



Rethinking ESG for Islamic Finance: A PESTEL-Based Strategic Framework (SREEF)

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Abstract

Islamic Financial Institutions (IFIs) increasingly operate within sustainability-oriented regulatory environments in which Environmental, Social, and Governance (ESG) requirements interact with established Shariah governance structures. Although the literature frequently highlights the ethical convergence between ESG and Islamic finance, less attention has been given to the operational challenges that may arise when ESG regulation and Shariah governance employ different concepts, indicators, reporting practices, and institutional authorities. This study applies a qualitative PESTEL analysis to examine the political, economic, social, technological, environmental, and legal conditions shaping ESG engagement within Islamic finance. Drawing on peer-reviewed literature, regulatory reports, and Islamic finance policy documents, the analysis identifies recurring issues involving regulatory coordination, differences in sustainability measurement, the recognition of Islamic social-finance instruments, and the integration of ESG and Shariah governance mechanisms. Building on Institutional Theory and Legal Pluralism, the study proposes the Shariah-Responsive ESG Engagement Framework (SREEF) as a conceptual-policy framework for examining compatibility and facilitating governance adaptation in dual-governance settings. SREEF is not presented as an empirically validated model, but as an analytical starting point for regulators, central banks, Shariah boards, and IFIs seeking to explore more coherent forms of ESG-Shariah regulatory alignment. The study contributes to discussions on sustainable finance, regulatory harmonisation, environmental governance, and institutional legitimacy in Islamic financial systems.

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INTRODUCTION

Environmental, Social, and Governance (ESG) considerations have increasingly moved from voluntary corporate practices towards more formal components of financial regulation, disclosure, risk management, and sustainable finance. This development also affects Islamic Financial Institutions (IFIs), which operate within governance systems that combine conventional financial regulation with Shariah-based principles and supervisory mechanisms. At a general normative level, ESG and Islamic finance share concerns relating to accountability, social welfare, environmental stewardship, ethical investment, and responsible governance (Mustafa Osman, 2023; Rabbani et al., 2021). However, normative convergence does not necessarily imply operational equivalence.

The interaction between ESG and Islamic finance becomes more complex when sustainability standards, disclosure requirements, Shariah governance, and national regulatory arrangements rely on different institutional authorities, evaluative concepts, or measurement practices. For example, ESG frameworks may primarily emphasise corporate disclosure, investor-oriented sustainability indicators, and internationally developed taxonomies, whereas Islamic financial governance also incorporates Shariah supervisory mechanisms, contractual requirements, Maqasid al-Shariah, zakat, waqf, qard al-hasan, and other faith-based institutional arrangements. These differences do not necessarily indicate incompatibility. Rather, they create a regulatory coordination problem that requires careful assessment at the level of specific principles, indicators, and governance mechanisms.

The existing literature predominantly emphasises the ethical convergence between ESG and Islamic finance and demonstrates the potential contribution of Islamic financial principles to sustainable development (Muhamad et al., 2022; Nasution et al., 2022; Rahim et al., 2024; Zain et al., 2024). However, comparatively limited attention has been given to the operational governance of situations in which ESG regulations and Shariah governance do not employ identical concepts, indicators, reporting structures, or institutional authorities. Consequently, there remains limited guidance on how IFIs operating within dual-governance environments can assess areas of convergence, identify institution-specific tensions, adapt governance processes, and pursue regulatory alignment without assuming either automatic compatibility or inherent conflict.

This gap is particularly important because IFIs operate within multiple institutional environments simultaneously. They respond to financial regulators, central banks, sustainability standards, investors, Shariah boards, and national legal frameworks. Accordingly, ESG-Shariah interaction can be understood as a form of institutional complexity in which organisations are required to respond to overlapping and potentially different normative and regulatory expectations. Institutional Theory therefore provides an appropriate theoretical lens for examining how external pressures generate organisational responses, while Legal Pluralism helps explain the coexistence and interaction of multiple normative and legal orders within Islamic financial governance.

