ESG Controversies and Bank Risk-taking: Islamic vs Conventional Banks

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Abstract
Environmental, social, and governance (ESG) controversies have gained increasing attention due to their potential financial and reputational risks, particularly within the banking sector. As regulatory pressures and stakeholder expectations escalate, understanding the impact of ESG controversies on banks' risk-taking behavior is critical for financial stability and sustainable banking practices. This study investigates the relationship between ESG controversies and bank risk-taking, comparing Islamic and conventional banks within the Organisation of Islamic Cooperation (OIC) countries. Using a panel dataset covering 35 Islamic banks and 68 conventional banks across 11 OIC countries between 2013 and 2022, we apply a fixed-effects regression model to assess the influence of ESG controversy exposure on bank risk. The results demonstrate that Islamic banks are significantly less exposed to ESG controversies than conventional banks, reflecting the normative ethical underpinnings of Islamic finance. However, Islamic banks exhibit higher risk levels compared to their conventional counterparts. The regression analysis also reveals that, in both the full sample and the conventional bank sub-sample, fewer ESG controversies are significantly associated with lower risk-taking, thereby enhancing bank stability. However, this effect is absent in Islamic banks. These results highlight the critical role of institutional, cultural, and regulatory contexts in shaping how ESG controversies influence bank behavior. While ESG controversies may act as effective risk control signals in conventional banking systems, their impact appears attenuated in Islamic banks, where ethical principles are already embedded in financial practices.

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1. Introduction

Nowadays, an increasingly large proportion of companies incorporate environmental, social and governance (ESG) goals into their future strategies and disclose their achievements on ESG related activity. This includes the banking industry. While banks may not have a direct negative effect on the environment, due to their role as financial intermediary and financial service companies, they nevertheless have an immense impact on society (Bressan, 2024). Banks have an important role in the accumulation of money and driving capital power to finance ESG compliant businesses only. Banks must pay attention to ESG because such efforts generate reputational and competitive advantages over their competitors (Bischof, 2021).

Since the Paris Climate Protection Agreement was agreed upon in 2015, 195 countries and territories are mandated to transform the global economy towards environmentally sustainable practices. This was followed by the establishment of the 2030 Agenda for Sustainable Development by the United Nations. These initiatives have prompted financial institutions to reorient their operations in alignment with ESG objectives (Quick, 2023). As a result, there has been a significant rise in stakeholder involvement in the pursuit of sustainable development, exerting pressure on companies to adopt ethical and responsible practices (Khattak and Saiti, 202). Several prior studies have provided evidence supporting the positive impact of ESG factors on a company's performance (Friede, Busch, & Bassen, 2015; Du, Zhang, & Wang, 2023; Giese, Lee, Melas, Nagy, & Nishikawa, 2021; Liu, Chen, & Zhao, 2023; Li & Zhang, 2024). The objectives encompassed in the literature include enhancing the company's standing among stakeholders (Kim *et al.*, 2018), mitigating potential risks (Galletta and Mazzù, 2023), and facilitating swift recovery from environmental controversies (Marsat *et al.*, 2022).

In light of the potential advantages of ESG practices, financial institutions are confronted with an increasing demand for ESG performance and heightened scrutiny from both the investors and media (Delloitte, 2024; RFI Global, 2024; UNEP FI, 2024). In this view, any negative ESG-related event that garners public and investor attention and can cause adverse publicity – such as regarding banks' environmental footprint or accidents (Aouadi and Marsat, 2018), social scandals, or governance failures – qualifies as an ESG controversy (Xue *et al*, 2023).

Given growing investor awareness of ESG issues, financial institutions can face substantial financial burdens as a result of ESG challenges, as well as potential negative impacts on their reputation due to adverse publicity. One prominent ESG

controversy within the banking sector is the widespread issue of 'greenwashing' of HSBC's advertisement. A recent manifestation of this issue was seen in HSBC's suspension of climate-related advertising, as reported by Makortoff (2022), which led to significant drops in the company's stock prices. However, other experts argue that providing finance for ESG projects can potentially lead to opportunity costs as a result of inefficient allocation of capital (Devinney, 2009), which in turn may have an impact on the overall financial performance of companies.

The Basel Committee on Banking Supervision (BCBS) has therefore stressed the significance of integrating ESG strategy into risk management procedures by 2021. Nevertheless, this strategy is presently restricted to mitigate climate-related issues impact on credit risk (BCBS, 2021). The potential for controversies concerning ESG is essentially a new risk component added to existing credit, market, operational, liquidity, and reputational risks (European Central Bank, 2020). Banks are now expected to perform two roles in promoting sustainability: an internal role related to business activities, and an external role that integrate ESG risks into their financing, lending, and investing (Buallay *et al.*, 2020). Their importance in ESG increases proportionally to the likelihood of ESG controversies. Unlike ESG performance indicators disclosed by companies, the media is responsible for the dissemination of ESG controversies (Aouadi and Marsat, 2018). Therefore, ESG controversies are a reliable indicator of how the market perceives companies' actual compliance with ESG criteria.

Even though many banks have experienced ESG controversies, existing research has shown that Islamic banks have stricter environmental and social polices (Alam *et al.*, 2022; Iqbal and Mirakhor 2004; Haq and Wahab 2019). Islamic banks are expected to perform better in the environmental dimension of ESG as they provide a broad range of products or mechanisms that exclusively support environmental-friendly investments, such as green bonds (sukuk). In addition, rules prohibiting interest (riba), gambling (maysir), excessive uncertainty (gharar), and maintaining social equity, justice, and inclusion through zakat and other similar programs, make Islamic institutions stronger proponents of social responsibility.

Moreover, Islamic banks' use of independent shariah supervisory boards assures a better governance mechanism and mitigates risk-taking, as religiosity restrains risk-taking within Islamic banks relative to their conventional counterparts (Mollah and Zaman, 2015). These added values are interesting to study in order to determine whether a bank experiences ESG controversies, what differentiates it from its counterpart, and whether there is an effect between ESG controversies

and bank risk-taking at Islamic banks versus conventional banks.

This study contributes to the literature on ESG controversies in the banking industry in several ways. First, to the best of the author's knowledge, this is the first comparative analysis of the ESG controversies in banking sector literature, which complements previous studies (Del Sarto, 2025; Galletta and Mazzù, 2023;Murè *et al.*, 2021; Mariia.,2022; Cicchiello, *et al.*, 2023) that only discuss conventional banks.

Second, this research extends the research of Galletta and Mazzù (2023) and Del Sarto (2025), which undertook a comparative study of the effect of ESG controversies on bank risk-taking at conventional banks and Islamic banks, by explaining ESG controversies by involving two different banking systems. This result of becomes a valuable foundation for a new dimension of research in the ESG controversies and banking literature for next future research.

1.1 Research Questions

This research aims to investigate the following research questions:

1. Is there any difference in bank risk-taking and ESG controversies between Islamic banks and conventional banks?

2. What is the effect of ESG controversy on bank risk-taking at conventional banks?

3. What is the effect of ESG controversy on bank risk-taking at Islamic banks?

1.2. Research Objectives

Regarding the research questions above, this research has two main objectives:

1. To identify whether there is any difference of ESG controversy and bank risk-taking at Islamic banks and conventional banks.

2. To examine whether there is any effect of ESG controversy on bank risk-taking at Islamic banks and conventional banks.

