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Sharia compliance on sustainable investment (ESG) and green sukuk

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Abstract

Global sustainability challenges promote the incorporation of Environmental, Social, and Governance (ESG) concepts in investment practices. Nonetheless, a complete framework ensuring sharia compliance for ESG and green sukuk investments is absent, resulting in a deficiency in the sharia financial literature. This study seeks to examine the intersections and possible synergies between sharia principles and ESG criteria while also assessing the sharia compliance of Green Sukuk as a sustainable finance mechanism. The invention consists of a conceptual model that amalgamates sharia maqasid with the ESG pillar, guaranteeing that investments are not only halal but also thayyib and yield a good impact. The findings discussion delineates the profound alignment, screening obstacles, and advantages of Green Sukuk in mobilising Sharia financing for sustainable development. In conclusion, significant potential exists for harmonisation, accompanied by proposals for standardisation and education to enhance the role of Islamic finance in the global sustainability agenda.

Keyword: Sharia Compliance, Sharia Finance, Sustainable Investment, Green Sukuk

Introduction

Current global economic trends underscore the significance of sustainability across all sectors of business and investment. The Environmental, Social, and Governance (ESG) framework has gained global recognition as a standard for assessing an entity's sustainability performance, prompting investors to factor in the non-financial implications of their investment choices [1]. ESG has evolved from being just a trend to becoming essential for many financial

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institutions and organisations that aim to enhance their reputation, attract environmentally conscious investors, and reduce long-term risks.

Conversely, Islamic banking, grounded in Islamic principles, possesses a robust philosophy concerning justice, ethics, and social responsibility. Principles like the prohibition of usury, gharar, and maysir, together with the promotion of investment in the beneficial real sector (maslahah), are intrinsically compatible with numerous elements of ESG [1]. This presents significant opportunities for Islamic finance to lead in the advancement of sustainable investments, particularly via new products like green sukuk.

Notwithstanding the philosophical congruence, the practical execution and verification of sharia compliance in sustainable investments, particularly with ESG and green sukuk, necessitate comprehensive examination. Sharia screening criteria and ESG criteria frequently function concurrently without explicit integration, resulting in confusion for investors and instrument issuers. This prompts an inquiry into how to guarantee that assets labelled as "sharia" are indeed "sustainable" according to ESG criteria, and conversely.

The aims of this research are: to analyse the commonalities and potential synergies between sharia compliance principles and sustainable investment (ESG) criteria. Assess the Sharia compliance framework in the issuance and administration of Green Sukuk as a sustainable financing vehicle. Develop a conceptual framework that amalgamates sharia and ESG principles for a more comprehensive investment approach.

This article addresses the research gap about the absence of a comprehensive framework that explicitly integrates sharia maqasid (sharia goals) with ESG pillars in the investment setting. While there have been distinct studies on ESG and Islamic finance, limited research has explored how sharia compliance may serve as a more rigorous filter or perhaps enhance existing ESG criteria, particularly in specific instruments like Green Sukuk. This research introduces a conceptual model that identifies alignment and proposes a mechanism to ensure that sharia investment is both halal (permissible) and thayyib (good and beneficial) from a sustainability standpoint, as evidenced in Green Sukuk.

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Methods

This study employs a descriptive qualitative methodology to thoroughly examine the connections among sharia compliance, sustainable investment (ESG), and green sukuk. The qualitative approach was selected, as it enables researchers to investigate intricate concepts, foundational philosophies, and the practical application of these principles within the realm of financial markets. The descriptive approach will be employed to thoroughly delineate the characteristics, alignments, and problems of the three research variables.

Sustainable Investment (ESG) is an investment strategy that incorporates environmental, social, and corporate governance issues alongside conventional financial criteria in the decision-making process. Environmental Factors (E) encompass topics such as climate change, pollution, waste management, and resource efficiency. The social factor encompasses the company's interactions with employees, suppliers, consumers, and communities, including human rights, labour standards, and product safety [2]. Governance aspects pertain to business leadership, executive compensation, auditing practices, shareholder rights, and openness. ESG seeks to discover companies that are both financially lucrative and ethically as well as socially accountable.

Conversely, Sharia compliance in investment denotes the alignment of financial instruments and activities with the tenets of Islamic law (Sharia). The fundamental principles encompass the prohibition of *riba* (interest), *gharar* (excessive uncertainty), *maysir* (gambling), and investment in non-halal sectors (e.g., alcohol, pork, gambling, weapons), alongside the promotion of investment in the productive real sector that yields social benefits (*maslahah*).

Green Sukuk is an Islamic financial instrument akin to a bond, wherein the capital raised is solely allocated to finance projects that yield favourable environmental outcomes or "green" initiatives. These initiatives may encompass renewable energy, energy efficiency, waste management, sustainable transportation, and conservation of natural resources. Green Sukuk integrates Sharia concepts, such as *Ijarah*, *Murabahah*, or *Musyarakah* contracts, with the environmental obligations of Green Bonds [3].

