



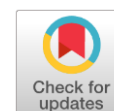
When ESG Meets Sharia: Does Sharia-Compliant Strengthen Financial Stability?

Imas Hasanah* and Abdul Qoyum

Universitas Islam Negeri Sunan Kalijaga, Yogyakarta, Indonesia

*Corresponding Email: imashasanah2704@gmail.com

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Abstract

This study addresses the ongoing debate regarding whether Environmental, Social, and Governance (ESG) activities enhance firm financial stability, particularly in emerging markets where institutional and religious factors may shape this relationship. In addition, this research wants to know does Sharia-compliant states have an impact on the relationship between ESG activities and financial stability. By using 27 samples of companies during the period 2009-2019, this study estimates a two-step system GMM dynamic panel data model. The findings indicate that Sharia-compliant status exerts a selective and dimension-specific moderating effect on the relationship between ESG activities and financial stability. Although the ESG composite index demonstrates a direct positive association with financial stability, its interaction with Sharia compliance is negative and statistically significant. This suggests that aggregated ESG measures may mask the distinct legitimacy mechanisms that are particularly relevant for Sharia-compliant firms. Further disaggregated analysis reveals that Sharia-compliant significantly strengthens the positive effects of social and governance index on financial stability, reflecting a strong alignment between Islamic ethical principles and stakeholder expectations. In contrast, the moderating effect of Sharia-compliant on the environmental index is statistically insignificant to financial stability. Furthermore, these findings have important implications for investors, regulators, and companies in integrating ESG and Sharia values into corporate risk management and sustainability strategies.

Keywords: Environmental, Social, Governance (ESG), Financial Stability, and Sharia-Compliant

JEL Classification: F64, G32, and G38

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Introduction

The global business landscape has undergone a significant transformation over the past few decades, marked by a fundamental shift from a traditional shareholder-oriented approach to a more comprehensive stakeholder-oriented business model (Porter & Kramer, 2011). This paradigm shift has been catalyzed by the emergence and evolution of Environmental, Social, and Governance (ESG) considerations as critical determinants of corporate strategy and performance evaluation (Gillan et al., 2021; Whelan et al., 2021). The term "ESG" was first initiated in 2004, in the United Nations Global Compact report "Who Cares Wins," which emphasized the integration of environmental, social, and governance factors (UN Secretary General & UN Global Compact, 2004). Environmental, Social, and Governance (ESG) is a framework that assesses the sustainability and social impact of corporate operations in three main areas: Environmental, Social, and Governance (Au et al., 2023).

ESG issues have become increasingly central to corporate strategy, particularly in the context of climate risk, social inequality, and governance failures. Poor ESG performance exposes firms to regulatory sanctions, reputational damage, and operational disruption, which may ultimately increase financial vulnerability. Conversely, firms with strong ESG engagement are better positioned to manage risks, maintain stakeholder trust, and enhance financial resilience. Therefore, ESG practices are closely linked to firm-level financial stability, particularly in uncertain economic environments. ESG issues are seen as critical to the economic environment, impacting the stability of the economy as a whole (Menicucci & Paolucci, 2023). This is because ESG helps manage important emerging risks, including market instability, social problems, ecosystem damage, and financial crises. In Indonesia, the importance of ESG implementation has gained significant momentum, particularly following the government's commitment to achieve net-zero emissions by 2060 (UNFCCC, 2021). Therefore, Indonesian businesses must incorporate ESG principles into their operational plans to meet the country's sustainability goals.

Given the current trends, governments in both developed and developing nations, as well as businesses and their investors, are becoming increasingly interested in sustainable development. This is due to the fact that social responsibility and sustainability can boost business stability and performance, making them crucial for capital providers. (Alexandra et al., 2024). The selection of financial stability as the impact of ESG activities is based on several compelling reasons that reflect contemporary business realities (Flammer & Bansal, 2015). In an era characterized by volatility, uncertainty, complexity, and ambiguity (VUCA), firms' ability to maintain stability has become a concern for investors, regulators, and other stakeholders (Bennett & Lemoine, 2014; Schoemaker et al., 2018). Financial stability refers to firm-level financial resilience, which is defined as the ability of a company to maintain stable asset growth and avoid financial distress over time. This concept differs from financial stability in the banking sector, which is typically associated with systemic risk and soundness of the financial system. The proxy used, the Asset Change Ratio (AChange), reflects the firm's capacity to sustain growth while maintaining financial health.