2. Literature Review

2.1. Theoretical Framework

2.1.1. Theoretical Basis

Two main theories can be used to see the connection between ESG controversies and bank risk-taking. First, according to stakeholder theory, companies should consider the interests of all stakeholders because this leads to long-term value maximisation and the company's future success. Moreover, it is argued that the

success of company does not only depend on the satisfaction of its shareholders but also its stakeholders. Bank stakeholders include investors, employees, consumers, public organisations, and government as well as all other parties which are impacted by the company business activities (Freeman, 1999).

Based on stakeholder theory, ESG activities are synergistic to the market performance of a company. For instance, employees who are well-compensated for their work are likely to exhibit higher levels of commitment towards their job responsibilities, while customers who are content with a company's products or services are more likely to develop a sense of loyalty towards the brand. Additionally, suppliers who are satisfied with their business relationship with a company may be willing to offer discounts or other favourable terms which, in turn, improves a company's reputation, financial performance, and long-term viability. Moreover, when a company becomes active in ESG activities, it can improve its performance, which helps mediate conflicts between leadership and stakeholders. This suggests that the ESG initiatives are essential for both safeguarding the bottom line and enhancing shareholder value (Jo and Harjoto, 2012; Ghoul *et al*, 2017). Stakeholder theory argues ESG initiatives should be a competitive advantage, opportunity, and innovation of company. Otherwise, it is not a cost, philanthropic act or constraint, according to stakeholder theory (Porter and Kramer, 2006; Alsaifi *et al*, 2020).

Legitimacy theory complements stakeholder theory by ensuring company legitimacy through addressing stakeholder interests. According to Suchman (1995), legitimacy aims to untangle individual, organisational, and societal norms on different levels of study in the social system. The concerns and sustainability of a company may be threatened if stakeholders view its performance as unsustainable and unsatisfactory. Thus, financial institutions can use the ESG scores to reassure stakeholders that they are operating ethically (Alsaifi *et al.*, 2020). Consequently, companies provide ESG disclosure as part of its accountability to maintain transparency and obtain social legitimacy (Knox-Hayes and Levy, 2011).

However, the company will face some challenges as it will not be easy to accommodate many stakeholder's interests. Companies may lose their legitimacy for three reasons: firstly, if there is a deterioration in their ESG performance; secondly, if there is evidence of irresponsible environmental and social conduct associated with corporate social responsibility (CSR) activities (Johnson, 2003); and thirdly, if there has been a shift in stakeholders' beliefs and expectations (Laidroo and Ööbik, 2013). Stakeholder expectations are dynamic and shaped by evolving societal norms, regulatory landscapes, and public discourse. When companies

fail to realign their strategies with these shifting expectations, particularly on ESG matters, they risk a legitimacy gap. This gap emerges not necessarily due to actual misconduct, but due to perceived inaction, outdated practices, or a failure to communicate values that resonate with stakeholders. As a result, companies may face ESG controversies and subsequent backlash.

In conclusion, in the context of ESG controversies and bank risk-taking, stakeholder theory and legitimacy theory consider stakeholders' interests and expectations by engaging with ESG activities and avoiding the potential for scandal or controversy, which can deteriorate shareholder value maximisation.

2.1.2. ESG Controversies

ESG controversies refer to any negative corporate behaviors or activities in that involve significant environmental, social, or governance misconduct – such as scandals, regulatory breaches, or widespread negative media coverage – that call into question a company's commitment to sustainability and ethical practices. According to Shakil *et al.* (2024), these controversies are identified through media stories highlighting product-harm scandals, suspicious social behavior, or governance failures that draw investor and regulatory scrutiny. Furthermore, as defined by Aouadi and Marsat (2018), ESG controversies represent a distinct measurable risk indicator, separate from ESG ratings, reflecting adverse public and stakeholder perceptions linked to corporate wrongdoing. According to Refinitiv (2022), ESG controversies are divided into 23 types, spanning community, human rights, management, product responsibility, resource use, shareholders, and workforce categories (Figure).

No.	Categories	Controversy Title
1	Community	Anti-Competition Controversy
2	Community	Business Ethics Controversies
3	Community	Intellectual Property Controversies
4	Community	Critical Countries Controversies
5	Community	Public Health Controversies
6	Community	Tax Fraud Controversies
7	Human Rights	Child Labor Controversies
8	Human Rights	Human Rights Controversies
9	Management	Management Compensation Controversies Count
10	Product Responsibility	Consumer Controversies
11	Product Responsibility	Customer Health and Safety Controversies
12	Product Responsibility	Privacy Controversies
13	Product Responsibility	Product Access Controversies
14	Product Responsibility	Responsible Marketing Controversies
15	Product Responsibility	Responsible R&D Controversies
16	Resource Use	Environmental Controversies
17	Shareholders	Accounting Controversies Count
18	Shareholders	Insider Dealings Controversies
19	Shareholders	Shareholder Rights Controversies
20	Workforce	Diversity And Opportunity Controversies
21	Workforce	Employee Health & Safety Controversies
22	Workforce	Wages Or Working Condition Controversies
23	Workforce	Strikes

Figure 1. Overview of ESG Controversies Score and ESG Score (Source : Refinitiv, 2022)

In order to measure a company's ESG performance, Refinitiv, the largest data provider for ESG databases (Durand and Jacqueminet, 2015), develops ESG ratings based on publicly available information. Additionally, a company's ultimate ESG Combined (ESGC) score is determined by adding its ESG Controversies score, which is derived on data from international media sources (Refinitiv, 2022) (Figure 2).

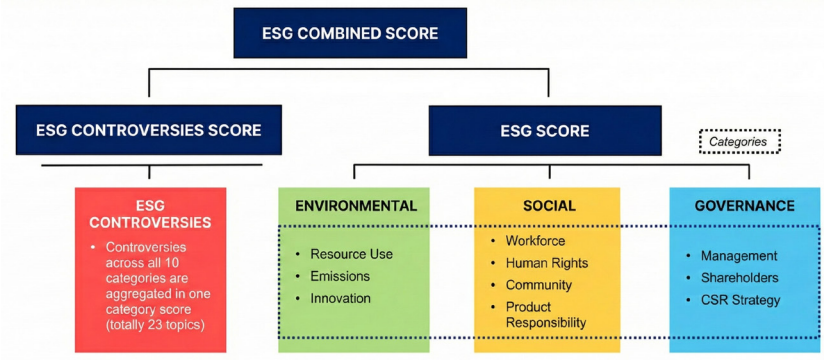

Figure 2. Overview of ESG Controversies Score and ESG Score (Source : Refinitiv, 2022)

Previous studies shown that company performance is significantly impacted by negative ESG news. For instance, according to a study by (Glossner, 2021), due to a lack of strong investor interest, the effect of ESG debates is not completely reflected in stock prices. According to this argument, ESG controversies typically reveal a company's prior behaviour, realisation of relative ESG risks, and perception of controversies by investors. As a result, ESG controversies may provide more useful information on a company than conventional ESG ratings (Glossner, 2021).

Most previous studies on ESG controversies focus on the effect of such controversies on company performance. First, they examine the effect of ESG controversies on firm value and investor reaction. In the majority of articles, the conclusions regarding ESG controversies and company value are consistent. For instance, according to Aoudi and Marsat (2018), investors react negatively following ESG controversies, impacting company value. This occurs because of investors' assumptions that similar events are likely to occur again in the future, which are reflected in lower profits projections, higher costs, and, thus, lower value. Interestingly, Aoudi and Marsat (2018) also found that the relationship between ESG controversies and firms' market value show an association with a greater firm value, becoming a way to attract investor attention and increase share prices despite the controversy. Additionally, Cui and Docherty's (2020) analysis of NYSE-listed companies demonstrated that ESG controversies only have an effect on value for a certain period of time, with share prices returning to their previous levels after

one quarter. This may be because when such circumstances arise, the company becomes the centre of attention.