Against this background, this study examines how political, economic, social, technological, environmental, and legal conditions shape ESG engagement within Islamic Financial Institutions through a PESTEL-based analysis. The study develops an analytical sequence linking external ESG pressure, institutional tension, compatibility assessment, governance adaptation, and regulatory alignment. Within this sequence, the Shariah-Responsive ESG Engagement Framework (SREEF) is proposed as a governance response mechanism rather than as an empirically validated model.

The study makes three contributions. First, it reframes ESG-Islamic finance interaction as an institutional and regulatory coordination issue rather than as a presumption of either convergence or conflict. Second, it integrates Institutional Theory and Legal Pluralism with PESTEL analysis to explain the dual-governance conditions faced by IFIs. Third, it proposes SREEF as a conceptual-policy framework that may assist regulators, central banks, Shariah boards, and IFIs in organising compatibility assessment and governance adaptation. Its effectiveness, however, remains an empirical question for future research.

LITERATURE REVIEW

The literature on Islamic finance and ESG generally identifies substantial normative convergence between the two domains. Islamic finance emphasises justice, accountability, risk sharing, social welfare, and stewardship, while ESG frameworks seek to incorporate environmental, social, and governance considerations into organisational and investment decision-making. Recent studies therefore increasingly explore ESG through Maqasid al-Shariah, sustainable Islamic finance, green finance, and Shariah governance perspectives (Muhamad et al., 2022; Nasution et al., 2022; Rahim et al., 2024; Zain et al., 2024).

Despite this convergence, the two systems are not institutionally identical. Islamic finance derives normative legitimacy from the Qur'an, Sunnah, fiqh traditions, Shariah standards, and supervisory structures, whereas ESG practices are shaped by a heterogeneous combination of regulatory requirements, investor expectations, disclosure standards, rating methodologies, and market conventions. Existing ESG reporting and scoring systems may therefore omit or insufficiently recognise Islamic social-finance instruments such as zakat, waqf, qard al-hasan, and Shariah-specific governance arrangements (Ansari & Alanzarouti, 2020; Muhamad et al., 2022; Nasution et al., 2022).

Existing scholarship also indicates that the social dimension of ESG may be interpreted differently across institutional and cultural settings. Studies concerning corporate activism, diversity and inclusion, stakeholder representation, and political CSR demonstrate that social-governance practices are not institutionally neutral and may be understood differently across regulatory contexts (Barzuza et al., 2020; Estevesmiranda et al., 2021; Sorour et al., 2020). However, these studies do not establish that ESG as a whole represents ideological conformity. Their relevance to Islamic finance instead lies in demonstrating that particular social indicators or governance practices may require contextual interpretation when applied within Shariah-governed institutions. Accordingly, the analytical concern of this study is not whether ESG is inherently compatible or incompatible with Islamic finance, but how specific ESG requirements interact with the normative, contractual, and governance arrangements of IFIs.

A further strand of research highlights measurement and reporting challenges. ESG ratings may diverge because rating providers differ in scope, indicator weighting, data treatment, and disclosure expectations (Liu, 2022; Sahin et al., 2021). In Islamic finance, this problem is compounded when conventional sustainability metrics do not capture Shariah-based instruments or governance mechanisms. At the same time, developments in green sukuk and Islamic sustainable finance demonstrate that environmental and Shariah objectives can be combined through appropriate institutional arrangements (Nur & Herianingrum, 2024; Utomo et al., 2024).

Existing research therefore remains fragmented and heavily conceptual. The literature tends to emphasise ethical convergence between ESG and Islamic finance but provides limited operational guidance for dual-governance settings where ESG regulation

and Shariah governance may not always employ identical concepts, indicators, reporting systems, or institutional authorities. Further gaps concern the limited integration of ESG considerations within Shariah governance arrangements and the limited treatment of overlapping legal and regulatory orders (Adams et al., 2023; Ayub et al., 2023; Katterbauer & Moschetta, 2022). These gaps provide the basis for developing a governance-oriented framework that can organise compatibility assessment and regulatory coordination without presuming either complete convergence or fundamental incompatibility.