While ESG practices are increasingly associated with long-term value creation, their relevance becomes more critical when firms are financially vulnerable. Poor ESG performance may expose firms to regulatory penalties, reputational damage, and operational risks, which can ultimately increase the likelihood of financial distress and

instability in the long run. Conversely, firms with strong ESG engagement are better equipped to manage risks, maintain stakeholder trust, and enhance resilience during economic shocks. Therefore, understanding the relationship between ESG activities and financial stability is essential, particularly in assessing how sustainability practices mitigate the risk of financial distress and bankruptcy.

Recent literature defines financial distress as a condition in which firms experience deteriorating financial performance and are unable to meet their obligations, often leading to restructuring or bankruptcy (Altman et al., 2017). The source of financial distress can stem from various factors, such as internal failures, industry decline, and economic pressures (Wruck, 1990), including global financial crises and pandemics such as COVID-19. The occurrence of bankruptcy is also influenced by the economic cycle, where during periods of rapid economic growth, only a few companies face financial pressure, while during periods of recession, many companies experience difficulties due to external factors.

Previous studies have provided mixed evidence regarding the relationship between ESG activities and financial outcomes. Through a meta-analysis of over 2,000 studies, Friede et al. (2015) document a predominantly positive relationship between ESG and financial performance, suggesting that ESG reduces risk and enhances firm value. Similarly, Broadstock et al. (2021) found that ESG performance improves firm resilience during crises. However, other studies highlight potential trade-offs, where ESG investments may increase operational costs or reduce short-term profitability (Di Tommaso & Thornton, 2020; Lupu et al., 2022). These conflicting findings indicate that the ESG–financial stability relationship is context-dependent and may vary across institutional settings, requiring further investigation.

The inclusion of Sharia-compliant principles as a moderating variable in this study is grounded in both theoretical and practical considerations that reflect the unique characteristics of Islamic business practices (Dusuki, 2008). The Islamic finance and business principles, which form the foundation of Sharia compliance, emphasize ethical conduct, social justice, environmental stewardship, and stakeholder welfare (Haniffa & Hudaib, 2007; Kamla & Haque, 2019). These principles align closely with ESG objectives, suggesting that Shariah-compliant companies may demonstrate stronger ESG performance and, consequently, greater financial stability (Aribi & Gao, 2011; Williams & Zinkin, 2010).

Moreover, based on the existing literature review, researchers have not found Sharia-compliant as a moderating variable, which is Sharia-compliant as one that affects ESG activities such as (Ashraf et al., 2025; Kabir Hassan et al., 2021; Qoyum et al., 2022). From a theoretical perspective, stakeholder theory reveals that Islamic companies maximize benefits for stakeholders, not just profits (Qoyum et al., 2022). This study also has another interesting finding: the financial criteria applied in Sharia screening have a significant effect on firm performance, which is in line with legitimacy theory by (Suchman, 1995). Hence, this study makes a new contribution to academic literature.

The moderating role of Sharia compliance can be explained using both risk- and legitimacy-based mechanisms. From a risk perspective, Sharia principles restrict excessive leverage, speculative activities (*gharar*), and interest-based financing (*riba*), leading to more conservative financial structures and lower systemic risk exposure. This implies that ESG activities in Sharia-compliant firms may translate more effectively into financial stability due to their inherently lower risk profiles. From a

legitimacy perspective, Sharia compliance enhances ethical credibility and stakeholder trust, particularly in Muslim-majority countries such as Indonesia. Consequently, ESG initiatives undertaken by Sharia-compliant firms may generate stronger reputational benefits and stakeholder support, thereby reinforcing financial stability. Therefore, Sharia compliance is expected to alter both the strength and direction of the ESG–financial stability relationship.

