THE ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) CRITERIA AND ITS IMPACT ON THE PORTFOLIO PERFORMANCE: IN SEARCH OF INTEGRATION BETWEEN ISLAMIC AND ESG SCREENING IN INDONESIA AND MALAYSIA

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DISSERTATION

A thesis submitted to School of Graduate Studies UIN Sunan Kalijaga
in fulfilment of the requirements for the award of the degree of Doctor in Islamic Studies with concentration in Islamic Economics

YOGYAKARTA
2020

KEMENTERIAN AGAMA RI
UIN SUNAN KALIJAGA
PASCASARJANA

PENGESAHAN

Disertasi berjudul	:	THE ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) CRITERIA AND ITS IMPACT ON THE PORTFOLIO PERFORMANCE: IN SEARCH OF INTEGRATION BETWEEN ISLAMIC AND ESG SCREENING IN INDONESIA AND MALAYSIA
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Konsentrasi	:	Ekonomi Islam

telah dapat diterima
sebagai salah satu syarat memperoleh gelar Doktor (Dr.)
dalam bidang Studi Islam Konsentrasi Ekonomi Islam

Yogyakarta, 10 Juni 2020

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Sebagaimana yang disarankan dalam Ujian Tertutup yang dilaksanakan pada tanggal 08 Januari 2020, saya berpendapat bahwa disertasi tersebut sudah dapat diajukan ke Pascasarjana UIN Sunan Kalijaga Yogyakarta untuk diujikan dalam Ujian Terbuka Promosi Doktor (S3) dalam rangka memperoleh gelar Doktor dalam bidang Ilmu Agama Islam.
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Wassalamu'alaikum wr.wb.

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ABSTRAK

Investasi syariah, dan ESG adalah dua alternatif bagi investor yang dapat mereka pilih baik sebagai sebagai subtitusi atau sebagai sebuah gabungan portfolio. Tujuan dari penelitian ini adalah untuk mengeksplorasi secara komprehensif, dan menguji dampak penyaringan ganda (Islamic dan ESG) terhadap kinerja portofolio; untuk mengeksplorasi dan meneliti secara komprehensif hubungan antara ESG dan Penyaringan Islami dengan probabilitas default; dan Untuk mengeksplorasi dampak risiko sistemik, ukuran, rasio nilai buku terhadap pasar, profitabilitas, investasi, dan momentum terhadap portofolio ESG Islam (*Islamic ESG*), portofolio ESG dan portofolio Islam, dan untuk memahami apakah terdapat perbedaan karakter antara ketiganya. Penelitian ini menggunakan portofolio yang disusun sendiri dari tahun 2011-2018 berdasarkan model *Fama and French Six Factor*. Dari portofolio tersebut, kemudian, rata-rata aritmatik dan Model Merton akan digunakan. Untuk pemahaman lebih lanjut tentang karakteristik portofolio *Islamic ESG*, enam faktor dalam model *Fama and French Six Factor* akan digunakan. Dari pengujian statistik, penelitian ini menemukan bahwa tidak ada perbedaan signifikan return portofolio antara portofolio Islam vs portofolio ESG, portofolio ESG Islam vs portofolio Islam, dan antara portofolio ESG Islam vs portofolio ESG. Selain itu, dari analisis, penelitian ini juga menemukan bahwa portofolio ESG Islam (*Islamic ESG*) di Indonesia dan Malaysia memiliki probabilitas default yang lebih rendah dibandingkan dengan portofolio Islam, dan portofolio ESG. Untuk penentu kinerja, penelitian ini secara empiris membuktikan bahwa secara keseluruhan, untuk semua portofolio yaitu Portfolio Islam, portfolio ESG, dan portofolio ESG Islam faktor MRP, SMB, dan HML adalah variabel paling kuat yang berdampak pada pengembalian portofolio. Studi ini juga mendokumentasikan hasil bahwa portofolio ESG Islami memberikan kinerja yang lebih baik dibandingkan dengan Portofolio Islami dan portofolio ESG di Indonesia dan Malaysia. Hal itu ditunjukkan oleh hubungan masing-masing variabel yaitu MRP, SMB, HML, RMW, CMA, dan UMD. Temuan ini menunjukkan bahwa investor dapat mempertimbangkan untuk berinvestasi di kedua jenis saham yaitu saham ESG dan saham Islami, atau bahkan, menggabungkan dua jenis saham tersebut ke dalam portofolio mereka. Bagi para pembuat kebijakan, sangat masuk relevan untuk membuat indeks ESG Islam yang terdiri dari perusahaan-perusahaan yang lolos seleksi sebagai saham yang sesuai syariah dan standard ESG.