In addition to raising a company's profile, unfavourable ESG occurrences can impact a company's financial performance. DasGupta (2022) examined 24,390 firm-year observations from 27 countries and found that when such firms are constrained by ESG controversies, they are reluctant to practice more stringent ESG principles, even though such incidences have a positive impact on the relationship between financial performance shortfalls and ESG performance.

Meanwhile, a study by Murè *et al.* (2021) found that ESG controversies affect banks' reputations. The study examined the correlation between the ESG score and the likelihood of sanctions among a selected group of Italian financial institutions. The findings of the study indicate a clear correlation, suggesting that banks subject to sanctions are motivated to adopt sustainable and environmentally conscious practises in order to enhance their reputation and mitigate the adverse effects of legal actions (Murè *et al.*, 2021). This is also in accordance with the findings of Cicchiello *et al.* (2023), who found that banks strive to preserve their standing by actively avoiding involvement in ESG disputes. This strategic approach contributes to the bank's competitive edge vis-à-vis other players in the market.

Another study conducted by Galletta and Mazzù (2023) revealed a notable correlation between ESG controversies and bank risk-taking. Based on a comprehensive dataset comprising 8,430 observations spanning the period from 2011 to 2020, the analysis found a noteworthy correlation between a bank's frequency of ESG controversies and its adherence to ESG strategies aimed at risk reduction. Specifically, banks with a smaller number of ESG controversies demonstrate a greater commitment to implementing ESG strategies, as evidenced by lower levels of risk-weighted assets and higher Z-scores. On the other hand, Mariia (2022) did not find any impact of ESG controversies on banks' stability after looking at 134 banks in multiple countries and 1,200 controversies between 2016 and 2020.

2.1.3. Bank Risk and ESG

Experts have proposed various universal definitions of bank risk. According to Ghosh (2012), the concept of risk in the banking sector encompasses the possibility of experiencing financial losses resulting from negative events. These events include economic downturns, negative changes in fiscal and trade policies, unfavourable fluctuations in interest rates or foreign exchange rates, and declines in equities values. Moreover, Bessis (2002) provides an interpretation of risk in

the banking sector as an adverse effect on returns resulting from many separate sources of uncertainty. In addition, the word ‘risk refers tothe presence of ambiguity regarding future events and the potential for different outcomes based on diverse actions (DeLorenzo, 2006).

The BCBS (2013) classifies bank risks into three main categories: credit, market, and operational risks. Other risks can also emerge, including business, liquidity, and reputational risks (Leo et al, 2019). Since the global financial crisis of 2008, bank risks have become an international concern. Haq and Heaney (2012) pointed out that due to the crisis, banks tend to take substantial risks to achieve high levels of possible returns. However, bank risks are expected to evolve and change over the time, owing to changes occurring both inside and outside banks (McKinsey, 2016).

From the perspective of banking supervisory boards, the BCBS (2022) has outlined protocols for the assessment of significant ESG risks. The protocols focus on integrating these risks into risk management frameworks and taking into account the impact of climate-related factors on credit, market, liquidity, and operational risks. It is imperative for banks to be aware of the impact of these emerging factors on operational risk, as they have the potential to heighten strategic, reputational, and regulatory compliance risks, as well as to increase liability costs related to investments and entities susceptible to climate-related influences (BCBS, 2022).

Consistent with this guiding concept, ESG challenges have the potential to significantly impact strategic decisions and require the re-evaluation of the business models adopted by banks. Banks must evaluate operational risk because high operational losses can also lead to significant reputational losses, especially when triggered by climate-related, environmental, and social challenges. In the latter instance, reputational risk may devalue banks. Supervisory agencies recommend that business models of bank industry incorporate ESG compliance to decrease climate-related and environmental risks on business strategy in the short-, medium-, and long-term (European Central Bank, 2020).

According to the European Central Bank's 2020 guidelines, climate risk is also related to physical and transaction risks. In addition, the guidelines describe the effects of such transitions on credit, market, operational, and liquidity risks. Operational risk is particularly associated with climate change due to concerns about the disruption of banking operations resulting from errors at branches and data centres. In addition, operational risk associated with climate change and environmental concerns has the potential to impact bank stakeholders, who may

face risks to bank reputation and liability due to controversies arising from the financing of activities that contribute to environmental damage.

Furthermore, the BCBS (2021) states that macro- and micro-economic transmission pathways from two types of climate risk drivers expose banks to climate change. First, rising severity and frequency of physical climate risk drivers may cost them financially. Second, economies' efforts to cut carbon dioxide emissions create transition risk drivers, including as the result of technological advances, government regulations, and investor and consumer opinion. They may also cause large bank and banking system losses. Evidence suggests that risk drivers' effect on banks can be observed through conventional risk categories (Table 1).

Table 1. Potential Effects of Climate Risk Drivers (Source: BCBS, 2021)

Risk	Potential Effects of Climate Risk Drivers (Physical and Transition Risk)
Credit risk	Credit risk elevates when climate risk factors diminish borrowers' capacity to repay and manage debt (income impact) or impede banks from completely reclaiming the loan's value in case of default (wealth effect).
Market risk	Market risk decreases in the value of financial assets, including the possibility of initiating significant, abrupt, and unfavourable price corrections in situations where climate risk hasn't been factored into valuations. Climate risk might also cause disruptions in connections between assets or alterations in asset-specific market liquidity, challenging established risk management presumptions.
Liquidity risk	Banks might encounter a decrease in their access to dependable funding channels due to shifts in market circumstances. Climate risk factors could prompt banks' counterparts to withdraw deposits and credit facilities.
Operational risk	Operational risk covers the legal and regulatory compliance risk tied to investments and enterprises sensitive to climate changes.
Reputational risk	Reputational risks to banks increases based on changing markets or consumer sentiment.

2.2. Hypothesis Development

2.2.1. Bank Risk and ESG Controversies at Islamic Banks and Conventional Banks

Although Islamic banks and conventional banks implement the same type of business (that is, banking), their risks are noticeably different. An Islamic bank is distinguished from a conventional bank by the imposition of religious principles on the products it offers, which are exempt from interest (riba) and excessive ambiguity (gharar) (Abedifar *et al.*, 2013). Consequently, Islamic banks have devised alternative operational mechanisms to those used by conventional banks, such as profit loss sharing (mudaraba) and nonprofit-loss sharing (murabaha and ijara) in comparison to conventional banks' time deposits, debt financing, and lease financing (Siddiqui, 2008).

The religious beliefs of depositors and the operational mechanisms available for profit-loss sharing can aid Islamic banks in maintaining pro-cyclical protection and reducing the risk of withdrawal due to falling customer loyalty during adverse

economic conditions. In addition, Islamic banking systems can mitigate the risk exposure associated with shariah-derived financial transactions (Hassan and Aliyu, 2018). As an illustration, shariah principles prohibit interest, speculation, complex derivatives, and gambling, which are viewed as the primary determinants of exploitation in society (Khan, 2010). However, due to the banks' relatively limited access to wholesale funding, the risk aversion of investors at Islamic banks increases (Abedifar *et al.*, 2013). The complexities associated with shariah compliance administration also represent an additional risk for Islamic banks. So the question becomes focused on whether the higher risks are compensated by higher returns.

