims to analyze the effect of Environmental, Social, and Governance (ESG) factors on the financial performance of Islamic banks in Indonesia, with Sharia Compliance proxied by the Islamic Income Ratio (IsIR) serving as an intervening variable. The study employs a quantitative approach using an associative causal research design. The sample consists of 12 Islamic Commercial Banks registered with the Financial Services Authority (OJK) during the 2020–2024 period. Data were analyzed using panel data regression, the Baron and Kenny mediation approach, and the Sobel test.*
The results indicate that, partially, the Environmental, Social, and Governance variables do not have a significant effect on the Islamic Income Ratio. Furthermore, each ESG dimension, as well as the Islamic Income Ratio, does not significantly affect Return on Assets (ROA) and Return on Equity (ROE). Simultaneously, ESG variables and the Islamic Income Ratio do not have a significant effect on ROA but have a significant effect on ROE. The Sobel test results reveal that the Islamic Income Ratio is unable to mediate the effects of Environmental, Social, and Governance factors on either ROA or ROE. These findings suggest that Sharia Compliance, as measured by the Islamic Income Ratio, has not yet functioned as an intervening variable in the relationship between ESG and the financial performance of Islamic banks. Nevertheless, ESG practices and Sharia compliance, when considered jointly, contribute to improving shareholders' return on equity

Keywords: ESG, Sharia Compliance, ROA, ROE

INTRODUCTION

Along with the development of the global economy, profitability is no longer the primary consideration for investors in evaluating a company. Other forms of assessment, particularly non-financial performance evaluation, have emerged through the implementation of sustainability aspects within an entity's operations. In pursuing and achieving profit, entities are also expected to maintain their relationship with environment, social, and governance aspects, commonly referred to as ESG. In recent years, ESG has become a distinct consideration for investors in addition to financial evaluation (Fadhly et al., 2025; Hadi, 2024). On September 25, 2015, a United Nations forum attended by 193 countries marked an important milestone for ESG to emerge as a principle and strategic instrument in making responsible and sustainable investment decisions (Fadhly et al., 2025; Rahmansyah & Mutmainah, 2024).

ESG assessment has been widely utilized to evaluate global corporations and can even be applied to assess regions or countries. The primary objective of this assessment is to achieve systematic changes regarding issues related to environment, social, and governance aspects within an entity (Daugaard & Ding, 2022). ESG disclosure and transparency have become part of policy reforms, regulations, and guidelines promoted by shareholders in both the private and public sectors, particularly within the ASEAN region

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
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(Prabawati & Rahmawati, 2022). As a member of ASEAN, Indonesia has actively contributed to the implementation of ESG practices. This is reflected in regulations and policies such as Law Number 32 of 2009 concerning Environment Protection and Management, as well as Financial Services Authority Regulation (POJK) Number 51/POJK.03/2017, which mandates the implementation of sustainable finance principles, the preparation of Sustainable Finance Action Plans, and the publication of sustainability reports for each economic and business entity (Tarihoran et al., 2025).

The values embodied in ESG are generally aligned with the principles of Maqashid Shariah. This provides a strategic position for Islamic banking in Indonesia, as both principles aim to preserve human welfare. The concept of ESG, along with its emphasis on economic benefits and social welfare, is reflected in the five principles of Maqashid Shariah. These principles consist of the protection of religion *(Hifz Ad-Din)*, protection of life *(Hifz Al-Nafs)*, protection of intellect *(Hifz Al-Aql),* protection of lineage *(Hifz Al-Nasl),* and protection of wealth *(Hifz Al-Mal)*. Therefore, the implementation of sustainable finance embodied in ESG is consistent with Sharia principles, which emphasize business ethics, social responsibility, and sustainability (Purwanto, 2024; Putri et al., 2025).

The development of ESG implementation in the national banking sector has demonstrated highly positive dynamics during the 2018–2025 period. Based on data from the projected ESG trend index of the Indonesian banking industry, there has been a consistent upward trend in ESG scores across all banking categories, including State-Owned Banks (BUMN), Private Banks, and leading Islamic banks such as Bank Syariah Indonesia (BSI). This trend reflects the collective commitment of the domestic financial industry to align economic growth with environment sustainability and social inclusion responsibilities.