Kata kunci: *Portofolio Islami, Portofolio ESG Islami, Portofolio ESG, Fama and French, Model Merton.*

JEL : G11, G17, Q56

Abstract

Islamic investment and ESG are two alternatives for investors that can be selected either as substitutive or by combining both markets. The objectives of this study are: 1) to comprehensively explore and examine the impact of double screening (Islamic ESG screening) on portfolio performance; 2) to comprehensively explore and examine the relationship between ESG and Islamic Screening with default probability; and 3) to explore the impacts of systemic risk, size, book to market value, profitability, investment, and momentum on Islamic ESG, ESG, and Islamic portfolios, and to identify if there is any difference in character among the three. This study uses a self-composed portfolio from 2011-2018 based on the Fama and French Six Factor Models. From the portfolio, the arithmetic means of excess return and Merton Model were then employed. For further understanding of the characteristics of the Islamic and ESG portfolios, the six factors that are implemented in the Fama and French Model were utilized. From the statistical testing, this study revealed that there is no difference in portfolio return between the Islamic portfolio and the ESG portfolio, the Islamic ESG portfolio and the Islamic portfolio, or the Islamic ESG portfolio and the ESG portfolio. In addition, from the analysis, this study found that the Islamic ESG portfolio in Indonesia and Malaysia has lower default probability compared to the Islamic and ESG portfolios. For the performance determinant, this study empirically evidenced that, overall, for all portfolios, namely Islamic, ESG, and Islamic ESG portfolio, MRP, SMB, and HML are the most powerful variables in terms of impact on portfolio return. The study also observed that the Islamic ESG portfolio provides better performance compared to the Islamic and ESG portfolios, both in Indonesia and Malaysia. This was indicated by the relationship of each variable, namely MRP, SMB, HML, RMW, CMA, and UMD. These findings suggest that *investors can consider investing in both markets, or even combining the two markets, in their portfolio. For the policymakers, it provides reasoning for establishing an Islamic ESG Index consisting of Islamic ESG firms.*

Keywords: Islamic Portfolio, Islamic ESG Portfolio, ESG Portfolio, Fama and French, Merton Model.

JEL : G11, G17, Q56

ملخص البحث

الاستثمار الإسلامي ، و ESG بديلان للمستثمرين سواء اختاروا أن يكونوا مبدعين أو يجمعوا بين الاثنين. الهدف من هذه الدراسة هو استكشاف واختبار تأثير الفحص المزدوج (ESG الإسلامي) بشكل شامل على أداء المحفظة ؛ لاستكشاف ودراسة العلاقة بين ESG والفحص الإسلامي مع الاحتمالات الافتراضية ؛ لاستكشاف تأثير المخاطر النظامية وحجمها ونسبة القيمة الدفترية إلى الأسواق، الربحية، الاستثمار والزخم على المحافظ الإسلامية ESG و ESG والمحافظ الإسلامية وفهم اختلافات في الشخصية إن وجد. تستخدم هذه الدراسة محفظة قائمة بذاتها من عام 2011 إلى عام 2018 استنادًا إلى نموذج العامل الفرنسي السادس(six factor). من الحافظة، سيتم استخدام المتوسط الحسابي ونموذج ميرتون (Merton). لمزيد من الفهم لخصائص المحفظة الإسلامية و ESG ، سيتم استخدام ستة عوامل مطبقة في نموذج Fama Six Factor. من الاختبار الإحصائي ، كشفت هذه الدراسة أنه لم يكن هناك فرق في عوائد المحفظة بين المحفظة الإسلامية مقابل محفظة ESG ، محفظة ESG الإسلامية مقابل المحفظة الإسلامية ، وبين محفظة ESG الإسلامية مقابل محفظة ESG. بالإضافة إلى ذلك ، من التحليل، وجدت هذه الدراسة أن محافظ ESG الإسلامية في إندونيسيا وماليزيا لديها احتمال أقل للتقصير مقارنة بالمحفظة الإسلامية ، وحافظات ESG. بالنسبة إلى محددات الأداء ، تثبت هذه الدراسة بشكل تجريبي ، بوجه عام ، أن عوامل MRP و SMB و HML هي جميع المتغيرات القوية التي لها تأثير على عوائد الحافظة ، بالنسبة لجميع المحافظ مثل الحافظة الإسلامية وحافظة ESG وحافظة ESG الإسلامية. توثق الدراسة أيضًا النتائج التي توفرها محفظة ESG الإسلامية أداء أفضل مقارنةً بمحفظة المحفظة الإسلامية و ESG في إندونيسيا وماليزيا. يتم توضيح ذلك بواسطة العلاقة بين كل متغير ، وهي MRP و SMB و HML و RMW و CMA و UMD. يوضح هذا الاكتشاف أنه يمكن للمستثمرين التفكير في الاستثمار في كلا النوعين من الأسهم ، أي أسهم ESG والأسهم الإسلامية ، أو حتى دمج النوعين من الأسهم في محافظهم الاستثمارية. بالنسبة لصانعي القرارات، من المنطقي إنشاء مؤشر ESG إسلامي يتكون من الشركات التي تتخطى الاختيار كأوراق مالية وفقًا لمعايير الشريعة والمعايير ESG.