Theoretical Framework

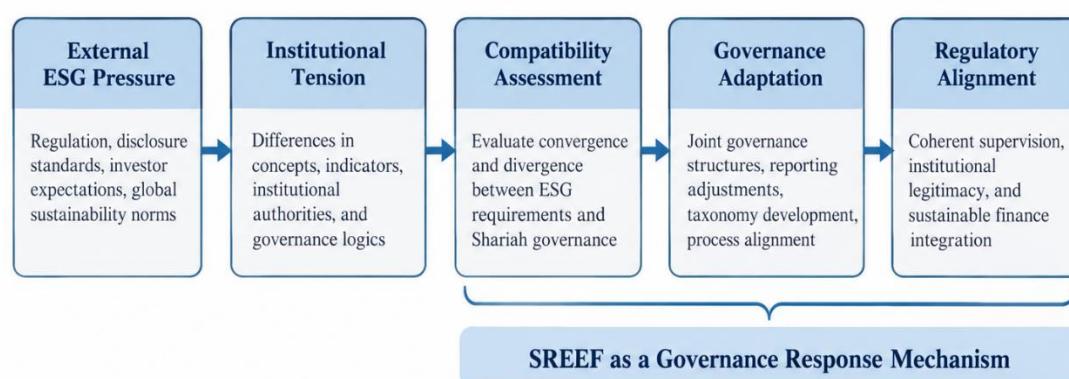
Institutional Theory provides the principal theoretical lens for understanding ESG engagement within Islamic Financial Institutions. Organisations do not respond exclusively to technical efficiency considerations; they are also influenced by regulatory, professional, normative, and market expectations within their institutional environments. DiMaggio and Powell (1983) identify coercive, normative, and mimetic pressures as important mechanisms through which organisations respond to external institutional expectations. In the context of Islamic finance, sustainability regulations, central-bank requirements, international reporting standards, investor expectations, and industry practices may therefore generate institutional pressures for ESG adoption.

However, IFIs are simultaneously accountable to Shariah boards, national financial regulators, international standards, market actors, and other governance authorities. Institutional complexity emerges when organisations encounter multiple institutional prescriptions that are not fully aligned. Greenwood et al. (2011) describe such complexity as a condition in which organisations confront incompatible prescriptions from multiple institutional logics and develop organisational responses to manage them. This perspective is particularly relevant to Islamic finance because ESG requirements and Shariah governance may share broad ethical objectives while differing in terminology, measurement, governance processes, or institutional authority.

Legal Pluralism provides a complementary perspective by recognising that multiple normative and legal orders may coexist within the same institutional environment. Griffiths (1986) and Merry (1988) conceptualise legal pluralism as the coexistence of more than one normative or legal order within a social field. For IFIs, this perspective helps explain how conventional financial regulation, sustainability regulation, Shariah governance, and jurisdiction-specific legal requirements may operate simultaneously.

Integrating these perspectives, this study conceptualises ESG-Shariah interaction as an institutional adjustment process rather than as an assumption of either automatic convergence or inherent conflict. External ESG pressures may generate institutional tension when specific requirements do not correspond directly with existing Shariah governance concepts or institutional arrangements. IFIs and regulators can subsequently undertake compatibility assessment, followed by governance adaptation and, where feasible, regulatory alignment. SREEF is positioned within this process as a proposed governance response mechanism that organises the assessment and adaptation stages.

Figure 1. Institutional-Legal Pluralist Framework for ESG-Shariah Governance Alignment



Source: Author's conceptualisation based on DiMaggio and Powell (1983), Greenwood et al. (2011), Griffiths (1986), and Merry (1988).

METHODS

This study applies the PESTEL framework to examine how external political, economic, social, technological, environmental, and legal conditions shape ESG engagement within Islamic Financial Institutions (IFIs). PESTEL is used as an environmental scanning framework because it enables systematic consideration of external regulatory pressures, institutional constraints, technological conditions, environmental priorities, and cross-border policy dynamics (Dinçer & Pınarbaşı, 2020; Kung, 2023; Matović, 2020; Thakur, 2020; Vojinovic & Stević, 2022).