Figure 1. ESG Trends in Indonesian Banking

More specifically, the performance of each banking group demonstrates distinctive growth characteristics worthy of further attention. At the beginning of the observation period in 2018, Bank Syariah Indonesia (BSI) recorded the lowest index score at 1.0. However, the trend illustrates a highly progressive improvement in performance from year to year. By the 2021–2022 period, BSI had succeeded in matching the average performance of State-Owned Banks (BUMN) with a score of 2.8. Thereafter, BSI experienced exponential growth, significantly surpassing other banking groups with a score reaching 5.6 in 2025. This acceleration indicates the successful integration of Sharia values (*Maqasid al-Shari'ah*), which are inherently aligned with the universal principles of ESG.

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
[June 2026] [ISSN 3047-0951]

Meanwhile, the State-Owned Bank (BUMN) group held the leading position at the beginning of the observation period in 2018, with a score approaching 1.5. Throughout the seven-year period, BUMN banks demonstrated stable and consistent growth, ultimately achieving a score of 4.0 in 2025. This performance reaffirms the role of State-Owned Banks as government development agents that are expected to serve as the forefront of sustainable finance adoption

The average ESG score of national private banks began at approximately 1.25 in 2018 and continued to increase linearly, reaching 3.6 by 2025. Although the growth rate remained slightly below that of State-Owned Banks (BUMN) and Bank Syariah Indonesia (BSI), this positive trend demonstrates that the private banking sector has become increasingly adaptive to the demands of global markets and investors, who are becoming more selective regarding sustainability-related issues.

Despite the overall positive macro trend, the growth gap between institutions such as BSI and the industry average, particularly after 2022, highlights the need for further investigation. These differences in the pace of adaptation indicate variations in strategic effectiveness, resource allocation, and operational constraints faced by each banking group

Based on the study conducted by Irsyad et al. (2024), ESG can contribute to banking stability in both conventional and Islamic banking institutions. This finding is further supported by the study of Izzadieny et al. (2025), which demonstrated that ESG disclosure can influence the profitability of Islamic banks. In their operations, Islamic banks are also required to comply with Sharia principles. As stated by Ovami (2020) and Rahmansyah and Mutmainah (2024), compliance with Sharia principles serves as a guarantee that all operational activities of Islamic banks are free from practices and behaviors prohibited under Islamic law. Furthermore, it ensures that the income generated by Islamic banks is derived in accordance with applicable Sharia principles.

ESG disclosure and compliance with Sharia principles are not solely intended to increase profitability, but also to demonstrate the capability of Islamic banks to consider the interests of all stakeholders beyond shareholders. In addition, these aspects provide added value to the existence of Islamic banking by reflecting the alignment of its values with the surrounding social environment. Both of these perspectives are consistent with stakeholder theory and legitimacy theory (Tarihoran et al., 2025).

To date, there has been no study examining the effect of ESG on financial performance mediated by Sharia compliance. Previous research conducted by Ovami (2020) treated Sharia compliance as an independent variable. The findings of the study indicated that the Islamic income ratio, profit-sharing ratio, and Islamic investment ratio simultaneously had a significant effect on the financial performance of Islamic banks in Indonesia. On the other hand, the study by Rahmansyah and Mutmainah (2024) positioned Sharia compliance as a moderating variable to examine whether Sharia compliance strengthens or weakens the effect of ESG disclosure on the performance of non-financial companies.

Furthermore, from the perspective of ESG disclosure itself, previous studies have demonstrated that ESG disclosure influences financial performance. Research conducted by Tarihoran et al. (2025) found that the Environment and Governance aspects of ESG disclosure positively affect financial performance. However, the Social aspect of ESG disclosure was found to have a negative effect on financial performance. Meanwhile, the study by Amrullah et al. (2025) revealed that ESG disclosure has a positive effect on financial performance, with the relationship being moderated by gender diversity.

The previous studies discussed above have not fully addressed the needs of the present research, in which Sharia Compliance is positioned as a intervening variable with samples consisting of Islamic Commercial Banks registered with the Indonesian Financial Services Authority (Otoritas Jasa Keuangan/OJK). In addition, there is still inconsistency regarding the effect of ESG disclosure on financial performance. Furthermore, many prior studies continue to rely on data that are not up to date. Therefore,

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
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this study is expected to provide a scientific contribution toward understanding the relationship between ESG disclosure, Sharia Compliance, and the financial performance of Islamic banking institutions in Indonesia. This study aims to examine the partial and simultaneous relationships or effects of ESG disclosure on financial performance, with Sharia Compliance serving as the intervening variable.