الكلمات المفتاحية: الحافظة الإسلامية، الحافظة ESG الإسلامي، محفظة ESG ، فاما (Fama) والفرنسية ، ميرتون موديل.

MOTTO

“SEMUANYA AKU JALANI KARENA ALLOH, DENGAN BIMBINGAN KYAI, DAN UNTUK ORANG TUA, DEMI UMMAT”

TRANSLITERATION GUIDELINES

The transliteration of Arabic words used in this thesis is based on the Joint Decree of the Minister of Religion and the Minister of Education and Culture of the Republic of Indonesia Number: 158/1987 and 0543b / U / 1987.

A. Single Consonant

Arabic font	Name	Latin letters	Name
ا	Alif	Not symbolized	Not symbolized
ب	Bā’	t	Te
ت	Tā’	ṡ	es (with the above point)
ث	Ṡā’	j	Je
ج	Jim	ḥ	ha (with the below point)
ح	Ḥā’	kh	Ka and ha
خ	Khā’	d	De
د	Dāl	ż	zet (with the above point)
ذ	Żāl	r	Er
ر	Rā’	z	Zet
ز	Zai	s	Es
س	Sin	sy	Es dan ye
ش	Syin	ṣ	es (with the below point)
ص	Ṣād	ḍ	de (with the below point)
ض	Ḍad	ṭ	te (with the below point)
ط	Ṭā’	ẓ	zet (with the below point)
ظ	Ẓā’	‘	inverted comma aboveGe
ف	‘Ain	g	Ef
ق	Gain	f	Qi
ك	Fā’	q	Ka
ل	Qāf	k	El
م	Kāf	l	Em
ن	Lām	m	En
و	Mim	n	W
ه	Nūn	w	Ha
ء			
ي			

	Waw Hā’ Hamzah Ya	h ‘ Y	Apostrof Ye

B. Dual Consonants for Shaddah Written in Multiple

متعدّدة عدّة	Written Written	Muta’addidah ‘iddah

C. *Ta’marbūtah*

All Ta'marbūtah are written with h, either at the end of a single word or in the middle of a combination of words (words quoted by the article "al"). This provision is not necessary for Arabic words that have been absorbed in the Indonesian language, such as prayer, zakat, etc. unless the original word is desired.