However, in terms of ESG, Islamic banks can become role models and distinguish themselves from conventional banks because ESG naturally fosters the Islamic moral economy as instructed by shariah. These values are in line with the primary objective of following Islamic beliefs, commonly called maqasidh al-shariah (Mergaliyev *et al.*, 2021). To achieve this objective, Muslims are supposed to maintain and sustain a good relationship with God, society, and the natural environment (Azmat and Subhan, 2022). Consequently, the ultimate objective consists of serving the interests of all human beings and protect the earth from any destructions; in other words, to prevent any ESG controversies. Aligning with this, Islamic banks are expected to be distinguished and better able to conduct their operations with positive ESG impact, due to its religious practices, than non-Islamic banks (Mergaliyev *et al.*, 2021). Therefore, my first hypothesis is:

H_1: *There is a significant difference between bank risk and ESG controversies at Islamic banks and conventional banks.*

2.2.2. Effect of ESG Controversies on Bank Risk-taking at Conventional Banks

There is limited research examining ESG controversies in the banking industry, particularly to compare Islamic banks and conventional banks. Most existing studies only discuss about interconnection between ESG performance and banks, without analyzing ESG controversies. One notable study by Galletta and Mazzù (2022) analyzed a sample of 8,430 observations from listed banks worldwide during the period 2011-2020. They discovered that banks with fewer ESG controversies tended to take fewer risks by considering risk-weighted assets and the Z-score in 41 countries.

Meanwhile, a study conducted by Aouadi and Marsat (2018) which covered 4,000 firms from 58 countries during 2002-2011, has a surprising result, finding

that the occurrence of ESG controversies is associated with greater firm value. Nevertheless, when examining the correlation between ESG controversies and corporate social performance scores, it is evident that ESG controversies do not exert a direct impact on company value. However, it is worth noting that the interaction between ESG controversies and corporate social performance scores demonstrates a strong and statistically significant positive relationship.

A recent study by Mariia (2022), which examined a cross-country sample of 134 banks and data on 1,200 ESG controversies from 2016, found that controversies had a negative impact on bank values but did not affect bank stability. The effect on share prices varied and was stronger for banks that attracted investor attention, particularly in developed markets with a high degree of press freedom. Additionally, investors considered the reasons behind ESG controversies and reacted strongly to negative ESG news related to the community and workforce.

However, it is important to acknowledge that ESG controversies are potentially tied to bias and overperformance due to information inefficiencies. As mentioned by Dorfleitner *et al.* (2020), small companies may benefit publicly from having controversies not covered by the media, so investors may overlook their ESG problems and not consider the negative effects in their valuation. These companies are referred to as 'small sinners' because their problems may be overlooked due to their size and lack of media coverage. As the ESG controversy score provided by rating agencies takes into account market capitalization bias, this results in larger companies suffering more as they receive more media attention. In line with the previous studies, the second hypothesis is:

H_2: *There is a significant effect between bank risk and ESG controversies at conventional banks.*

2.2.3. Effect of ESG Controversies on Bank Risk-taking at Islamic Banks

Guided by religious principles, Islamic Banks are expected to endogenize ESG issues in their provision of Islamic financial services (Sairally, 2015). Islamic banks must achieve multiple objectives and satisfy both 'form' (shariah legal rulings) and 'substance' (Islamic worldview on social and moral requirements) (Asutay, 2012).

A study by Sairally (2015) found that the incorporation of ESG factors into the operations of Islamic banks is deemed essential within the framework of maqasid al-shariah. Consequently, Islamic banks should strive to attain both ESG and shariah compliance targets concurrently. According to Haq and Wahab (2019), there is a connection between ESG and the major purpose of Islamic

principles. as the similarities between maqasid al-shariah and the sustainability paradigm stem from their shared focus on stakeholder benefit, which aligns with stakeholder theory. The authors emphasize the Islamic notion of human beings' responsibility towards nature, which arises from the notion that humans do not possess ownership of nature, but rather function as stewards or managers. Iqbal and Mirakhor (2004) also argue that Islamic finance is created in a system that prioritizes the stakeholder's interests.

As a result, the connection between Islamic principles and ESG is reflected through the products offered by Islamic banks which support environmental project financing through sukuk and prohibitions on investments in 'sinful industries' such as pork, alcohol, tobacco, pornography, weaponry, and gambling, as well as any unlawful activities or activities which violate human rights; this makes Islamic banks' coverage broader than ESG (Tarabishi *et al.*, 2023). This approach means it is unlikely that Islamic banks will be involved in ESG controversies.

Moreover, the presence of a shariah supervisory board makes Islamic banks less susceptible to risks compared to conventional banks. A study conducted by Mollah and Zaman (2015) on 172 Islamic and conventional banks in 25 countries between 2007 and 2010 found that board structure plays a role in preventing Islamic banks from taking excessive risks and, thus, safeguards the banks from financial instability during crises. Although the shariah board lacks monitoring abilities beyond shariah audits and validation of Islamic banking products and services, the strong ethical and value-driven boards help the banks comply with capital regulations, maintain high equity levels, diversify their income, and avoid financial fragility (Mollah and Zaman, 2015). As a result, Islamic banks have been largely able to avoid ESG controversies. Therefore, my third hypothesis is:

H_3: *There is a significant effect between bank risk and ESG controversies at Islamic banks.*

3. Methodology

3.1. Research Model

The effect of the ESG controversies score on bank risk is analyzed using a dynamic panel estimation with a lagged dependent variable. A dynamic model is helpful for mitigating concerns regarding persistence and the correlation between past and future error term values. The model shown below:

$$RISK_{it} = \alpha_i + \gamma RISK_{it} + \beta_1 ESGCon_{it} + \beta_2 SIZE_{it} + \beta_3 EQA_{it} + \beta_4 ROA_{it} + \beta_5 NONINT_{it} + \beta_6 NLTA_{it} + \beta_7 LADSTF_{it} + \beta_8 BOARD_{it} + \beta_9 GDP_{it} + \delta_t + \varepsilon_{it}$$

Where RISK it represents dependent variable for bank i in year t and ESGCon it denotes the independent variable with β_1 as the coefficient which coefficient indicates the effect of ESG controversy on bank risks. A positive β_1 (coefficient of ESG controversies) value suggests that higher levels of ESG controversy are associated with increased bank risk, assuming other variables remain constant.

3.2. Research Variables

3.2.1. Dependent Variable

The dependent variable of this study is Bank Risk. To examine bank risk-taking, I employ each bank's Z-score, which indicates the likelihood of insolvency and is extensively utilised in the empirical banking literature. I use the natural logarithm of the Z-score instead of the raw Z-score because the raw Z-score is considerably skewed, per Laeven and Levine (2009). The Z-score is inversely proportional to the likelihood of bank insolvency. Banks become insolvent when the value of their assets falls below the value of their liabilities. A bank with a higher Z-score is more stable and takes smaller risks. This bank risk proxy is consistent with previous literature (Laeven and Levine, 2009; Mollah, *et al* 2021; Galletta and Mazzù, 2023). I calculate the Z-score using this formula:

$$\mathrm{Z-score} = \frac{\mathrm{Retrun\ \ on\ \ Assets\ \ +\ \ (Equity/Total\ \ Assets)}}{\mathrm{Standard\ \ Deviation\ \ of\ \ Return\ \ on\ \ Assets}}$$

3.2.2. Independent Variable

ESG controversy is the independent variable on this research. The ESG controversy scores are captured based on scandals and negative events, and consist of 23 topics of controversy, including business ethics, intellectual property, anti-competition, environmental problems, tax fraud privacy, diversity and opportunity, and others. The score is percentile rank that considers ESG controversies occurring in the most recent closed fiscal year. All controversy scores possess a default value of 0, and companies with no controversies are assigned a score of 100 (Refinitiv, 2022).