The relationship among Sharia compliance, ESG, and green sukuk is substantial. Philosophically, the *maslahah* principle in Sharia aligns closely with the ESG objective of

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generating a beneficial influence on society and the environment. The prohibition on investment in the non-halal industry under Sharia functions as a stringent preliminary filter, augmenting the negative screening in ESG. Green Sukuk exemplifies this synergy by utilising Islamic financial instruments to fund projects that adhere to ESG sustainability criteria.

This research employs a complete literature review methodology. Primary data sources will encompass fatwa documents from the National Sharia Council (DSN-MUI), standards from the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), and recommendations pertaining to Green Bond Principles (GBP) and Green Sukuk released by international entities. Secondary data will be sourced from scientific journals, books, research reports, publications by Islamic financial institutions, and news pertaining to ESG and Green Sukuk [4]. The employed data analysis methodologies are content analysis and comparison analysis. We will use content analysis to identify fundamental topics, principles, and relevant criteria in both Sharia and ESG texts. A comparative analysis will be conducted to discover similarities and discrepancies between sharia compliance criteria and ESG criteria, specifically regarding the issuance and administration of Green Sukuk.

Discussion and results

This discourse will delineate the profound congruence between sharia compliance and ESG principles, emphasising the achievements and obstacles in the execution of Green Sukuk, along with its ramifications and advantages for sustainable financial development.

There is a profound synergy between the principles of sharia compliance and ESG standards. The *maslahah* concept in sharia inherently promotes investments that yield social and environmental advantages, aligning with the social and environmental pillars of ESG. The ban on usury, *gharar*, and *maysir* in Sharia indirectly promotes more transparent and accountable governance procedures, along with pillar G. Moreover, sharia screening, which forbids investments in specific industries (e.g., alcohol, gambling, tobacco), serves as a stringent negative filter, much more rigorous than many standard ESG screenings [5]. This indicates that sharia-compliant investments inherently satisfy the majority of ESG requirements.

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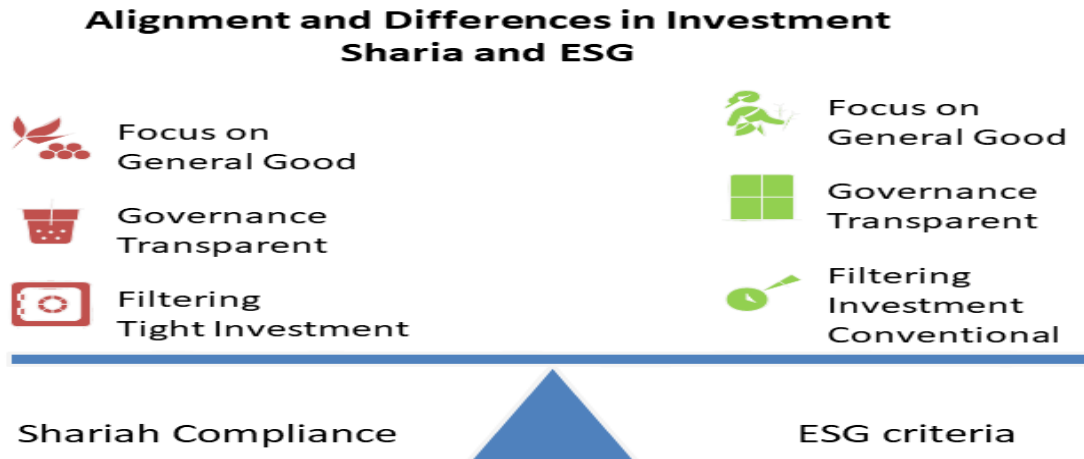


Figure: Alignment and Differences in Investment Sharia and ESG

In practice, green sukuk has emerged as a fundamental tool that connects Islamic finance with sustainable investment. The efficacy of Green Sukuk is attributed to its capacity to attract sharia-compliant funds from environmentally conscious investors, simultaneously offering alternative funding for sustainable initiatives. Indonesia, as a pioneer in the issuing of green sukuk, has demonstrated the significant potential of this instrument in advancing national climate objectives. Green Sukuk guarantees that the capital obtained is allocated solely to externally validated initiatives that yield a beneficial environmental impact, including renewable energy, conservation, or green transport, so offering twin advantages: adherence to Sharia law and promotion of sustainability [6].