حكمة جزية كرامةالاولياء	Written Written Written	*Ḥikmah* *Jizyah* *Karāmah al-auliyā’*

D. Short Vowels and Their Application

_ َ___ _ ِ___ _ ُ___	Fatḥah Kasrah Ḍammah	Written Written Written	*A* *i* *u*

E. Long vowels

1 2 3 4	Fathah + alif جاهلية Fathah + ya’ sukun تنسى Kasrah + ya’ sukun كريم Dammah + wawu sukunفروض	Written Written Written Written	*Jāhiliyyah* *tansā* *karīm* *furūd*

E. Vokal Rangkap

1	Fathah + ya sukun بينكم	Written Written	*Ai* *bainakum*
2	Dammah + wawu sukun قول	Written Written	*au* *qaul*

F. Sequential Short Vowels in One Word Separated with Apostrophe

أأنتم أعدّ ت لئن شكرتم	Written Written Written	*a'antum* *u'iddat* *la'in syakartum*

G. The article Alif + Lam

If followed by the Qomariyyah letter, it is written using the initial letter "al"

القران القياس	Written Written	*Al-Qur'ān* *Al-Qiyās*

H. When followed by Syamsiyah letters written with the first Syamsiyah letter.

السماء الشمس	Ditulis Ditulis	*As-Samā'* *Asy-Syams*

I. **Arrangement of words in a series of sentences**

Written according to the writing

ذوي الفروض أهل السنة	Written Written	*Zawi al-Furūd* *Ahl as-Sunnah*

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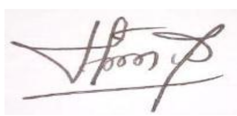
Yogyakarta, 23 Januari 2020

Penulis



Abdul Qoyum

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CHAPTER I
INTRODUCTION

A. Background of Study

Research and studies of Islamic equities have been growing rapidly, from the methodological aspects to research focus. Briefly, Islamic equity is stock which is classified as complying with sharia, using screening methods which consist of both qualitative and quantitative criteria. Firms with any involvement in conventional financial institutions, gambling, gaming, tobacco, hotels, entertainment, and so on are excluded from the list of Islamic companies. Financial ratios are also applied to Islamic companies to limit the level of interest-based income, interest-based debt, and cash and accounts receivable.[1]

One of the research focuses of Islamic equity is the screening methods, which play a vital role in differentiating Islamic equity from conventional equity. This is a current focus of both academia and practitioners[2] as there is much debate among Islamic finance scholars about the best model for sharia screening. Globally, there are many models of sharia screening which, according to Derigs and Marzban (2008), lead to different results regarding whether or not the company enters the list of sharia classified firms.[3]

Nowadays, sharia screening focuses more on negative screening[4] rather than positive screening[5]. Therefore, according to

[1] Mansur Masih and Mohammad Ashraful Ferdous Chowdhury, 'Socially Responsible Investment and Shariah-Compliant Investment Compared: Can Investors Benefit from Diversification? An ARDL Approach', 2015.

[2] Mansur Masih, Nazrol K. M. Kamil, and Obiyathulla I. Bacha, 'Issues in Islamic Equities: A Literature Survey', *Emerging Markets Finance and Trade* 54, no. 1 (2 January 2018): 1–26, https://doi.org/10.1080/1540496X.2016.1234370.

[3] Ulrich Derigs and Shehab Marzban, 'Review and Analysis of Current Shariah- compliant Equity Screening Practices', *International Journal of Islamic and Middle Eastern Finance and Management* 1, no. 4 (21 November 2008): 285–303, https://doi.org/10.1108/17538390810919600.

[4] According to Luc Renneboog, Jenke Ter Horst, Chendi Zhang (2008) negative screening refers to the practice of screening that is conducted by excluding firms from the list based on specific criteria. In sharia screening these criteria include not engaging with *riba*, *maysir*, and non-halal business activities.

Masih *et. al.*[6] the next phase of the development of Islamic equities is the integration of Environmental, Social, and Governance (ESG) factors in sharia stock screening. Moghul and Safar-Aly (2015),[7] Bennett, and Iqbal (2013)[8] have supported this view and stated the importance of infusing ESG factors in the screening process of Islamic equity where the objective is to realize *maqasid al-shari'a*. The integration of ESG factors with Islamic screening is very important because of the following reasons.