3.2.3. Control Variables

To capture the effect of bank-specific variables on the dependent variables, control variables from multiple sources are adopted. The natural logarithm of a bank's total assets is used to calculate bank size, designated as SIZE, while EQA, defined as equity over assets, serves as a representative of the bank's capital structure (Boudawara *et al.*, 2023). In accordance with previous research (Pucheta-Martínez, 2020) the third control variable is a profitability indicator, represented by the return on assets (ROA), calculated as net income over total assets. Additionally,

the ratio of non-interest income to total revenue (NONINT) is included as a proxy for the degree of diversification, controlling for additional sources of bank income (Polizzi *et al.*, 2020).

Furthermore, two variables from Galletta and Mazzu (2023) are employed to account for the lending portfolio (NLTA) and the liquidity ratio (LADSTF) of the banks. Considering that ESG-related mechanisms may influence company-specific corporate governance characteristics, the number of directors on the board (BOARD-SIZE), as adopted from Berger *et al.* (2016), is also included. Lastly, the natural logarithm of gross domestic product per capita (GDP) is used as a macroeconomic control variable, in line with Laeven and Levine (2009). The sources and classifications of both dependent and independent variables are defined in Table 2.

Table 2. Descriptions and Sources of Variables by Author

Variable	Description	Source
Dependent Variable		
Z-score	Log [{return on asset + (equity/ asset)}/standard deviation of return on asset]	Author's calculation
Independent Variable		
ESG Con	ESG controversies score is the measurement of a company's exposure to environmental, social and governance controversies and negative news reflected in media (0–100)	Refinitiv (2022)
Control Variables		
BOARD Size	The number of directors sitting on the board	Bank Focus
SIZE	Natural logarithm of total assets	Bank Focus
EQA	Total equity to total assets	Bank Focus
ROA	Net income by average total assets, as profitability of a bank asset	Bank Focus
NONINT	Non-interest income/Total operating income	Bank Focus
NLTA	Net loans/total asset	Bank Focus
LADSTF	Liquid asset or deposits and short-term funding	Bank Focus
GDP	Natural Logarithm of Real GDP	World Bank

3.3. Research Sample

This research period covers a ten-year timeframe from 2013 to 2022. While data is available on 568 Islamic banks in the Refinitiv database, only 35 Islamic banks provide data on their ESG controversy scores. Meanwhile, 734 conventional banks provide ESG data, but ESG controversy scores are available for only 68 conventional banks. Therefore, the final sample consists of 35 Islamic banks and 68 conventional banks, located in the same 11 countries. The total of research observations for 10

years should be 76 bank-year observations for Islamic banks and 669 bank-year observations for conventional banks. However, due to missing variable data, some samples had to be dropped for particular years, thus the final sample of Islamic banks and conventional banks covers 326 and 654 observations, respectively. The sample number of banks and their country headquarter locations are shown in Table 3.

Table 3. List of Research Samples by Author

No	Country	Islamic banks	Conventional banks	All banks	% Islamic bank
1	Bahrain	5	2	7	71.43%
2	Egypt	3	3	6	50.00%
3	Indonesia	3	13	16	18.75%
4	Jordan	2	5	7	28.57%
5	Kuwait	4	4	8	50.00%
6	Pakistan	3	5	8	37.50%
7	Qatar	4	4	8	50.00%
8	Saudi Arabia	4	6	10	40.00%
9	United Arab Emirates	5	12	17	29.41%
10	Türkiye	1	8	9	11.11%
11	Oman	1	6	7	14.29%
	Total banks	**35**	**68**	**103**	**33.98%**

4. Results

4.1. Descriptive Statistics

The highest score for Islamic banks' risk (proxied by the natural logarithm of Z-score) is 2.10, while conventional banks' risk is slightly higher at 2.26. The lowest Z-score of Islamic banks is -1.60, with conventional banks' lowest being -0.18. The average risk for Islamic banks and convention banks is 1.23 and 1.38, respectively. The t-test concludes that there is a significant difference between Islamic banks and conventional banks in terms of bank risk. Since a lower Z-score indicates a high risk, this means that Islamic banks have bigger risks than conventional banks. Since a higher Z-score indicates lower insolvency risk (Laeven and Levine, 2009), these findings suggest that Islamic banks, on average, exhibit more prudent risk-taking behavior than their conventional counterparts. This aligns with the extant literature, which posits that Islamic financial systems – characterized by risk-sharing mechanisms, the prohibition of speculative behavior (gharar), and profit-and-loss sharing – may inherently foster greater stability (Abedifar *et al.*, 2013; Mollah and Zaman, 2015).

In terms of ESG controversy scores, Islamic banks show a significantly higher

mean (99.432) compared to conventional banks (54.900), indicating markedly lower exposure to ESG-related incidents (t = -7.914, p < 0.001). Refinitiv (2022) assigns a score of 100 to institutions with no controversies, meaning the elevated score among Islamic banks reflects a stronger adherence to ESG standards. This supports theoretical expectations that maqasid al-shariah is influential on adherence, as it underpins Islamic banking's ethical orientation and social responsibility (Sairally, 2015; Haq and Wahab, 2019).

Profitability, measured by ROA, shows a maximum of 14% for Islamic banks and 7% for conventional banks, with respective minimum values of -4% and -9%. The mean ROA is 2% for Islamic banks and 1.5% for conventional banks, but the difference is not statistically significant. Similarly, non-interest income to total revenue (NONINT) ranges from 0.01 to 1.26 at Islamic banks and from -0.05 to 10.16 at conventional banks, with average values of 0.28 and 0.32, respectively, also yielding no significant difference.

Regarding the lending portfolio (NLTA), both Islamic banks and conventional banks exhibit similar ranges (Islamic: 0.07–0.83; conventional: 0.00–0.84) with nearly identical means (0.58 vs. 0.57), showing no significant variation. Liquidity, proxied by the LADSF ratio, reveals more volatility at Islamic banks (mean = 30.85; max = 500.39) compared to conventional banks (mean = 33.18; max = 83.23), though the t-test indicates no statistical difference.

Board size is comparable across the two systems, with average values of 9.87 for Islamic banks and 9.65 for conventional banks, and a shared minimum of three members.

Capital adequacy, proxied by the equity-to-asset ratio (EQA), shows a higher average at conventional banks (0.115) than Islamic banks (0.102), but the difference is not statistically significant. This suggests both banking models maintain comparable solvency buffers under Basel-based frameworks.

Lastly, while GDP per capita across the 11 shared countries displays identical minimum and maximum values due to the matched country sample, the mean GDP for Islamic banks is slightly higher than conventional banks (4.18 vs. 4.07). The t-test confirms a statistically significant difference.