LITERATURE REVIEW

Stakeholder Theory

According to Freeman, as presented in his book Strategic Management: A Stakeholder Approach published in 1984, stakeholder theory refers to a company's ability to consider the interests of all stakeholders beyond shareholders in order to achieve long-term benefits for the company (Tarihoran et al., 2025). On the other hand, stakeholder theory, as explained by Saqib et al. (2025), suggests that the existence of a business entity is not solely intended to generate profit for shareholders, but also to create value that benefits all stakeholders who are affected by or have an impact on the business itself. By paying attention to the needs of other stakeholders through ESG disclosure, business entities are expected to support their growth through positive investor perceptions, which may increase operational capital investment. Furthermore, the utilization of the entity's products and services by other stakeholders may also increase based on the positive value that has been created (Tarihoran et al., 2025).

Legitimacy Theory

Quoting Suchman (1995), Vo Van et al. (2025) describe legitimacy theory as a social contract that binds business entities and society, in which obligations and expectations exist between both parties, encompassing social norms, legal frameworks, and institutional structures established by society, as well as the operational compliance of business entities with such arrangements. On the other hand, also referring to Suchman (1995), Mehadi et al. (2025) argue that legitimacy theory represents a concept or general assumption that the activities of a business entity are conducted in accordance with prevailing social norms. Within the framework of legitimacy theory, ESG disclosure can serve as a strategic instrument for business entities or companies to align their activities and operations with societal norms and regulatory requirements, thereby enabling them to obtain legitimacy from society itself (Tarihoran et al., 2025).

Sharia Compliance

Sharia Compliance refers to the activities of companies or business entities in adhering to Sharia principles, such as avoiding transactions prohibited under Islamic law. Sharia-based products generally exhibit lower risk and volatility compared to conventional products, particularly within the financial sector (Mohanan et al., 2025). Sharia Compliance serves as the fundamental foundation for the character, integrity, credibility, and operational guidelines of Islamic banking institutions. Specifically, for Islamic banks in Indonesia, the regulations governing operational compliance have been established through Bank Indonesia Regulation Number 13/2/PBI/2011 concerning the Implementation of the Compliance Function for Commercial Banks, which outlines the Sharia principles that must be adhered to by Islamic banking institutions (Ovami, 2020). In this study, Sharia Compliance is proxied by the Islamic Income Ratio (IsIR). IsIR represents the ratio used to measure the proportion of halal income earned by a company or Islamic banking institution (Ovami, 2020).

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ESG

In assessing the sustainability of a business entity's or company's operations, ESG (Environment, Social, and Governance) serves as a commonly used evaluation framework. The elements encompassed within this framework are interrelated in fostering ethical, sustainable business operations that also create added value for stakeholders (Tarihoran et al., 2025). ESG disclosure has become an important strategy that business entities or companies need to implement in order to build legitimacy, accountability, and social expectations (Adibah et al., 2025).

In its disclosure, the Environment aspect includes the management of waste generated, the use of energy and natural resources, as well as carbon emissions resulting from the operations of a business entity or company. The Environment aspect of ESG requires business entities or companies to demonstrate accountability in maintaining and preserving the environment. Environment preservation and sustainability can also enhance stakeholder satisfaction and fulfill stakeholder expectations (Adibah et al., 2025; Rahmansyah & Mutmainah, 2024).

In addition to the Environment aspect, the Social aspect constitutes another important component of the ESG evaluation framework. The Social aspect focuses on the relationship between a business entity or company and individuals, communities, or other institutions within the scope of its operations, both internally and externally. The Social aspect requires business entities or companies to pay attention to labor-related issues and to maintain responsible and harmonious relationships with parties from diverse social backgrounds, including communities located within their operational areas. The implementation of sustainable Social principles can provide added value and enhance investor confidence in the business entity or company over the long term (Prasetyo & Musmini, 2025; Tarihoran et al., 2025).

Lastly, in the implementation of the ESG evaluation framework, business entities or companies are required to maintain good governance in their operations. Effective and efficient management and governance practices, sound decision-making processes, and compliance with legal regulations are essential for business entities or companies in order to foster trust and support from stakeholders. Good governance can ensure transparent and accountable corporate operations, which may generate positive impacts for all parties involved (Ramadhani, 2025; Tarihoran et al., 2025).