First, the ultimate objective in Islamic finance, as well as in Islamic equities established as an alternative financial system, is to realize *maqasid al-shari'a,* which emphasizes socioeconomic justice,[9] poverty alleviation, income distribution, and economic productivity.[10] According to Al-Ghazali, one of the famous scholars of the eleventh century, the purpose of *sharia* is "*to promote the welfare of the people, which lies in safeguarding their faith, their*

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[5] Positive screening, including moral, ethical, and environmental issues, should be covered by Islamic finance. There are many quranic views regarding ESG factors that strongly focus on positive screening rather than the negative screenings currently practised by Islamic finance such as *amanah*, *kholifah*, environment, and *milkiyah*. The positive principles guiding Islamic investments are: promotion of justice (*adl*), honesty and trust (*amanah*); involvement in decision-making and governance (*shura*); supervision, follow-up and monitoring (*hisba*); purification of wealth (*zakat*) and voluntary almsgiving (*sadaqah*); brotherhood and the advancement of the Islamic community (*ummah*); and protection of nature and the environment.

[6] Masih and Mohammad Ashraful Ferdous Chowdhury, 'Socially Responsible Investment and Shariah-Compliant Investment Compared: Can Investors Benefit from Diversification? An ARDL Approach'.

[7] Umar F Moghul and Samir H K Safar-Aly, 'Green Sukuk: The Introduction of Islam's Environmental Ethics to Contemporary Islamic Finance' 27 (2014): 60.

[8] Michael S. Bennett and Zamir Iqbal, 'How Socially Responsible Investing Can Help Bridge the Gap between Islamic and Conventional Financial Markets', *International Journal of Islamic and Middle Eastern Finance and Management* 6, no. 3 (23 August 2013): 221, https://doi.org/10.1108/IMEFM-Aug-2012-0078.

[9] Masih and Mohammad Ashraful Ferdous Chowdhury, 'Socially Responsible Investment and Shariah-Compliant Investment Compared: Can Investors Benefit from Diversification? An ARDL Approach'.

[10] Elias Erragragui and Christophe Revelli, 'Is It Costly to Be Both Shariah Compliant and Socially Responsible?', *Review of Financial Economics* 31 (November 2016): 64–74, https://doi.org/10.1016/j.rfe.2016.08.003.

life, their intellect, their prosperity and their wealth".[11] Given this, integrating ESG factors in to the screening methods of Islamic equity is expected to improve the achievement of *maqasid al-shari'a* in Islamic equity. This should allow for the current screening process used in Islamic equity, argued to be just *"mathematical formalism"* by critics such as Elias Erragragui and Christophe Revelli,[12] to be erased gradually.

Second, a case reported by the Human Rights Watch in 2013 further supports the integration of ESG factors into Islamic finance. Systematic *"ethnic cleansing"* of the Rohingya and extensive human rights violations perpetrated by Burma's oppressive military regime were documented.[13] Surprisingly, the report states that a regional oil company, Unical (a subsidiary of Chevron group), contributed to the situation and was named in a civil lawsuit in the U.S. federal court.[14] In response, the provider of ethical indices excluded Chevron from the ESG listed firms. While Islamic investors express their willingness to conform to Islamic ethics, controversial firms such as Chevron often stand out in the Islamic indices.

In the case of Indonesia, many firms have contributed to environmental damage. According to Indonesian President Joko Widodo, 11 companies have been penalized due to such problems.[15] Accordingly, *Pengurus Besar Nahdlatul Ulama* have stated that companies whose activities cause environmental damage are strictly prohibited.[16]

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[11] Zakaria Ali Aribi and Simon Gao, 'Corporate Social Responsibility Disclosure', n.d., 24.

[13] Erragragui and Revelli.

[14] Bernard Paranque and Elias Erragragui, 'Islamic Investment versus Socially Responsible Investment: Lessons from Comparison', in *Critical Studies on Corporate Responsibility, Governance and Sustainability*, ed. Bernard Paranque and Roland Pérez, vol. 10 (Emerald Group Publishing Limited, 2016), 355–83, https://doi.org/10.1108/S2043-905920160000010034.pp.356

[15] https://finance.detik.com/berita-ekonomi-bisnis/d-4432154/tindak-tegas-perusak-lingkungan-jokowi-11-perusahaan-sudah-didenda accessed 26/08/2019.