Table 4. Descriptive Statistics

All Sample					Islamic Banks					Conventional Banks					t-test
Obs	Mean	Std. Dev.	Min	Max	Obs	Mean	Std. Dev.	Min	Max	Obs	Mean	Std. Dev.	Min	Max	
745	1.275	0.552	-0.169	2.268	76	1.585	0.285	0.714	2.002	669	1.240	0.564	-0.169	2.268	-5.260***
745	59.443	48.21	0.000	100.000	76	99.432	3.487	77.143	100.000	669	54.900	48.842	0.000	100.000	-7.914***
745	5.960	5.044	0.000	18.000	76	10.158	2.046	4.000	16.000	669	5.483	5.063	0.000	18.000	-7.971***

745	10.285	0.559	7.609	11.511	76	10.525	0.388	9.133	11.307	669	10.258	0.569	7.609	11.511	-3.983***
745	0.075	0.853	0.000	21.188	76	0.128	0.038	0.046	0.397	669	0.069	0.900	0.000	21.188	-0.575
745	0.013	0.013	-0.045	0.090	76	0.017	0.011	-0.002	0.090	669	0.012	0.013	-0.045	0.072	-3.293***
745	0.320	0.499	-0.056	10.163	76	0.308	0.186	0.005	1.053	669	0.322	0.523	-0.056	10.163	0.221
745	0.585	0.129	0.000	0.840	76	0.650	0.117	0.352	0.829	669	0.577	0.128	0.000	0.840	-4.727***
745	29.946	15.807	0.000	83.230	76	24.306	11.656	6.000	57.740	669	30.586	16.094	0.000	83.230	3.304***
745	23123	21158	1126	97631	76	40001	20458	1505	93126	669	21205	20384	1126	97631	

4.2 Independent Group t-test Results

In general, Islamic banks show a significant higher mean than conventional banks for several variables (Table 6), including financial stability (Z-score), ESG controversy (EGC), board size (BOARDSIZE), bank size (SIZE), return on assets (ROA), and net loans to total assets (NLTA). These differences, all statistically significant at the 1% level (***), suggest that Islamic banks tend to operate with more stability but experience more ESG controversies, compared to their conventional counterparts. In addition, Islamic banks are more likely to have larger board size, bigger bank size, higher return on assets, and greater net loans to total assets. By contrast, only one variable (LADSTF) shows significant but positive t-test result, suggesting that conventional banks tend to have higher liquid assets or deposits and short-term funding (LADSTF) than Islamic banks. However, equity to total assets (EQA) and non-interest income to total operating income (NOINT) shows no significant difference between these two categories of banks, as shown in t-test result.

4.3. Correlation Analysis

Based on the correlation matrix results, there is no strong degree of correlation between the key variables (Table 7). A positive correlation is observed between bank risk (Z-score) and all variables except EQA, NOINT, and LADSF. The highest coefficient between dependent variable (Z-score) and independent variable (EGC), as well as all control variables, is 0.474 (Z-score and SIZE), but these values are still accepted. Generally, a correlation coefficient between ±0.1 and ±0.3 indicates a weak relationship, if the correlation between ±0.3 and ±0.7 indicates a moderate relationship and greater than ±0.7 indicates a strong relationship. Therefore, there is no coefficient that is greater than 0.7, which means there is no multicollinearity issue and the model can be tested.

Table 5. Correlation Matrix

	(1)									
	Z-score	**egc**	**boardsize**	**size**	**eqa**	**Roa**	**nonint**	**nlta**	**ladsf**	**gdp**
Z-score	1									
Egc	0.279***	1								
boardsize	0.252***	0.915***	1							
Size	0.474***	0.436***	0.496***	1						
Eqa	-0.136***	-0.0573	-0.0619	-0.269***	1					
Roa	0.308***	0.110**	0.0836*	0.290***	-0.0568	1				
Nonint	-0.0860*	-0.0362	-0.0591	-0.0526	0.00621	-0.0874*	1			
Nlta	0.192***	0.0762*	0.0846*	0.190***	-0.0299	0.0849*	0.0311	1		
Ladsf	-0.0222	0.0946**	0.0621	0.0687	-0.114**	-0.0491	0.0117	-0.432***	1	
Gdp	0.158***	0.0754*	0.0654	0.200***	-0.0449	-0.0409	0.115**	0.324***	-0.0479	1

* p < 0.05, ** p < 0.01, *** p < 0.001

4.4. Regression Result

Table 6. Regression Results

	Full Sample	**Islamic Banks**	**Conventional Banks**
VARIABLES	**Z-score**	**Z-score**	**Z-score**
Egc	0.00377***	0.00147	0.00471***
	(0.000778)	(0.00416)	(0.000846)
Boardsize	-0.0236***	0.0143	-0.0336***
	(0.00783)	(0.0186)	(0.00843)
Size	0.338***	-0.0347	0.319***
	(0.0359)	(0.138)	(0.0428)
Eqa	-0.0207**	2.695*	-0.0227**
	(0.00926)	(1.404)	(0.0102)
Roa	9.000***	-9.898	9.126***
	(1.575)	(6.499)	(1.705)
Nonint	-0.0909***	-0.540**	-0.0908***
	(0.0200)	(0.235)	(0.0201)
Nlta	0.921***	-0.860	0.916***
	(0.186)	(0.565)	(0.222)
Ladsf	0.00127	-0.00848*	0.00213
	(0.00139)	(0.00451)	(0.00149)
Gdp	-6.08e-07	5.08e-06*	-2.29e-07
	(9.93e-07)	(2.99e-06)	(1.27e-06)
Year Dummies	YES	YES	YES
Country Dummies	YES	YES	YES

Constant	-2.626***	1.743	-2.328***
	(0.384)	(1.888)	(0.444)
Observations	745	76	669
R-squared	0.421	0.817	0.422

Note: Robust Standard errors are in parentheses.
**** p<0.01, ** p<0.05, * p<0.1*

Based on the regression results (Table 8), in regard to Islamic banks, the P value is 0.400, which is less than the significance level at 0.05. It means that there is no statistically significant effect of ESG controversies on bank risk-taking. The same result applies to conventional banks. This indicates that hypothesis 2 and 3 are rejected.

However, there is a significant effect between Z-score to SIZE and ROA, while being a conventional bank has significant effect on ROA, NONINT, BOARD SIZE, and GDP. It means that, in terms of profitability (ROA), both Islamic banks and conventional banks have the same significant effect to bank risk, but different in terms of direction, as the coefficient of ROA for Islamic banks is -1.664 but is 1.9534 for conventional banks. Interestingly, there is no significant effect in terms of governance mechanism in IBs.

The R-adjusted value is 0.255 for Islamic banks and 0.577 for conventional banks. This means that the explanatory power is strong. Both these models are extremely strong at 25% and 52%, respectively. In other words, 25% of variation in bank risk at Islamic banks and 57% variation of bank risk at conventional banks can be explained by ESG controversies, bank size, Tier 1, ROA, NONINT, NLTA, LADSF, BOARD SIZE, and GDP, while the other remaining 75% and 43%, respectively, are affected by other variables not examined in this research.

4.5. Robustness Tests

Table 7. Sensitivity Tests with Lagged Value of Independent Variable

VARIABLES	Full Z-score	Islamic Banks Z-score	Conventional Banks Z-score
L.egc	0.00198***	0.00488	0.00227***
	(0.000609)	(0.00328)	(0.000644)
boardsize	-0.00433	0.00291	-0.00735
	(0.00602)	(0.00896)	(0.00632)
size	0.311***	0.457***	0.288***
	(0.0459)	(0.0525)	(0.0503)
eqa	-0.0635	1.684**	-0.0700
	(0.0479)	(0.746)	(0.0494)
roa	8.959***	-3.750	8.947***

	(1.611)	(2.963)	(1.684)
nonint	-0.0869***	0.274**	-0.0856**
	(0.0336)	(0.125)	(0.0345)
nlta	0.884***	0.739***	0.897***
	(0.200)	(0.195)	(0.221)
ladsf	0.000847	0.000257	0.00184
	(0.00131)	(0.00158)	(0.00141)
gdp	-3.37e-07	1.86e-06	-1.91e-08
	(1.14e-06)	(1.52e-06)	(1.30e-06)
Year Dummies	YES	YES	YES
Country Dummies	YES	YES	YES
Constant	-2.323***	-5.418***	-2.023***
	(0.480)	(0.673)	(0.524)
Observations	660	60	600
R-squared	0.415	0.978	0.411

In order to address the potential endogeneity issues, this research follows past studies (Haque and Ntim, 2022; Tumewang *et al.*, 2025) to re-estimate the regression model by employing the lagged values of independent variables (L.EGC) across the full sample as well as sub-samples of Islamic banks and conventional banks. The results are consistent with the main baseline regressions, confirming the robustness of the study.