Where Islamic Finance Meets Environmental Impact

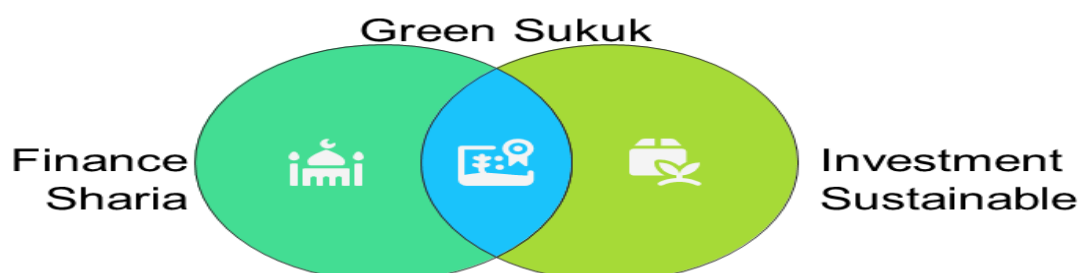


Figure: The Intersection of Islamic Finance and Environmental Impact

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Nonetheless, the execution of green sukuk and Sharia-compliant ESG investments encounters obstacles. The standardisation of screening criteria is one of them. Despite the basic congruence, the specifics of Sharia and ESG screening standards may differ, necessitating harmonisation to eliminate uncertainty. A further barrier is market literacy; both investors and issuers require an enhanced comprehension of how to successfully integrate these two frameworks. Moreover, transparent and accountable verification and reporting of the impacts of Green Sukuk projects are essential for sustaining confidence and attracting additional investors.

The ramifications and advantages of aligning sharia compliance with ESG are substantial. Initially, it can draw a broader investment demographic, encompassing ESG-aware Sharia investors and traditional ESG investors seeking ethical products [7]. Secondly, it enhances the legitimacy and integrity of Islamic investments, demonstrating that Islamic finance prioritises not only prohibitions but also good outcomes. Third, expediting the funding of sustainable initiatives is essential for attaining the Sustainable Development Goals (SDGs). Fourth, enhancing Indonesia's status as a global hub for Islamic finance and a pioneer in green finance by providing a repeatable model.

Table: Consequences and Advantages of Harmonising Sharia and ESG Compliance

Elements	Consequences and Advantages
Expanded Investor Base	Attracting sharia-compliant investors focused on ESG principles and conventional ESG investors seeking ethical securities. This facilitates access to a broader and more varied funding base.
Enhanced Credibility and Integrity	Enhancing the authenticity and integrity of Islamic investments by demonstrating that Islamic finance emphasises not only prohibitions but also good societal and environmental consequences.

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Expedited Sustainable Project Financing Expediting the funding of sustainable initiatives essential for attaining the Sustainable Development Goals (SDGs), including renewable energy, sustainable agriculture, and green infrastructure.

Enhance Indonesia's status as a global Islamic finance centre and
Fortifying Indonesia's Standing a pioneer in green finance by providing a cohesive model that can be emulated and serve as a benchmark for other nations.

Green Sukuk exemplifies how Islamic finance can effectively promote sustainable investment. By persistently enhancing the synergy between sharia compliance and ESG standards, the capacity to mobilise substantial money for responsible and ethical development can be completely actualised, yielding advantages that are both financial and social, as well as environmental.

Conclusion

This study concludes that there exists a robust logical and practical congruence between the concepts of sharia compliance and the sustainable investment (ESG) criteria. The concept of *maslahah* in Sharia inherently endorses sustainability objectives, whereas Sharia screening functions as an efficient preliminary filter to address numerous facets of ESG. Green Sukuk has demonstrated significant relevance and efficacy as a mechanism for integrating these two frameworks, effectively mobilising Sharia-compliant financing to finance environmentally sustainable projects. Nevertheless, issues pertaining to the standardisation of screening criteria and the enhancement of market literacy must be resolved to fully realise the potential of this synergy.

In light of the findings and conclusions, the following recommendations are proposed :

- **For Sharia Financial Regulators and Authorities:**
 - Formulate comprehensive norms and standards for Sharia compliance and ESG criteria in Islamic financial instruments, particularly Sukuk.

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- Promote the alignment of sharia screening requirements with international ESG frameworks to enhance global attractiveness.
- Establish a transparent platform and database for reporting the effects of Green Sukuk projects.
- **For Green Sukuk Issuers and Corporations:**
 - Ensuring that Green Sukuk-funded projects adhere to environmental standards while also fulfilling robust social and governance criteria in alignment with Sharia values.
 - Enhance openness in financial reporting and project outcomes to foster investor confidence.
 - Inform investors about the dual benefits of green sukuk, namely Sharia compliance and sustainability).
- **For Sharia-compliant and Conventional Investors:**
 - Enhance comprehension of possible synergies between Sharia and ESG investing.
 - Engage proactively in the green sukuk market to promote sustainable growth.

This research facilitated subsequent investigations, including but not limited to:

- Empirical analysis of the actual influence of green sukuk on the attainment of Sustainable Development Goals (SDGs) in the issuing nations.
- Comparative examination of the efficacy of sharia screening against standard ESG screening in discerning genuinely ethical and sustainable assets.
- Investigation on the determinants affecting investors' choices to allocate funds in green sukuk and other Sharia-compliant ESG instruments

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