[16] https://republika.co.id/berita/koran/khazanah-koran/15/05/13/noa0s821-pbnu-haramkan-eksploitasi-alam-yang-merusak accessed 26/08/2019

Handling of such cases is critical to the future of Islamic finance as companies excluded from the ESG list due to mistakes in supporting social problems (such as *ethnic cleansing*) are still sharia listed companies. In addition, the attainment of *maqasid al-shari'a* in Islamic finance is still criticized by many experts. Hence, the integration of ESG factors in to Islamic finance combined with *maqasid al-shari'a* is very important to develop Islamic finance.

Third, statistics indicate that Socially Responsible Investing (SRI) and the Islamic finance industry have been undergoing a resurgence over the last three decades. Given the promising growth rate of both sectors in the financial market, the role of SRI and Islamic finance are particularly important.[17] According to the Islamic Financial Services Industry,[18] the total assets of Islamic finance showed around USD 1.89 trillion or documented a very impressive growth rate at 15-20% per annum. SRI, which is predominantly led by the US and European markets, documented $21,358 billion of global assets under management, in which approximately $8,572 billion was placed in the US, and $13,608 billion was in Europe.[19] Even though the assets of the Islamic finance industry are far beyond that of SRI, the growth of both industries shows the same trend.

Although Islamic equity shows promising growth as stated in the previous paragraph, it is important for it to continue to move toward attaining *maqasid al-shari'a* and also cover the ESG issues which have been growing rapidly in the conventional market. According to a study from Hassan and Harahap (2010), there are many debates concerning the inconsistencies in stock screening. The study illustrated that, in the stock screening process, if a company

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[17] Michael S. Bennett and Zamir Iqbal, 'How Socially Responsible Investing Can Help Bridge the Gap between Islamic and Conventional Financial Markets', *International Journal of Islamic and Middle Eastern Finance and Management* 6, no. 3 (23 August 2013): 211–25, https://doi.org/10.1108/IMEFM-Aug-2012-0078.

[18] Islamic Financial Services Industry, 'Islamic Financial Services Industry Stability Report 2017' (IFSB, 2017).

[19] Elias Erragragui et al., 'Does Ethics Improve Stock Market Resilience in Times of Instability?', *Economic Systems* 42, no. 3 (September 2018): 450–69, https://doi.org/10.1016/j.ecosys.2017.09.003.

shows elements of *riba*, *ghoror*, *maysir*, or a non-halal product, it will not be accepted as sharia company. However, companies that contradict sharia in their daily operations can still be accepted as a sharia company. Some Islamic scholars view this as unacceptable while others argue that it can be acceptable with the employment of a purification mechanism.[20] In summary, a company contributing to environmental or social problems can still be listed as a sharia-compliant company, although sharia principles indicate that it should not be listed.

Thus, the integration of ESG factors into sharia stock screening is crucial. The negative screening currently practiced by Islamic finance can be improved with positive screening.[21] Integration of ESG factors is further supported by that fact that these values are similar to the values of Islamic finance - commitment to social interests, ethical concern, individual responsibility, promotion of human welfare, preservation of the environment, and economic and social justice. The similarities indicate the compatibility of Islamic finance and SRI in terms of ethics. Through this integration, Islamic finance would not only be complying with sharia but also be beneficial to the Environment, Society, and Governance.[23] Differences of Islamic finance and SRI lie in their religious foundations. Islamic finance is derived from *maqasid al-sharia*, while SRI comes from Christian values.[24] Through integration,

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[20] Abul Hassan and Sofyan Syafri Harahap, 'Exploring Corporate Social Responsibility Disclosure: The Case of Islamic Banks', *International Journal of Islamic and Middle Eastern Finance and Management* 3, no. 3 (31 August 2010): 203–27, https://doi.org/10.1108/17538391011072417.

[21] Mervyn K. Lewis, 'Accentuating the Positive: Governance of Islamic Investment Funds', *Journal of Islamic Accounting and Business Research* 1, no. 1 (16 April 2010): 42–59, https://doi.org/10.1108/17590811011033406.

[23] Erragragui and Revelli, 'Is It Costly to Be Both Shariah Compliant and Socially Responsible?', pp.65

[24] Beebee Salma Sairally, 'Evaluating the Corporate Social Performance of Islamic Financial Institutions: An Empirical Study', *International Journal of Islamic and Middle Eastern Finance and Management* 6, no. 3 (23 August 2013): 238–60, https://doi.org/10.1108/IMEFM-02-2013-0026., pp.240

impact investing[25] in the Islamic finance industry can also be promoted.