Table 8. OLS and 2SLS regressions

	OLS	**2sls IV=L1.ESG**	**2sls IV=L2.ESG**
VARIABLES	**Z-score**	**Z-score**	**Z-score**
egc	0.00351***	0.00811***	0.0139***
	(0.000899)	(0.00246)	(0.00460)
boardsize	-0.0267***	-0.0591***	-0.108***
	(0.00893)	(0.0210)	(0.0389)
size	0.372***	0.360***	0.355***
	(0.0399)	(0.0455)	(0.0542)
eqa	-0.0126	-0.0590	-0.530***
	(0.0211)	(0.0472)	(0.149)
roa	7.691***	7.873***	7.101***
	(1.465)	(1.647)	(2.048)
nonint	-0.0704**	-0.0932***	-0.102***
	(0.0349)	(0.0332)	(0.0355)
nlta	0.326**	0.890***	0.963***
	(0.161)	(0.197)	(0.229)
ladsf	-0.000663	-0.000291	-0.00241
	(0.00124)	(0.00137)	(0.00176)
gdp	1.66e-06*	-1.32e-06	-2.25e-06

	(8.85e-07)	(1.15e-06)	(1.42e-06)
Constant	-2.881***	-2.980***	-2.901***
	(0.391)	(0.466)	(0.548)
Year Dummies		YES	YES
Country Dummies		YES	YES
Observations	745	660	580
R-squared	0.289	0.406	0.349

Furthermore, this study also presents the results of OLS (Ordinary Least Square) regression in Column 1, followed by 2SLS (Two Stage Least Square) regressions in columns (2) and (3). I use the first and second lags of independent variables (L.ESC & L2.EGC) as the instrumental variables, as applied by Xie, 2024. The coefficient of ^ESG is positive and significant at the 1% level, which confirms the robustness of the main finding.

5. Discussion

5.1. Overview of Differences in Bank Risk and ESG Controversies at Islamic Banks and Conventional Banks

Based on the t-test results, which shows that Islamic banks have a significantly higher risk difference than conventional banks, Hypothesis 1 is supported. Although the features of Islamic banks seem to reduce risk due to the religious principles guarding their operations, Islamic banks have higher risk than conventional banks due to the characteristics of Islamic loans, which include minimal default fines and moral hazard incentives. For example, this could be the result of profit loss sharing financing contracts (Abedifar *et al.*, 2015). Furthermore, the complexities associated with the administration of shariah compliance represent an additional risk faced by Islamic banks. Thus, even Islamic investments are riskier than conventional investments due to the products' complexity and more restricted transaction mechanisms (Abedifar *et al.* 2013). A study by Čihák and Hesse (2010) compared the solvency of the two banking systems and discovered evidence that the risk of default for small Islamic banks is lower than that of conventional banks, but that larger Islamic banks show a higher insolvency risk than smaller banks.

Research by Mollah *et al*. (2017) pointed out the pivotal role of governance structures in Islamic banks, shaping distinct risk-taking and financial performance compared to conventional banks. Specifically, Islamic banks benefit from these structures by being able to take higher risks and, therefore, achieve superior performance. Furthermore, al Abbad *et al*. (2019) found a significant positive influence of shariah supervisory board size and board engagement on Islamic

banks' asset returns and insolvency risks. Abedifar *et al*. (2013) added that Islamic banks encounter additional risks due to the complexity of Islamic financing modes and limitations in funding, investment, and risk management practices. These are some of the key factors behind why Islamic banks face the higher risks than conventional banks.

In terms of the comparative analysis on ESG controversies, based on the author's compilation of ESG controversy news pieces from Reuters (in the Refinitiv database; see Appendix), it was found that overall, there is a difference between Islamic banks and conventional banks in regard to the number and types of ESG controversies. In terms of the number of ESG controversies experienced, there is a considerable difference between Islamic banks and conventional banks. The database found just three controversies faced by Islamic banks, compared to 21 cases faced by conventional banks. Islamic banks are more likely to be involved in ESG controversies falling into the categories of community and product responsibility, such as tax fraud and customer data breach. Conventional banks are more likely to experience many type of cases relating to community controversies, such as regulatory violation, market manipulation, business ethics, competition controversies, financial warfare, tax fraud, and critical countries controversy, and relating to product responsibility, such as data leaks and insurance violations. The detailed list of ESG controversy differences between Islamic banks and conventional banks is can be found in the Appendix.

5.2. ESG Controversy Effect on Bank Risk at Conventional Banks

The empirical findings show a significant and positive effect of ESG controversies on bank risk-taking in both the overall sample and specifically among conventional banks, thus supporting Hypothesis 2. Since a higher ESG score indicates a lower number of ESG controversies and a higher Z-scores implies lower risk, the result shows that fewer ESG controversies significantly increases bank stability for both the full sample and conventional sub-sample. This result aligns with studies from Galletta & Mazzù (2023) and Del Sarto (2025), which found that lower number of ESG controversies can reflect stronger ESG compliance, thereby lowering risk and improving stability.

Furthermore, according to Capelle-Blancard & Petit (2019), shareholders primarily react to negative ESG news, which leads to an average market value loss of 0.1% within three days, while positive ESG news has little impact. However, this loss is mitigated for firms with strong prior ESG disclosures and a reputable sector image, but amplified when the news is economically framed or emotionally

linked to the firm. On the other hand, banks associated with more frequent ESG controversies will be perceived as disregarding sustainability issues in their business practices, so may be exposed to financial risks stemming from negative shifts in market perception (European Central Bank, 2021). Moreover, according to Galletta & Mazzù (2023), ESG controversy scores function as a market-driven control tool, guiding responsible banking conduct and mitigating operational, credit, and reputational risks in decision-making.

This positive effect might also be influenced by institutional differences in ESG implementation across countries. As noted by Aguilera & Jackson (2003) and Ioannou & Serafeim (2012), ESG practices are shaped by cultural, political, and regulatory contexts. Jackson & Apostolakou (2010) and Hahn & Kühnen (2013) further emphasized the role of societal expectations in shaping corporate ESG behavior, reinforcing the legitimacy perspective.

5.3. ESG Controversy Effect on Bank Risk at Islamic Banks

The empirical findings provide no evidence in favour of Hypothesis 3, as the effect of ESG controversies on bank risk taking at Islamic banks is insignificant. Therefore, Hypothesis 3 is rejected. This finding is consistent with Williams and Zinkin (2010), who found that although religion can be incorporated with ESG activities, there is no proof that religious beliefs affect how the UN Global Compact principles are implemented which consist of human right, labour, environment and anti-corruption principle's category. Moreover, some researchers have argued that CSR in the Islamic banking sector is merely a tangential activity (Sairally, 2013).

Furthermore, the study finds that most the Islamic banks were observed to be focused on meeting their legal, economic and shariah responsibilities, concerned primarily with profit maximisation and ensuring transactions comply with shariah principles. ESG-related activities were practised as a minor side-line activity as opposed to being an integral, well thought out and deliberate policy decision of management.