Sharia-compliant companies are expected to exhibit superior ESG scores compared to conventional companies for several interconnected reasons (Abdullah et al., 2015; Farook et al., 2011). First, Islamic business principles inherently emphasize environmental conservation (*hifz al-bi'ah*) and social welfare (*maslaha*), which directly correspond to the environmental and social dimensions of ESG (Dusuki & Abdullah, 2007). Second, according to Qoyum et al. (2022), Sharia-compliant principles cannot engage in activities involving *riba* (usury), *gharar* (speculation), and *maysir* (gambling). Third, Sharia compliance requires adherence to ethical business practices and the prohibition of activities that may harm society or the environment (Chapra, 2000; Khan et al., 2013). The theoretical expectation that Shariah-compliant companies should demonstrate better ESG performance is supported by empirical evidence from various studies (Salma Sairally, 2013). Research by (Kabir Hassan et al., 2021; Platonova et al., 2018) has shown that Islamic financial institutions and Shariah-compliant companies often exhibit superior social and environmental performance compared to their conventional counterparts.

Companies that meet Shariah criteria are not only required to demonstrate formal ESG performance but must also avoid speculative practices, excessive leverage, and unethical sources of income, resulting in a more conservative and sustainable asset structure and growth (Sendi et al., 2024). In this context, ESG activities in Sharia-compliant companies can produce different implications for asset change dynamics compared to non-Sharia-compliant companies, both through mechanisms that strengthen legitimacy in the eyes of stakeholders and through financial restrictions that constrain the flexibility of asset expansion. Therefore, sharia compliance is positioned as a moderating variable to capture these institutional and ethical differences, while also explaining whether and how sharia compliance strengthens or alters the direction of the influence of ESG activities on corporate financial stability.

Literature Review

Stakeholder Theory

Several theoretical works link ESG activities to financial stability, such as stakeholder theory. Stakeholder theory was first proposed by Freeman in 1984. This theory states that companies have a responsibility not only to shareholders but also to all stakeholders involved in or affected by the company's activities, including investors, employees, customers, suppliers, the government, and the surrounding community, including environmentalists (Freeman, 1984). A stakeholder is a group or individual that can affect or be affected by the achievement of organizational goals (Cahyani et al., 2020). According to stakeholder theory, all stakeholders have the right to receive information on how a company's activities contribute to the surrounding environment (Dahlia et al., 2024).

From a risk management perspective, ESG activities may also reduce business risks and increase stability (Goss & Roberts, 2011). Thus, reputational and systemic

risks can be avoided by engaging in ESG activities. ESG can act as a hedging device, mitigating risks and the cost of capital (Fatemi et al., 2015; Lee & Faff, 2009). Additionally, ESG creates business complexity if it cannot be properly implemented or if there is a mismatch between ESG claims and actual performance.

Legitimacy Theory

Legitimacy theory is a concept in accounting and management that states that organizations or companies strive to ensure that their activities and goals are in accordance with the values, norms, and social expectations of the society in which they operate (Hoque, 2006). Legitimacy theory (Suchman, 1995) is a framework for understanding how organizations maintain their social acceptance by acting in ways that are perceived as desirable and appropriate within a society's system of norms and values. In the context of legitimacy theory, Sharia compliance can affect the public perception of a company (Rakhmayani et al., 2022). By following Islamic ethical practices, companies can increase their legitimacy in the eyes of the public.

According to Suchman (1995), legitimacy is a generalized perception or assumption that an entity's actions are desirable, proper, or appropriate within a socially constructed system of norms, values, beliefs, and definitions. Legitimacy theory argues that the greater the social exposure a company receives due to its large size, the greater the need to legitimize its existence in the eyes of the relevant public (Patten, 1991). In this business era, the role of ESG activities in creating a company image is becoming increasingly important (Septiana & Aminah, 2025). ESG initiatives help firms legitimize their actions by addressing global environmental, social, and governance issues (Deegan, 2019).

Previous Studies

The relationship between environmental, social, and governance (ESG) activities and financial stability has been extensively investigated in various contexts; however, the findings are inconsistent. Some research has shown that strong ESG performance contributes to greater financial stability. For example, Choi et al. (2024) found that ESG activities increased the stability of Korean financial firms, with environmental factors having the most positive impact. Similarly, Chiaramonte et al. (2022) showed that European banks with higher ESG scores were more resilient during the financial crisis, supporting the idea that ESG practices can reduce risks. These findings are consistent with stakeholder theory, which suggests that addressing the needs of different stakeholders leads to more sustainable and stable business performance (Bouattour et al., 2024; Chiaramonte et al., 2022; Sain & Kashiramka, 2024).