Despite having been proposed by many Islamic finance scholars, the idea of integrating ESG factors and Islamic finance is still the subject of many debates among Islamic finance academia and practitioners. In the macro perspectives, integrating ESG factors into Islamic screening provides many benefits such as realizing *maqasid al-shari'a*, improving the quality of Islamic equity, and creating more impact investing. However, the micro perspective, namely the point of view of the investor, still needs to be convincing. Thus, a study is required to provide evidence of the benefits of integrating ESG and *Sharia* screening (referred to as Islamic ESG).[26]

Table 1.1 The Number of Publications on ESG, and ESG and Islamic Finance

Database	Total Publications on ESG	Publications on ESG and Islamic Finance
ScienceDirect	3,532	32
Scopus-Elsevier	246	4
Emerald Insight	451	14
Springer	2,796	15
Taylor and Francis	1,375	1
Wiley-Blackwall	2,975	1
Total	11,375	67

Source: Data was collected from six international databases, using the keywords "*ESG, SRI, Islamic ESG, Islamic SRI*"

[25]Impact investing refers to the investment activities that have a direct impact on the environmental and society.

[26]There are lack of studies concerning the compatibility of integrating ESG into Islamic finance. In fact, some studies show the inclusiveness result, such as one conducted by Raphie Hayat and M. Kabir Hassan (2017); Omneya Abdelsalam et al. (2014)), Abdullah M. Al-Awadhi and Michael Dempsey (2017). Bernard Paranque and Elias Erragragui (2016); Elias Erragraguy, Christophe Revelli (2016); and Erragragui Elias (2017).

Across the past 40 years, research on the issues of ESG has gained popularity among practitioners, academia and also policymakers. Moreover, the number of publications on ESG has also increased remarkably. However, this outpouring of references on ESG has been primarily concerned with the conventional perspectives.[28]

Table 1.1 shows the number of publications on ESG from 1980 to 2018. In total, there are more than 11,375 published research articles in 6 top indexed journals. However, to the best of the author's knowledge, there is limited published research on Islamic finance and its relationship with Environmental, Social, and Governance (ESG) issues. Our search of 6 international databases produced only 67 articles discussing this issue.

Although many kinds of literature discuss ESG issues, namely journals, conference proceedings, and book chapters, there are only a few examples of research focused on the issues of ESG and Islamic finance. Wilson (1997) started the discussion on ESG and Islamic finance by introducing ethical investment as the basic foundation of both ESG and Islamic finance.[29] This study has since been developed further by many researchers but studies have been mainly theoretically focussed, such as Lewis (2010),[30] and Bennett and Iqbal (2013).[31] Empirical studies have also been conducted, such as those

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[28] Many studies have produced ambiguous, inconsistent, or contradictory results (Aupperle, Carroll, and Hatfield 1985; Griffin and Mahon 1997; Rowley and Berman 2000; van Beurden and Gössling 2008; Hoepner and McMillan 2009; Revelli and Viviani 2015). Scholars and practitioners are, in particular, undecided on the general effects, including its measurement and durability (Barnett 2007; Devinney 2009; Wood 2010; Orlitzky 2011; Borgers et al. 2013; Orlitzky 2013; Reynolds 2014; Authers 2015).

[29] Rodney Wilson, 'Islamic Finance and Ethical Investment', *International Journal of Social Economics* 24, no. 11 (November 1997): 1325–42, https://doi.org/10.1108/03068299710193624.

[30] Mervyn K. Lewis, 'Accentuating the Positive: Governance of Islamic Investment Funds', *Journal of Islamic Accounting and Business Research* 1, no. 1 (16 April 2010): 42–59, https://doi.org/10.1108/17590811011033406.

[31] Bennett and Iqbal, 'How Socially Responsible Investing Can Help Bridge the Gap between Islamic and Conventional Financial Markets', 23 August 2013.

by BinMahfouz and Hassan (2013),[32] and Abdelsalam *et. al.* (2014).[33]

The theoretical studies generally discuss the basic commonalities and similarities between ESG, or SRI, and Islamic finance. The differences between ESG screening and Islamic finance need to be a subject of discussion in these works of literature. Within these discussions, the majority of researchers have called for the incorporation or integration of ESG issues into Islamic finance. There is no debate among researchers on the need for doing this as they agree that Islamic finance will more easily achieve *Maqasid al-Sharia* with the incorporation of ESG. Islamic finance should move forward from just negative screening and into the positive screening process.