The study adopts a qualitative conceptual review design based on peer-reviewed studies, regulatory reports, and Islamic finance policy documents addressing ESG adoption, sustainability governance, Shariah supervision, regulatory coordination, and institutional strategy. Materials are synthesised thematically across the six PESTEL dimensions and interpreted through Institutional Theory and Legal Pluralism. The analysis focuses on recurring patterns of external pressure, institutional tension, compatibility assessment, governance adaptation, and regulatory alignment.

The analytical scope covers IFIs operating in OIC member states and mixed regulatory environments in which Islamic finance has a meaningful institutional presence or where sustainable-finance regulation has gained policy relevance. Particular attention is given to Southeast Asia, the Gulf, and South Asia because these regions illustrate varying configurations of financial regulation, Shariah governance, ESG policy, and market development. The study relies exclusively on secondary and publicly available materials; internal institutional deliberations and proprietary ESG processes remain outside its scope.

Findings are synthesised into the ESG-Shariah compatibility logic and the proposed Shariah-Responsive ESG Engagement Framework (SREEF). Given the conceptual and qualitative design, the study does not test causal relationships or evaluate the empirical effectiveness of SREEF. The framework is derived from analytical synthesis of the literature and policy materials reviewed across the PESTEL dimensions. It should therefore be interpreted as a conceptual-policy proposition whose practical effectiveness, transferability across jurisdictions, and organisational outcomes require subsequent empirical validation through case studies, expert interviews, Delphi studies, comparative regulatory analysis, or institution-level implementation research.

RESULT AND DISCUSSION

The PESTEL analysis indicates that ESG engagement within Islamic Financial Institutions is shaped by interconnected political, economic, social, technological, environmental, and legal pressures rather than by ethical considerations alone. Political and regulatory conditions influence whether sustainability requirements are introduced through central-bank supervision, disclosure obligations, market incentives, or broader national development strategies. Differences across jurisdictions suggest that ESG-Shariah integration is institutionally contingent and depends on the degree of coordination among financial regulators, sustainability authorities, and Shariah governance bodies (Sadek et al., 2024; Jawad & Abdulla, 2022).

From an economic perspective, ESG adoption creates different capacity requirements across institutions. Larger IFIs are generally better positioned to absorb reporting, data, assurance, and specialist-personnel costs, whereas smaller institutions may face constraints relating to technology, human resources, and audit infrastructure (Affandi et al., 2024). Conventional sustainability disclosure models may also insufficiently capture the contribution of Islamic instruments such as green sukuk, waqf financing, and zakat redistribution. The policy challenge is therefore not merely to increase disclosure volume, but to improve comparability while recognising institutionally relevant Islamic finance mechanisms (Sharipuddin et al., 2021; Utomo et al., 2024).

The social dimension demonstrates that ESG and Islamic finance may operationalise social objectives through different institutional mechanisms. ESG frameworks frequently incorporate indicators concerning workforce practices, stakeholder representation, diversity, inclusion, community impact, and corporate governance, whereas Islamic finance may additionally articulate social welfare through Maqasid al-Shariah, zakat, waqf, qard al-hasan, distributive justice, and Shariah-compliant institutional arrangements. These differences should not be interpreted as evidence that ESG is inherently incompatible with Islamic finance. Rather, they indicate that particular social indicators may require contextual assessment to determine how they relate to the legal, ethical, and governance requirements applicable to IFIs. Literature concerning corporate activism, DEI strategies, and political CSR illustrates the possibility of institutional variation in social-governance practices, but does not justify characterising ESG as a whole as a form of ideological conformity (Barzuza et al., 2020; Estevesmiranda et al., 2021; Sorour et al., 2020).

Technological conditions influence how sustainability information is collected, interpreted, and compared. Mainstream ESG databases and automated scoring systems may not consistently capture Shariah-specific instruments or governance indicators, particularly when such information is disclosed outside conventional ESG taxonomies (Ansari & Alanzarouti, 2020; Sahin et al., 2021). This creates a practical need for data architectures and reporting systems that can map Islamic finance indicators to sustainability requirements without assuming that one reporting framework fully substitutes for the other.