Several studies have explored the impact of ESG on financial stability in the banking sector. Giese et al. (2019) found that banks with higher ESG scores tended to experience lower volatility in their financial performance and were better positioned to withstand economic shocks. Similarly, Nofsinger et al. (2018) demonstrated that banks focusing on sustainability during market crises showed better financial performance than those that did not. Interestingly, Athari (2024) found a non-linear relationship between ESG and stability in the Gulf Cooperation Council (GCC), where a moderate level of ESG investment improved stability, but excessive spending had diminishing returns. This observation echoes the argument that high ESG scores may reduce risk-taking but may also divert resources from value-adding activities,

potentially damaging companies' performance (Di Tommaso & Thornton, 2020; Lupu et al., 2022). This finding aligns with the proactive risk management theory, which suggests that integrating ESG considerations helps banks anticipate and mitigate emerging risks, thereby enhancing their financial stability. ESG strategies enhance bank stability during financial crises in Europe (Chiaramonte et al., 2022).

The role of Sharia compliance adds another dimension to this discussion. Sharia-compliant firms that adhere to Islamic ethical principles often exhibit distinct ESG characteristics. Qoyum et al. (2022) found that Sharia-compliant firms in Indonesia and Malaysia outperformed their conventional counterparts in environmental and social governance, likely because of their emphasis on ethical and stakeholder-focused practices. Hassan et al. (2021) further demonstrated that Sharia-compliant finance enhances the risk-mitigating effects of ESG, as Islamic finance principles prohibit excessive speculation and promote risk sharing. These studies suggest that Sharia-compliant firms may derive unique stability benefits from ESG activities (Mirza et al., 2025; Peng & Isa, 2020; Touti & Taïb, 2024).

The relationship between Shariah compliance and financial stability is not straightforward. Ashraf et al. (2025) observed that Malaysian firms that frequently switch their compliance status experienced increased volatility, implying that consistent adherence to Shariah principles is crucial for maintaining stability. In contrast, Albaity et al. (2019) found that Islamic banks in the Middle East and North Africa (MENA) region were more vulnerable to competitive pressures, indicating that Sharia compliance alone is insufficient to ensure stability without strong ESG integration. These findings underscore the complexity of the interplay between Sharia compliance and ESG in influencing firm stability.