Financial Performance

Financial performance is an important aspect in measuring the performance of a business entity or company, particularly through profitability indicators that reflect the company's ability to generate profit based on analytical ratio calculations (Hadi, 2024). In its measurement, Return on Assets (ROA) is one of the most commonly used indicators for assessing corporate performance. ROA refers to a company's ability to generate net income by utilizing its total assets (Lestari, 2020; Ovami, 2020). In addition to ROA, financial performance can also be measured using Return on Equity (ROE). While ROA evaluates how a business entity or company generates profit through its assets, ROE measures the entity's ability to generate returns at a particular level of shareholders' equity (Triyani et al., 2020).

METHODS

This study employs a quantitative method with an associative/causal approach. According to Sugiyono and Lestari (2021), quantitative research focuses on data collection through research instruments, which are subsequently analyzed statistically to describe phenomena and test predetermined hypotheses. The data collected in this study are secondary data obtained from annual reports and sustainability reports published by Islamic Commercial Banks during the 2020–2024 period. Data from these reports were collected to fulfill the requirements of the five variables used in this study.

The sustainability reports were utilized to measure the three independent variables, namely Environment (X1), Social (X2), and Governance (X3). Meanwhile, data from the annual reports were used to measure the intervening variable, namely the Islamic Income Ratio (M) as an indicator of Sharia Compliance

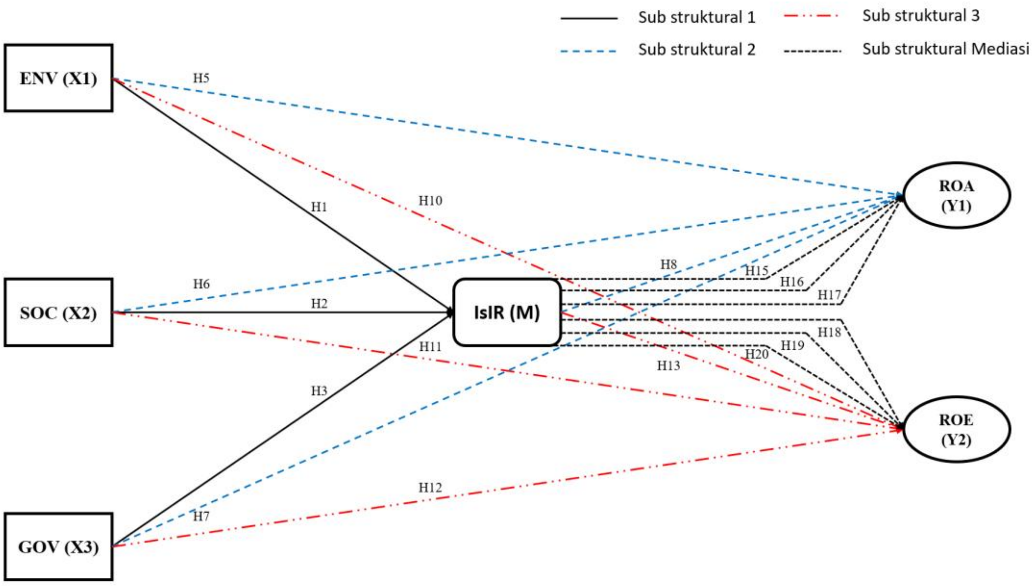
(Ovami, 2020), as well as the two dependent variables, namely Return on Assets (ROA) (Y1) and Return on Equity (ROE) (Y2).

In addition, ESG data in this study were measured using the Global Reporting Initiative (GRI) Index as the measurement indicator. The GRI serves as a global standard for sustainability reporting by business entities or companies (Global Reporting Initiative, 2026). Each variable consists of a different number of indicators. The Environment variable (ENV) (X1) employs the GRI 300 series index with a total of 30 indicators. The Social variable (SOC) (X2) uses the GRI 400 series index with a total of 36 indicators. Meanwhile, the Governance variable (GOV) (X3) applies the GRI 2 index with a total of 30 indicators (Ramadhani, 2025; Tarihoran et al., 2025).

The data were collected using the Boolean Data method, in which a score of 1 was assigned if the information was disclosed in the report, and a score of 0 was assigned if the information was not disclosed. The scores obtained are then summed and averaged for each variable (Davis & Jamie, 2024).

Based on the explanation above, the following presents the conceptual framework alongside the hypothesis of this study:

Figure 2. Conceptual Framework



The sampling technique employed in this study is Non-Probability Sampling using the Purposive Sampling method, with the following criteria:

1. Islamic Commercial Banks (BUS) that consistently published sustainability reports during the 2020–2024 research period.
2. Islamic Commercial Banks (BUS) that consistently published annual financial reports during the 2020–2024 research period.