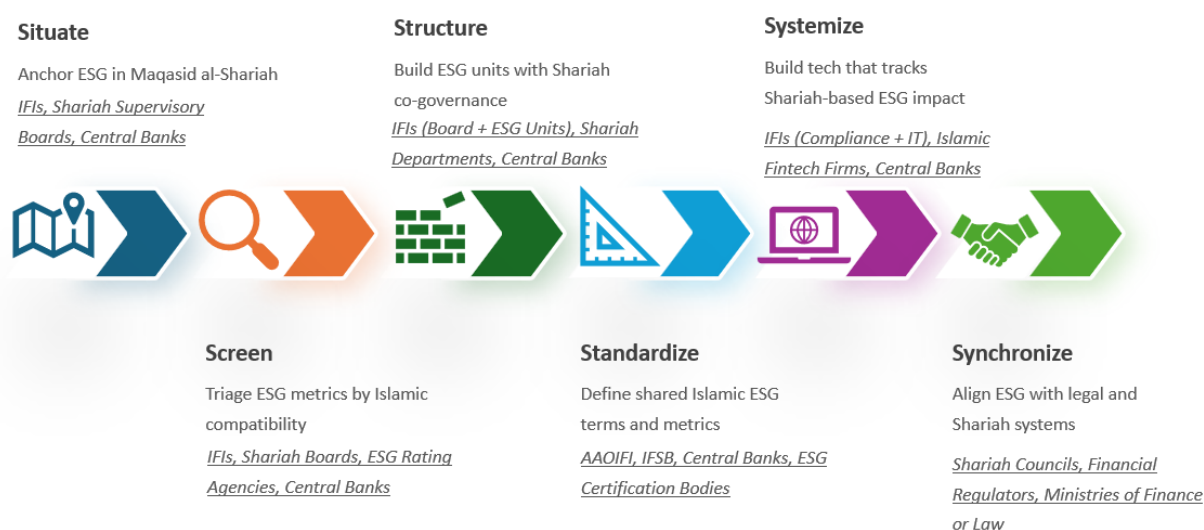
Environmental alignment is comparatively strong at the level of broad principles. Islamic concepts such as khalifah, maslahah, and harm prevention can support environmental stewardship, while green sukuk and waqf-based initiatives illustrate possible institutional pathways for financing environmental objectives (Beerbaum, 2021; Nur & Herianingrum, 2024). However, differences in taxonomy, certification, disclosure, and recognition may still affect how Islamic sustainable-finance instruments are classified within broader ESG markets.

The legal dimension is central because IFIs operate within dual-compliance environments shaped by national financial regulation and Shariah governance. Sustainability obligations may be developed by authorities whose mandates differ from those of Shariah supervisory institutions, while cross-border instruments such as green sukuk may need to satisfy both sustainability screening and Shariah contractual requirements (Yas, 2023; Williams & Apollonio, 2024). Institutional Theory interprets these overlapping expectations as a source of institutional complexity, while Legal Pluralism highlights the coexistence of multiple normative and regulatory orders. Together, these perspectives suggest that the appropriate response is structured coordination rather than an assumption that one governance system should displace the other.

Across the six PESTEL dimensions, the analytical pattern can be summarised as follows: external ESG pressures may generate institutional tension when sustainability requirements and Shariah governance arrangements differ in concepts, indicators, reporting practices, or authority. Compatibility assessment then becomes necessary to identify whether a particular ESG requirement is directly aligned, adaptable, or requires further governance deliberation. Governance adaptation may involve joint committees, revised disclosure systems, taxonomy mapping, specialist review, or changes in internal reporting processes. Regulatory alignment represents the longer-term objective of reducing ambiguity and improving consistency across sustainability supervision and Shariah governance.