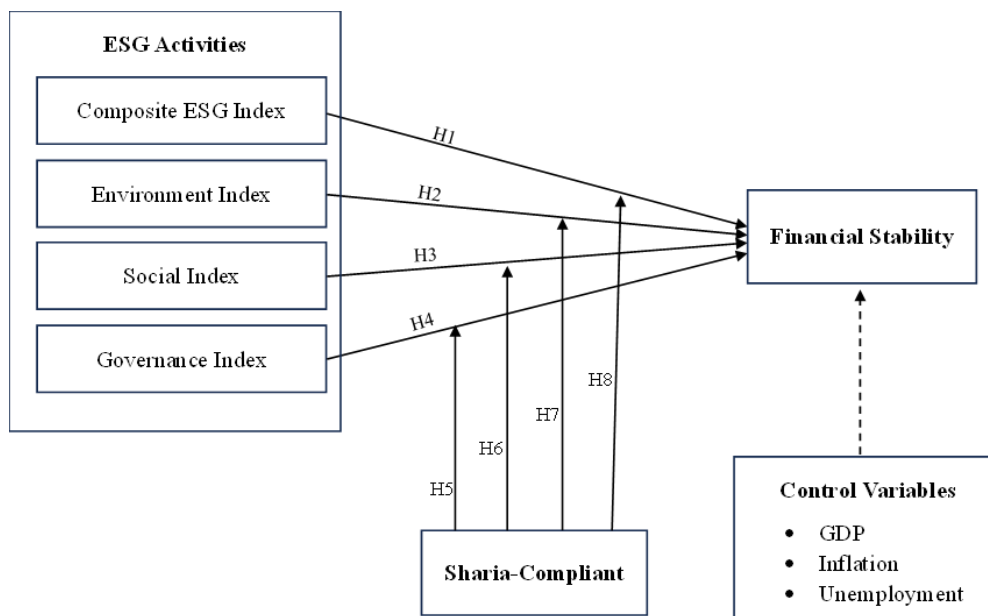


Figure 1. Research Framework

This study aims to address these gaps by focusing on Indonesian ESG-listed firms from 2009 to 2019. It investigates how Sharia compliance moderates the impact of ESG activities on financial stability, treating compliance as an active factor rather than a static classification. This study also disaggregates ESG into its core components

to determine which dimensions are most effective in enhancing stability. The theoretical framework integrates stakeholder theory, which emphasizes the importance of balancing diverse stakeholder interests, with *Maqasid al-Sharia*, which links Islamic ethical principles to sustainable risk management. This approach acknowledges competing perspectives, such as the "overinvestment" hypothesis, which cautions against the potential costs of excessive ESG spending. Figure 1 depicts the research framework used in this study.

Method

This study used secondary data for data collection. The company sample used is Indonesia ESG-Listed Firms obtained from the Thomson Reuters – Eikon platform. Hence, this study focuses on data from 11 years ago, from 2009 to 2019 (pre-COVID-19), which was chosen to avoid data bias due to the pandemic or unstable economic conditions. Although recent studies highlight the importance of ESG during the COVID-19 crisis (e.g., Broadstock et al., 2021; Albuquerque et al., 2020), this study deliberately focuses on the pre-pandemic period to isolate the structural relationship between ESG and financial stability under normal economic conditions. Including the pandemic period may introduce extreme shocks that could bias the estimation of long-term relationships in the data.

Finally, we obtained 27 companies that have been consistently included in the Indonesian ESG-Listed Firms during the period 2009-2019 (at least 5 years) as our sample in this study. Moreover, of the 27 companies in the sample, 16 are Sharia companies and 11 are conventional companies. This proportion shows that more than half of the ESG-compliant companies in Indonesia during the observation period fall into the Shariah-compliant category. This research is quantitative, using a two-step system GMM dynamic panel data model. The analysis tool used is STATA.14 software. This study employs a dynamic panel data approach using the two-step system GMM estimator to address potential endogeneity issues arising from reverse causality and omitted variable bias. Financial stability is inherently persistent over time, justifying the inclusion of lagged dependent variables. To confirm the presence of endogeneity, preliminary tests indicate that ESG variables are not strictly exogenous. Therefore, GMM is preferred over static panel models such as Fixed Effects or Random Effects. Additionally, system GMM is suitable for datasets with relatively small cross-sections and longer time periods. The empirical model is specified as follows:

$$\begin{aligned} AChange_{it} = & \beta_0 + \beta_1 AChange_{it-1} + \beta_2 ESG_{it} + \beta_3 ENV_{it} + \beta_4 SOC_{it} + \\ & \beta_5 GOV_{it} + \beta_6 IS_{it} + \beta_7 GDP_{it} + \beta_8 INF_{it} + \beta_9 UNEMP_{it} + \beta_{10} ESG_{it} * \\ & IS_{it} + \beta_{11} ENV_{it} * IS_{it} + \beta_{12} SOC_{it} * IS_{it} + \beta_{13} GOV_{it} * IS_{it} + \varepsilon_{it} \end{aligned} \quad (1)$$

where AChange represents financial stability, measured by the asset change ratio. where α is a constant and β denotes the regression coefficient. ESG refers to the composite ESG index, and ENV, SOC, and GOV represent its environmental, social, and governance dimensions, respectively. IS indicates Sharia-compliant status as a moderating variable. GDP, INF, and UNEMP are the control variables that capture economic growth, inflation, and unemployment, respectively. ε is the error term, and i and t denote firm and time periods, respectively.

Result And Discussion

Descriptive Statistics

The descriptive statistics of all variables employed in this study are presented in Table 1, which includes the dependent (Financial Stability/AChange), independent (ESG, ENV, SOC, GOV), and moderating variables (IS), and control variables (GDP, INF, UNEMP). The results provide an overview of the data distribution across the research sample of Indonesian listed firms with ESG scores from 2009 to 2019.