The sample of Islamic banks used in this research are from emerging and developing countries, meaning there may be a limited level of awareness and attention from investors toward ESG, including ESG controversies. This may lead to low impact of controversies on investors, and, in turn, no significant effect to bank risk. In addition, the disclosure of ESG controversies in sustainability reports or ESG databases (including Refinitiv) remains limited; this may also mean stakeholders are unaware of banks' ESG controversy scores, so there is no effect

on their investment decisions and, therefore, for bank risk (Alam *et al*, 2022).

6. Conclusion

6.1. Conclusion

The findings of this study confirm that Islamic banks exhibit significantly lower exposure to ESG controversies compared to conventional banks, aligning with the normative expectations of Islamic financial principles. Additionally, findings show that Islamic banks have higher risks than conventional banks, in line with studies from Čihák and Hesse (2010), Abedifar *et al*. (2015), and Mollah *et al*. (2017). The regression analysis also reveals that in the full sample, and the conventional banks sub-sample, fewer ESG controversies are associated with lower risk-taking, which significantly increase bank stability. However, this effect is absent for Islamic banks. The divergence in findings highlights the importance of institutional, cultural, and regulatory contexts in influencing the effects of ESG controversies.

6.2. Implication

The results offer several implications for policymakers, investors, and bank executives. First, for policymakers, this study highlights the need to strengthen regulatory oversight and ESG risk integration into core supervisory systems, including collaborating with media outlets to provide double oversight. This can help to prevent greenwashing, reduce bank risks, and enhance financial system resilience.

Second, for investors, this study underscores the role of ESG controversies as early warning indicators of financial and reputational risk at conventional banks. However, their limited informativeness at Islamic banks suggests that investors should adopt a more nuanced interpretation of ESG signals in contexts where religious principles already impose ethical constraints on bank behavior. Investment strategies may need to be adapted to account for these structural and institutional distinctions.

Third, for bank executives, particularly at conventional banks, executives must recognize the financial and reputational consequences of ESG controversies, which may invite increased regulatory scrutiny and stakeholder dissatisfaction. Furthermore, Islamic bank executives are encouraged to strategically leverage their institutions' ethical mandates, rooted in maqasid al-shariah, not only to enhance ESG compliance but also to proactively build stakeholder trust and long-

term reputational capital.

6.3. Limitations

As this study performs a comparative analysis of the effect of ESG controversies on bank risk-taking between Islamic and conventional banks, the sample was restricted to countries where both banking systems operate concurrently. This sampling criterion, while necessary to ensure comparability, significantly reduced the overall sample size.

Furthermore, given the relatively recent emergence of ESG controversies as a measurable construct, the availability of ESG controversy score data remains limited, particularly for Islamic banks. The underreporting of ESG-related controversies in the Refinitiv database has contributed to a notably smaller sample size for Islamic banks compared to their conventional counterparts.

Lastly, this study did not include several variables such as bank age, CSR committee, and institutional ownership, which could have an indirect effect on the nexus between ESG controversies and bank risk.

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APPENDIX

List of Cases in ESG Controversies in Islamic Bank retrieved from Refinitiv by Author

No	Name of Bank	Country Headquarter	Type of bank	Controversy Sectors	Topic	News Title
1	Masraf Al Rayan QPSC	Qatar	Islamic Bank	Community - Controversies	Recent Tax Fraud Controversies (2022)	UK watchdog fines Al Rayan bank over money laundering control failures - Reuters
2	Bank Syariah Indonesia Tbk PT	Indonesia	Islamic Bank	Product Responsibility - Controversies	Recent Privacy Controversies (2023)	Indonesias biggest Islamic bank says customer data safe amid reports of breach - Reuters News
				Product Responsibility - Controversies	Recent Privacy Controversies (2023)	Indonesias biggest Islamic bank says customer data safe amid reports of breach - Reuters
3	Bank Rakyat Indonesia (Persero) Tbk PT	Indonesia	Conventional Bank	Resource Use - Controversies	Environmental Controversies Count (2021)	Big banks fund rainforest deforestation - IFR News
				Product Responsibility - Controversies	Controversies Privacy (2021)	Indonesias BRI Life probes reported data leak of two mln users - Reuters News
4	Arab Bank PLC	Jordan	Conventional Bank	Human Rights - Controversies	Human Rights Controversies (2020)	U.S. Supreme Court rules for Arab Bank over human rights claims - Reuters
5	Banque Saudi Fransi SJSC	Saudi Arabia	Conventional Bank	Workforce - Controversie	Wages Working Condition Controversies Count (2018)	Ex-CEO of Banque Saudi Fransi under travel ban amid probe into staff bonus breach - Reuters New
				Community - Controversies	Business Ethics Controversies (2017)	Banque Saudi Fransi faces fine over regulatory violations -SAMA-
6	First Abu Dhabi Bank PJSC	United Arab Emirates	Conventional Bank	Community - Controversies	Anti-Competition Controversies Count (2020)	Qatar starts legal proceedings against FAB in New York in market manipulation row - Reuters News
				Community - Controversies	Business Ethics Controversies (2019)	QFC Regulatory Authority T Reuters akes Further Action Against FAB -
				Community - Controversies	Business Ethics Controversies (2019)	Qatar fines First Abu Dhabi Bank $55 mln in market manipulation probe
				Community - Controversies	Anti-Competition Controversies Count (2019)	Qatar freezes new business for First Abu Dhabi Bank amid currency probe - Reuters News
				Community - Controversies	Business Ethics Controversies (2018)	Qatar asks U.S. to investigate UAE bank for 'financial warfare' - Reuters News
7	Yapi ve Kredi Bankasi AS	Turkey	Conventional Bank	Product Responsibility - Controversies	Controversies Responsible Marketing	Two Turkish banks fined for insurance violations, shares slide - Reuters

8	Akbank TAS	Turkey	Conventional Bank	Product Responsibility - Controversies	Controversies Responsible Marketing (2020)	Two Turkish banks fined for insurance violations, shares slide - Reuters
				Workforce - Controversies	Strikes (2017)	T Gazette - Reuters urkish cabinet postpones strike at Akbank by 60 days - Official
9	Turkiye Halk Bankasi AS	Turkey	Conventional Bank	Community - Controversies	Tax Fraud Controversies (2021)	T U.S. appeals court rules urkeys Halkbank can be prosecuted over Iran sanction violations,
				Community - Controversies	Critical Countries Controversies (2021)	T U.S. appeals court rules urkeys Halkbank can be prosecuted over Iran sanction violations,
				Community - Controversies	Tax Fraud Controversies (2020)	U.S. seeks big contempt fines against T News urkeys Halkbank - Reuters
				Community - Controversies	Critical Countries Controversies (2020)	T violations, judge rules - Reuters News urkey's Halkbank must face U.S. indictment over Iran sanctions
				Community - Controversies	Critical Countries Controversies (2020)	U.S. seeks big contempt fines against T News urkeys Halkbank - Reuters
				Community - Controversies	Critical Countries Controversies (2019)	U.S. prosecutors accuse T Iran sanctions - Reuters News urkey's Halkbank of scheme to evade
				Community - Controversies	Critical Countries Controversies (2018)	U.S. seeks about 20 years prison for T sanctions case - Reuters News urkish banker in Iran
10	Bank Muscat SAOG	Oman	Conventional Bank	Community - Controversies	Business Ethics Controversies (2019)	Bank Muscat Says Fraud Complaints Reported T Prosecution In Ibri -Reuters o Public