Based on the criteria above, a population of 14 Islamic Commercial Banks registered with the Financial Services Authority (OJK) was identified. The research sample consists of PT Bank Aceh Syariah (BAS), PT BPD Riau Kepri Syariah (BRKS), PT BPD Nusa Tenggara Barat Syariah (NTBS), PT Bank Muamalat Indonesia (MMT), PT Bank Victoria Syariah (VTRS), PT Bank Jabar Banten Syariah (BJBS), PT Bank Syariah Indonesia (BSI), PT Bank Mega Syariah (BMS), PT Bank Panin Dubai Syariah (PDSB), PT Bank Syariah Bukopin (KBBS), PT BCA Syariah (BCAS), and PT Bank Tabungan Pensiunan Nasional Syariah (BTPNS).

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
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The data for this study were analyzed using EViews 13 software through a panel data regression approach based on the Causal Steps Approach developed by Reuben Baron and David Kenny. According to Baron and Kenny, this method is used to examine the mediating role of a variable in explaining the relationship between independent and dependent variables through a series of regression analyses, in which the effect of the independent variable on the dependent variable is transmitted through a mediator variable

Based on the procedure proposed by Baron and Kenny, this study employed three stages of regression analysis. The first stage, referred to as Sub-Structural Model 1, examines the effect of the independent variables on the intervening variable. The second stage, Sub-Structural Model 2, analyzes the effects of the independent variables and the intervening variable on the first dependent variable. The third stage, Sub-Structural Model 3, investigates the effects of the independent variables and the intervening variable on the second dependent variable. After completing these three stages, the significance of the mediating variable is further assessed using the Sobel test

The following presents the estimated panel data regression equations for each research model :

Sub-Structural Model 1

$$IsIR_{it} = \alpha + \beta_1 ENV_{it} + \beta_2 SOC_{it} + \beta_3 GOV_{it} + e_{it}$$

Equation 1 Sub-Structural Model 1

Sub-Structural Model 2

$$ROA_{it} = \alpha + \beta_1 ENV_{it} + \beta_2 SOC_{it} + \beta_3 GOV_{it} + \beta_4 IsIR_{it} + e_{it}$$

Equation 2 Sub-Structural Model 2

Sub-Structural Model 3

$$ROE_{it} = \alpha + \beta_1 ENV_{it} + \beta_2 SOC_{it} + \beta_3 GOV_{it} + \beta_4 IsIR_{it} + e_{it}$$

Equation 3 Sub-Structural Model 3

The Sobel test formula used to examine the significance of the mediating effect is presented below:

$$\boldsymbol{t = \frac{ab}{\sqrt{(b^2 SEa^2) + (a^2 SEb^2)}}}$$

As in conventional panel data regression analysis, the estimated models are evaluated using the Chow test, Hausman test, and Lagrange Multiplier test to determine the most appropriate model among the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM) for each of the three regression stages. Subsequently, each selected regression model is subjected to classical assumption tests, including multicollinearity and heteroscedasticity tests, to ensure the validity and reliability of the estimation results

Subsequently, each regression stage was subjected to hypothesis testing using the t-test for partial effects and the F-test for simultaneous effects, both at a significance level of 5%. These tests were employed to examine the influence of the independent variables on the dependent variables within each regression stage. Furthermore, the coefficient of determination (R^2) was used to measure the extent to which the independent variables in each regression model explain the variation in the corresponding dependent variable.

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
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RESULTS AND DISCUSSION

Sobel Test

Based on Sub-Structural Model 2 (t-table = 2.002)