Table 1. Descriptive Statistic for Each Variables

Variable	Obs.	Mean	Std. Dev	Min	Max
AChange	297	0.090	0.161	-0.221	1.176
ESG	297	45.200	19.628	7.036	85.276
ENV	297	36.817	22.845	0.172	88.608
SOC	297	48.698	22.235	4.444	93.490
GOV	297	50.479	22.005	5.5556	92.275
IS	297	0.593	0.492	0	1
GDP	297	4.155	0.476	3.307	4.903
INF	297	4.717	1.233	3.031	6.413
UNEMP	297	6.232	0.852	5.230	7.870

Note: AChange is the Asset Change Ratio, ESG is the Composite ESG Index, ENV is the Environmental Index, SOC is the Social Index, GOV is the Governance Index, IS is Sharia-Compliant, GDP is GDP Growth, INF is Inflation Rate, and UNEMP is Employment Rate.

Parameter Significant Test

The first stage in the two-step Arellano-Bond GMM estimation process is to test the significance of the parameters as a whole or simultaneously. The Wald and parameter significance tests were performed simultaneously to determine whether there was a relationship in the model (see Table 2). The Wald test results show that the F statistic value is 11.82 with degrees of freedom (8.195) and a probability value of 0.0000. This probability value is smaller than the significance level $\alpha = 0.05$, so the decision taken is to reject H_0 . Thus, it can be concluded that the independent variables ESG, ENV, SOC, GOV, IS, GDP, INF, and UNEMP have a significant effect on the dependent variable in the model. This indicates that the regression model used is feasible (fit) and capable of explaining the variation in the dependent variable through the independent variables included.

The second step is partial significance testing. The Z test was used to determine whether the coefficient value had a significant effect on the model. However, the parameters ESG, ENV, SOC, GOV, IS, GDP, INF, and UNEMP have a significant effect on the model. This is because these parameters have a p-value less than α , which means that the conclusion is H_0 rejected. The results of the parameter significance test show that the ESG composite index has a negative effect on financial stability, while each ESG dimension (Environmental, Social, and Governance) has a positive and significant effect. In addition, Sharia-compliant status and macroeconomic variables play a significant role in explaining variations in corporate financial stability.

Table 2. The Result of Two-Step Arellano Bond GMM

Variable	Coef.	St. Error	z	p-Value
AChange-1	0.001	0.072	0.01	0.993
ESG	-0.007	0.002	-3.62	0.001
ENV	0.001	0.001	2.10	0.046
SOC	0.004	0.001	2.73	0.011
GOV	0.002	0.001	1.19	0.038
IS	-0.043	0.010	-4.05	0.000
GDP	-0.141	0.027	-5.33	0.000
INF	-0.067	0.006	-11.81	0.000
UNEMP	0.168	0.014	11.58	0.000
Constant	0.024	0.082	0.29	0.771

Note: AChange is the Asset Change Ratio, ESG is the Composite ESG Index, ENV is the Environmental Index, SOC is the Social Index, GOV is the Governance Index, IS is Sharia-Compliant, GDP is GDP Growth, INF is Inflation Rate, and UNEMP is Employment Rate.

Model Specifications Test

In Table 3, the two-step Arellano-Bond GMM dynamic panel method met the criteria for the best statistical model, in which the instrument variables used were consistent and valid.

Table 3. The Result of Model Specification Test

Statistic Value of Arellano-Bond Test	P-Value
-3.01 (m1)	0.003
0.41 (m2)	0.680
Statistic Value of Hansen test	P-Value
10.11	0.258

In m2, the Arellano–Bond estimate indicates consistency with values that are not statistically significant. As shown in Table 3, the Arellano-Bond (AB) m1 statistical value is -3.01, and the probability value is 0.003. The m2 statistical value was 0.41, and the probability was 0.680. The p-value is greater than α of 5%, so the conclusion is that H_0 cannot be rejected, indicating that the estimate is consistent, or that there is no autocorrelation.