Based on the analytical patterns identified through the PESTEL assessment, this study proposes the Shariah-Responsive ESG Engagement Framework (SREEF) as a six-stage conceptual-policy framework for organising ESG-Shariah governance responses. The six stages are Situate, Screen, Structure, Standardize, Systemize, and Synchronize. Rather than prescribing a universally applicable solution, these stages provide an analytical sequence through which regulators, central banks, Shariah boards, and IFIs may examine ESG requirements in relation to their jurisdiction-specific governance arrangements. Situate places ESG issues within Maqasid al-Shariah and the relevant regulatory environment; Screen evaluates specific ESG indicators for institutional and Shariah compatibility; Structure considers appropriate governance arrangements; Standardize concerns possible terminology, taxonomy, and disclosure alignment; Systemize addresses supporting information and reporting infrastructure; and Synchronize concerns coordination between sustainability requirements, financial regulation, and Shariah governance. SREEF should therefore be regarded as a proposed governance response mechanism derived from the literature rather than as a validated framework whose effectiveness has already been established.

Figure 2. SREEF Process Framework: Six Stages for Maqasid-Based ESG Alignment in Islamic Finance



Policy And Practical Implications

From a practical perspective, SREEF may serve as a starting point for regulators, central banks, Shariah boards, and Islamic Financial Institutions when examining the relationship between sustainability requirements and existing governance arrangements. Its potential value lies primarily in structuring discussion rather than prescribing a uniform regulatory outcome. For regulators and central banks, the framework may support the identification of areas in which ESG terminology, disclosure rules, sustainable-finance taxonomies, and Shariah governance requirements require further coordination. For Shariah boards, it may provide a structured basis for evaluating particular ESG indicators rather than assessing ESG as a single undifferentiated concept. For IFIs, it may assist in identifying governance, reporting, data, and institutional-capacity requirements associated with dual compliance.

From a policy perspective, the framework is relevant to sustainable finance, regulatory harmonisation, environmental governance, and institutional legitimacy. Greater coordination between sustainability regulators, financial supervisors, Islamic standard-setting bodies, and Shariah authorities could potentially reduce regulatory ambiguity and improve the comparability of sustainability practices across Islamic financial institutions. Nevertheless, these implications remain conceptual. The present study does not demonstrate that implementation of SREEF improves regulatory effectiveness, sustainability performance, financial outcomes, or Shariah compliance. These propositions should be examined empirically in future research.

CONCLUSION

This study examined ESG engagement within Islamic Financial Institutions through a PESTEL-based analysis informed by Institutional Theory and Legal Pluralism. The analysis suggests that ESG and Islamic finance share broad concerns relating to accountability, social welfare, responsible governance, and environmental stewardship, while their operationalisation may differ across indicators, disclosure systems, governance structures, and institutional authorities. The central issue is therefore not whether ESG and Islamic finance are inherently compatible or incompatible, but how

their interaction is governed in institutional environments characterised by overlapping regulatory and normative expectations.

The study contributes to the literature by reframing ESG-Islamic finance interaction as a problem of institutional coordination and dual governance. External sustainability pressures may generate institutional tension where ESG requirements do not directly correspond with existing Shariah concepts or governance arrangements. Compatibility assessment and governance adaptation consequently become important intermediate processes in pursuing regulatory alignment.

Within this analytical sequence, the study proposes the Shariah-Responsive ESG Engagement Framework (SREEF), consisting of Situate, Screen, Structure, Standardize, Systemize, and Synchronize. SREEF is intended as a conceptual-policy framework that may help regulators, central banks, Shariah boards, and IFIs organise discussions concerning ESG-Shariah compatibility, governance structures, disclosure practices, taxonomies, and institutional coordination. It should not, however, be interpreted as an empirically validated model or as evidence that these six stages necessarily produce superior regulatory or sustainability outcomes.

The study is limited by its reliance on secondary literature and publicly available regulatory documents. It does not examine how individual IFIs operationalise ESG decisions internally, nor does it empirically test the implementation or effectiveness of SREEF across jurisdictions. Future studies could therefore employ comparative case studies, interviews with regulators and Shariah scholars, Delphi techniques, or cross-jurisdictional policy analysis to assess the framework's applicability and refine its individual stages. Such research would help determine whether and under what institutional conditions ESG and Shariah governance can be coordinated effectively.

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