Table 1. Sobel Test Results Based on Sub-Structural Model 2

X1 terhadap Y1 melalui M	X2 terhadap Y1 melalui M	X3 terhadap Y1 melalui M
$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$ $t = \frac{-0,05 \times -0,48}{\sqrt{(-0,48^2 \times 0,38^2) + (-0,05^2 \times 0,98^2)}}$ *t = 0,13*	$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$ $t = \frac{0,13 \times -0,48}{\sqrt{(-0,48^2 \times 0,29^2) + (0,13^2 \times 0,98^2)}}$ *t = -0,33*	$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$ $t = \frac{0,14 \times -0,48}{\sqrt{(-0,48^2 \times 0,16^2) + (0,14^2 \times 0,98^2)}}$ *t =- 0,43*
Nilai t-hitung (0,13) < t-tabel (2,002) maka H15 ditolak dan H0 diterima, artinya Variabel Environment (X1) tidak berpengaruh terhadap ROA (Y1) melalui IsIR (M) sebagai variabel intervening	Nilai t-hitung (0,33) < t-tabel (2,002) maka H16 ditolak dan H0 diterima, artinya Variabel Social (X2) tidak berpengaruh terhadap ROA (Y1) melalui IsIR (M) sebagai variabel intervening	Nilai t-hitung (0,43) < t-tabel (2,002) maka H17 ditolak dan H0 diterima, artinya Variabel Governance (X3) tidak berpengaruh terhadap ROA (Y1) melalui IsIR (M) sebagai variabel intervening

Source: Processed data by the researcher

Based on the results of the Sobel test for Sub-Structural Model 2 with Return on Assets (ROA) as the dependent variable, the calculated t-value for the Environmental (X1) variable was 0.13, which is lower than the critical t-value of 2.002 (0.13 < 2.002). Therefore, H15 is rejected and the null hypothesis (H0) is accepted. It can be concluded that the Environmental variable (X1) does not affect ROA (Y1) through the Islamic Income Ratio (IsIR) (M) as an intervening variable.

Furthermore, the Social (X2) variable obtained a calculated t-value of 0.33, which is also lower than the critical t-value of 2.002 (0.33 < 2.002). Accordingly, H16 is rejected and H0 is accepted, indicating that the Social variable (X2) does not affect ROA (Y1) through IsIR (M) as an intervening variable.

The Governance (X3) variable produced a calculated t-value of 0.43, which is lower than the critical t-value of 2.002 (0.43 < 2.002). Therefore, H17 is rejected and H0 is accepted, indicating that the Governance variable (X3) does not affect ROA (Y1) through IsIR (M) as an intervening variable.

Overall, the results of the Sobel test for Sub-Structural Model 2 indicate that the Islamic Income Ratio (IsIR) (M) is not capable of mediating the effects of Environmental (ENV), Social (SOC), and Governance (GOV) variables on Return on Assets (ROA).

Based on Sub-Structural Model 3 (t-table = 2.002)

Table 2. Sobel Test Results Based on Sub-Structural Model 3

X1 terhadap Y2 melalui M	X2 terhadap Y2 melalui M	X3 terhadap Y2 melalui M
$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$	$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$	$t = \frac{ab}{\sqrt{(b^2SEa^2) + (a^2SEb^2)}}$

Proceedings of the Perbanas International Seminar on Economics, Business, Management, Accounting and IT
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$t = \frac{-0,05 \times -8,59}{\sqrt{(-8,59^2 \times 0,38^2) + (-0,05^2 \times 5,47^2)}}$	$t = \frac{0,13 \times -8.59}{\sqrt{(-8.59^2 \times 0,29^2) + (0,13^2 \times 5,47^2)}}$	$t = \frac{0,14 \times -8.59}{\sqrt{(-8.59^2 \times 0,16^2) + (0,14^2 \times 5,47^2)}}$
t = 0,13	***t = -0,43***	***t =- 0,76***
Nilai t-hitung (0,13) < t-tabel (2,002) maka H18 ditolak dan H0 diterima, artinya Variabel Environment (X1) tidak berpengaruh terhadap ROE (Y2) melalui IsIR (M) sebagai variabel intervening	Nilai t-hitung (0,43) < t-tabel (2,002) maka H19 ditolak dan H0 diterima, artinya Variabel Social (X2) tidak berpengaruh terhadap ROE (Y2) melalui IsIR (M) sebagai variabel intervening	Nilai t-hitung (0,76) < t-tabel (2,002) maka H20 ditolak dan H0 diterima, artinya Variabel Governance (X3) berpengaruh terhadap ROE (Y2) melalui IsIR (M) sebagai variabel intervening

Source: Processed data by the researcher

Based on the results of the Sobel test for the sub-structural model 2 with Return on Equity (ROE) as the dependent variable, the calculated t-value for the Environmental (X1) variable was 0.13, which is lower than the critical t-value of 2.002 (0.13 < 2.002). Therefore, H18 is rejected and the null hypothesis (H0) is accepted. It can be concluded that the Environmental variable (X1) does not affect ROE (Y2) through the Islamic Income Ratio (IsIR) (M) as an intervening variable.