The Hansen test shows that the instrumental variables are valid, as shown in Table 3. The statistical value was 10.11, and the probability value was 0.258. The Hansen estimate shows that there are good criteria for dynamic models. In this study, α was set at 0.05 or 5%, and the p-value was greater than α . The conclusion is that there is no correlation between the residuals and over-identifying restrictions; in other words, the instrumental variables are used more than the estimated number of parameters. Therefore, there are no problems with the validity of the instruments, and the model estimation is valid.

The R-square value of 0.3267 indicates that approximately 0.3267 or 32.67% of the variation in financial stability proxied by the Asset Change Ratio (AChange) can be explained by the independent variables in the model, namely ESG activities, Sharia-compliant status, the interaction between the two, and macroeconomic control variables (GDP, inflation, and unemployment rate). This finding indicates that the model has moderate explanatory power, which is reasonable in financial and sustainability research using dynamic panel data and the GMM method, where the

growth behavior of company assets is also influenced by other internal and external factors that cannot be fully captured by the model itself. Thus, although the R-squared value is not high, the estimation results remain relevant and reliable as long as they are supported by coefficient significance and instrument validity and are consistent with the stakeholder theory and legitimacy theory frameworks that underline the relationship between ESG activities, Sharia compliance, and financial stability.

Hypothesis Testing

To sum up, Table 4 presents the influence of the variable composite ESG index, environment index, social index, and governance index on financial stability with the moderating variables of Sharia-compliant, a case study on Indonesia ESG listed firm for the period 2009 to 2019.

Table 4. The Summary of Research Finding

Variable	Coef.	P-Value	Sign	Result	Hypothesis
AChange-1	0.412	0.021	+	Significant	Supported
ESG	0.019	0.012	+	Significant	Supported
ENV	-0.001	0.160	-	Not Significant	Not Supported
SOC	-0.010	0.017	-	Significant	Not Supported
GOV	-0.009	0.003	-	Significant	Not Supported
ESG*IS	-0.024	0.020	-	Significant	Not Supported
ENV*IS	0.001	0.712	+	Not Significant	Not Supported
SOC*IS	0.012	0.010	+	Significant	Supported
GOV*IS	0.010	0.007	+	Significant	Supported

Note: AChange is the Asset Change Ratio, ESG is the Composite ESG Index, ENV is the Environmental Index, SOC is the Social Index, GOV is the Governance Index, IS is Sharia-Compliant, GDP is GDP Growth, INF is Inflation Rate, and UNEMP is Employment Rate.

Therefore, the result shows that the composite ESG index has a positive and significant effect on financial stability, as illustrated by a coefficient value of 0.019 and a p-value of $0.012 < 0.05$ or 5%. This finding suggests that firms with higher ESG engagement tend to demonstrate greater resilience in terms of financial stability. The results align with stakeholder theory and are also supported by [Nizam et al. \(2019\)](#) and [Shen et al. \(2016\)](#). According to the Stakeholder Theory, companies that pay attention to stakeholder interests through good environmental, social, and governance practices will gain greater legitimacy, support, and trust. Good ESG practices reduce environmental risks, improve employee welfare and social relations, and strengthen internal governance, enabling companies to maintain long-term sustainability and financial stability.

Meanwhile, when ESG is disaggregated into its three pillars, the results are mixed. The Environmental Index shows no significant effect, indicating that environmental initiatives in Indonesian firms may not yet deliver measurable stability-related benefits. In Stakeholder Theory ([Freeman, 1984](#)), the influence of environmental activities on financial stability is highly dependent on the level of pressure and expectations of stakeholders. However, during the period 2009–2019, stakeholder pressure in Indonesia was relatively weak because sustainability reporting was voluntary before the enactment of OJK Regulation No. 51/POJK.03/2017 on Sustainability Reporting. Consequently, environmental activities lacked sufficient legitimacy to influence investor perceptions or corporate financial stability ([Suchman,](#)

1995). Furthermore, prior to major crises such as the COVID-19 pandemic, extreme environmental risks were not a major factor threatening the stability of Indonesia's financial markets.