Furthermore, the Social (X2) variable obtained a calculated t-value of 0.43, which is also lower than the critical t-value of 2.002 (0.43 < 2.002). Accordingly, H19 is rejected and H0 is accepted, indicating that the Social variable (X2) does not affect ROE (Y2) through IsIR (M) as an intervening variable.

The Governance (X3) variable produced a calculated t-value of 0.76, which is lower than the critical t-value of 2.002 (0.76 < 2.002). Therefore, H20 is rejected and H0 is accepted, indicating that the Governance variable (X3) does not affect ROE (Y2) through IsIR (M) as an intervening variable.

Overall, the results of the Sobel test indicate that the Islamic Income Ratio (IsIR) (M) is not capable of mediating the effects of Environmental (ENV), Social (SOC), and Governance (GOV) variables on Return on Equity (ROE).

Discussions

The Effect of Environment on Financial Performance through the Islamic Income Ratio

Based on the results of the Sobel test in Sub-Structural Model 2 and Sub-Structural Model 3, the Environmental variable was found to have no effect on financial performance through the Islamic Income Ratio (IsIR) as an intervening variable. This finding is evidenced by the calculated t-value of 0.13 in both the ROA and ROE models, which is lower than the critical t-value of 2.002. Therefore, the hypothesis stating that IsIR mediates the relationship between Environmental performance and financial performance is rejected.

These findings are consistent with the results of Sub-Structural Model 1, which indicate that the Environmental variable does not have a significant effect on IsIR, as reflected by a probability value of 0.1488 (> 0.05). Furthermore, the results of Sub-Structural Models 2 and 3 reveal that Environmental performance does not have a direct effect on either ROA or ROE, with probability values of 0.1261 and 0.5862, respectively (> 0.05). This condition suggests that one of the essential requirements for mediation is not satisfied, namely the existence of a significant relationship between the independent variable and the mediator, as well as between the independent variable and the dependent variable.

The findings are consistent with those reported by Nugroho and Hersugondo (2022), who found that the Environmental aspect does not significantly influence financial performance. However, these results differ

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from the findings of Fadhillah and Marsono (2023), who reported a significant relationship between Environmental performance and financial performance.

Moreover, the Islamic Income Ratio, as a mediating variable, was unable to mediate the relationship between Environmental performance and financial performance. This finding is in line with the study conducted by Rahmansyah and Mutmainah (2024), which concluded that Sharia compliance does not moderate the relationship between the Environmental dimension and corporate financial performance.

The Effect of Social on Financial Performance through the Islamic Income Ratio

The results of the Sobel test indicate that the Islamic Income Ratio (IsIR) is unable to mediate the effect of the Social variable on financial performance. This finding is evidenced by the calculated t-values of 0.33 in the ROA model and 0.43 in the ROE model, both of which are lower than the critical t-value of 2.002. Therefore, the hypothesis stating that the Social variable affects financial performance through IsIR is rejected.

The absence of a mediating effect is supported by the results of the previous analyses, which revealed that the Social variable does not significantly affect IsIR, as indicated by a probability value of 0.6470 (> 0.05). Furthermore, the Social variable was also found to have no direct effect on either ROA or ROE, with probability values of 0.8210 and 0.9582, respectively (> 0.05).

These findings are consistent with the study conducted by Tarihoran et al. (2025), which reported that the Social dimension does not significantly influence financial performance. Similarly, Fadhillah and Marsono (2023) found that the Social aspect of ESG has no significant effect on financial performance. However, the present findings differ from those of Nugroho and Hersugondo (2022), who reported a significant relationship between the Social dimension of ESG and financial performance.

The results of this study also indicate that the Islamic Income Ratio is not effective in mediating the relationship between the Social dimension and financial performance. This finding is consistent with the study of Rahmansyah and Mutmainah (2024), which concluded that Sharia compliance does not act as a moderating variable in the relationship between the Social dimension and financial performance.

The Effect of Governance on Financial Performance through the Islamic Income Ratio

Based on the results of the Sobel test, the Islamic Income Ratio (IsIR) is unable to mediate the effect of Governance on financial performance. This is indicated by the calculated t-values of 0.43 in the ROA model and 0.76 in the ROE model, both of which are lower than the critical t-value of 2.002. Therefore, the hypothesis stating that Governance affects financial performance through IsIR is rejected.