However, the Social Index and Governance Index both display negative and significant effects, suggesting that social and governance practices may increase costs or create inefficiencies in the short term. This result is supported by (Lupu et al., 2022), who noted that in some contexts, social investments can be costly and may undermine short-term performance. Hence, these results reflect that before COVID-19, the implementation of good corporate governance (GCG) principles in Indonesia was still at the formal compliance stage rather than at the value creation stage. Many companies apply governance principles solely to meet regulations and external demands rather than to strengthen internal efficiency and risk management.

The moderating role of Sharia compliance reveals further complexity. Sharia-compliant has a significant negative effect on the effect of the Composite ESG Index on stability. Initially, a positive and significant direct ESG coefficient indicates that ESG improves financial stability for all companies (baseline effect), including conventional companies. This finding is consistent with previous studies highlighting the limitations of composite ESG measures. Gillan et al. (2021) and Whelan et al. (2021) argue that ESG aggregation may conceal heterogeneous effects across individual pillars, resulting in biased interpretations of firm performance. In the context of Islamic finance, Alsaadi et al. (2020) and Kabir Hassan et al. (2021) demonstrate that Sharia-compliant firms respond differently to ESG initiatives because of the presence of religious screening and ethical constraints, which are not explicitly captured in composite ESG scores.

Furthermore, the environmental index affects financial stability. Surprisingly, it significantly amplifies the positive effects of the Social Index and Governance Index, reflecting the alignment between Sharia principles and the two ESG pillars. Similarly, Qoyum et al. (2022) found that Sharia compliance reinforces stakeholder-oriented activities, leading to greater resilience. In Indonesia, where Islamic values are deeply rooted in society, social initiatives by Sharia-compliant firms are likely to gain stronger acceptance and contribute more directly to stability. This evidence is also supported by El Ghouli and Karoui (2017), who document that firms with stronger social responsibility experience lower risk and improved financial resilience. Moreover, Farooq et al. (2021) found that governance mechanisms significantly enhance risk management in Islamic firms. Mollah and Zaman (2015) and Nguyen et al. (2022) further demonstrate that Sharia supervision and governance quality improve financial performance and stability. These studies emphasize the role of governance in mitigating agency problems and strengthening resilience.

Conclusion

Overall, the findings show that while ESG and Sharia compliance have the potential to improve financial stability, their effects are nuanced and context-dependent. This study challenges the assumption that all ESG dimensions and governance practices automatically enhance resilience and underscores the importance of aligning ESG with cultural, institutional, and religious contexts. Hence, this study has limitations, which are essential to contextualize the findings and provide a foundation for future research directions. First, this study relies on ESG data from listed firms in Indonesia for the

period 2009–2019. Although the ESG indices used are standardized, they may not fully capture the qualitative aspects of sustainability practices, such as firm culture, innovation, or stakeholder perceptions. Future research should incorporate qualitative data, case studies, or alternative ESG scoring methods to gain a deeper understanding.

Second, this study focuses on ESG-listed firms in Indonesia, which limits the generalizability of the findings. The Indonesian context is unique, with specific institutional, cultural, and religious dynamics that shape ESG implementation and Sharia compliance. Future research could expand the analysis to cross-country comparisons, especially among other emerging markets or Muslim-majority economies, to examine whether the patterns observed in this study are context-specific or more universal.

Third, the study employs the Generalized Method of Moments (GMM) approach to address endogeneity and dynamic panel issues, but no method is without limitations. The selection of instruments, lag structures, and cut-off periods may influence the robustness. Future studies could use alternative econometric techniques, such as panel threshold regression, difference-in-difference analysis, and structural equation modelling, to validate and extend these findings.

Fourth, the study examined Sharia compliance. This study treats Sharia-compliant as a binary classification (Sharia versus non-Sharia). However, in practice, Sharia compliance may exist on a spectrum, with varying levels of adherence to Islamic finance principles. Future research could adopt a more nuanced measurement of Sharia compliance, such as using Sharia screening ratios, corporate disclosures, or Sharia audit reports, to capture differences in the depth and rigor of implementation. Finally, regarding the timeframe. The dataset ended in 2019, just before the COVID-19 pandemic. The pandemic created extraordinary disruptions in financial markets and corporate stability, which could alter the relationship between ESG and financial stability. Future studies should extend the analysis to the post-pandemic period to examine whether ESG and Sharia compliance provide greater resilience during global crises.

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