This result is consistent with the findings from Sub-Structural Model 1, which show that Governance does not have a significant effect on IsIR, as indicated by a probability value of 0.3660 (> 0.05). In addition, Governance is also found to have no direct effect on either ROA or ROE, with probability values of 0.3097 and 0.8413, respectively (> 0.05).

These findings are supported by Nugroho and Hersugondo (2022), who reported that Governance does not significantly affect financial performance. However, they contrast with the findings of Tarihoran et al. (2025), which suggest that Governance has a significant influence on financial performance.

Furthermore, the Islamic Income Ratio as a mediating variable does not demonstrate the ability to transmit the effect of Governance on financial performance. This result aligns with the study by Rahmansyah and Mutmainah (2024), which found that Sharia compliance neither strengthens nor weakens the relationship between Governance and financial performance.

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The Effect of ESG and the Islamic Income Ratio on Financial Performance

Based on the results of the F-test in Sub-Structural Model 2, it is found that the Environmental, Social, Governance, and Islamic Income Ratio variables do not simultaneously have a significant effect on Return on Assets (ROA). This is indicated by the Prob(F-statistic) value of 0.590970, which is greater than the significance level of 0.05. Therefore, the model is not able to adequately explain variations in ROA among the sampled firms.

This result suggests that profitability measured by ROA is more likely influenced by other factors outside the research model, such as operational efficiency, financing quality, financing risk level, capital structure, macroeconomic conditions, and firm-level business strategies.

In contrast, the simultaneous test in Sub-Structural Model 3 shows that the Environmental, Social, Governance, and Islamic Income Ratio variables jointly have a significant effect on Return on Equity (ROE). This is evidenced by the Prob(F-statistic) value of 0.000070, which is lower than 0.05. Thus, ESG and IsIR are collectively able to explain variations in ROE.

Interestingly, although the t-test results indicate that each variable individually does not significantly affect ROE, the F-test results show a significant joint effect. This condition suggests that the contribution of these variables is more pronounced when analyzed simultaneously rather than individually. In other words, changes in ROE are not driven by a single ESG dimension or IsIR in isolation, but rather by the combined effect of all these components.

CONCLUSIONS

Overall, the findings indicate that the Islamic Income Ratio (IsIR) is not able to function as an intervening variable in the relationship between ESG and the financial performance of Islamic banks. In addition, each ESG dimension and IsIR do not show a significant partial effect on either Return on Assets (ROA) or Return on Equity (ROE). However, when examined simultaneously, ESG and IsIR are found to have a significant effect on ROE, suggesting that the synergy between sustainability aspects and Sharia compliance contributes to improving shareholders' equity returns.

Based on the conclusions drawn in this study, several recommendations are proposed. Islamic banks are encouraged to enhance the quality of ESG implementation in a more integrated manner within their business strategies. ESG practices should not merely focus on regulatory compliance and reporting obligations, but should also be directed toward creating economic value that contributes to improved financial performance.

In addition, Islamic banks should further strengthen compliance with Sharia principles by optimizing halal income generation. Although the Islamic Income Ratio was not found to significantly affect financial performance in this study, improving the quality of Sharia-compliant income remains essential to maintaining public trust and reinforcing the identity of Islamic banking institutions.

For investors, ESG indicators and the Islamic Income Ratio should not be used as the sole basis for investment decision-making in Islamic banks. Investors are advised to also consider other factors that may influence financial performance, such as asset quality, operational efficiency, non-performing financing levels, capital structure, and macroeconomic conditions.

For future researchers, it is recommended to extend the observation period to allow a more comprehensive assessment of the long-term impact of ESG implementation and Sharia compliance on financial performance. Furthermore, the scope of the sample may be expanded beyond Islamic banks to include other Islamic financial institutions, thereby improving the generalizability of the findings. Future studies may also incorporate more diverse financial performance indicators, such as Return on Investment (ROI), Net Profit Margin (NPM), and firm value, to provide a broader understanding of the impact of ESG and IsIR on corporate performance. Moreover, alternative intervening or moderating variables such as firm size, corporate reputation, operational efficiency, Good Corporate Governance (GCG), and risk level may be considered to further enrich the analysis of relationships among variables. Finally, future research is encouraged to employ different analytical approaches, such as Structural Equation Modeling (SEM) or more advanced panel data techniques, to obtain a more comprehensive understanding of the relationship between ESG, Islamic Income Ratio, and financial performance

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