The empirical research literature can be classified into two groups: 1) research comparing the performance of ESG and Islamic finance; and 2) research on integrating double screenings for the portfolio and its impact on performance. Research comparing the performance of ESG and Islamic finance continues to raise debate among scholars. Some of the findings have concluded that Islamic finance has better performance (Hayat and Hassan (2017),[34] Abdelsalam *et al*. (2014)[35]), whereas others have indicated the opposite (Al-Awadhi and Dempsey (2017).[36]

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[32] Saeed BinMahfouz and M. Kabir Hassan, 'Sustainable and Socially Responsible Investing: Does Islamic Investing Make a Difference?', *Humanomics* 29, no. 3 (23 August 2013): 164–86, https://doi.org/10.1108/H-07-2013-0043.

[33] Omneya Abdelsalam et al., 'On the Comparative Performance of Socially Responsible and Islamic Mutual Funds', *Journal of Economic Behavior & Organization* 103 (July 2014): S108–28, https://doi.org/10.1016/j.jebo.2013.06.011.

[34] Raphie Hayat and M. Kabir Hassan, 'Does an Islamic Label Indicate Good Corporate Governance?', *Journal of Corporate Finance* 43 (April 2017): 159–74, https://doi.org/10.1016/j.jcorpfin.2016.12.012.

[35] Omneya Abdelsalam et al., 'Do Ethics Imply Persistence? The Case of Islamic and Socially Responsible Funds', *Journal of Banking & Finance* 40 (March 2014): 182–94, https://doi.org/10.1016/j.jbankfin.2013.11.027.

[36] Abdullah M. Al-Awadhi and Michael Dempsey, 'Social Norms and Market Outcomes: The Effects of Religious Beliefs on Stock Markets', *Journal of*

The empirical work on integrating double screening portfolio via the simulation of certain portfolio has found that the simultaneous application of ESG and Islamic finance screening does not have any impact on the portfolio return and also results in a financial cost for the investor (Paranque and Erragragui (2016);[37] Erragragui and Revelli (2016);[38] Erragragui (2017)[39]).

However, the testing of the impacts of screening on portfolio performance is still not convincing. It needs more comprehensive and deeper analysis, especially on what factors determine the portfolio performance. The Fama and French Model is the most robust method in finance that can be applied to identify the determinants of portfolio performance. Many previous empirical studies used this model as a main tool (BinMahfouz and Hassan (2013); Al-Awadhi and Dempsey (2017); El-Masry *et al.* (2016); Ashraf and Khawaja (2016); Erragragui and Revelli (2016); Junkus and Berry (2016); Erragragui (2017); Paranque and Erragragui (2016)).

According to the Fama and French Theory (FF), there are six variables that impact on portfolio performance, namely Market Risk Premium, Size, and Book to Market Value (stated in the FF Three Factors Model),[40] plus Profitability and Investment (FF Five Factors Models),[41] and plus Momentum (FF Six Factors Model).[42] However,

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International Financial Markets, Institutions and Money 50 (September 2017): 119–34, https://doi.org/10.1016/j.intfin.2017.05.008.

[37]Paranque and Erragragui, 'Islamic Investment versus Socially Responsible Investment'.

[38]Erragragui and Revelli, 'Is It Costly to Be Both Shariah Compliant and Socially Responsible?'

[39]Erragragui Elias, 'Is It Costly to Introduce SRI into Islamic Portfolios ?', *Islamic Economic Studies* 25, no. Special Issue (April 2017): 23–54, https://doi.org/10.12816/0036189.

[40] Eugene F. Fama and Kenneth R. French, 'The Cross-Section of Expected Stock Returns', *The Journal of Finance* 47, no. 2 (June 1992): 427–65, https://doi.org/10.1111/j.1540-6261.1992.tb04398.x.

[41] Eugene F. Fama and Kenneth R. French, 'A Five-Factor Asset Pricing Model', *Journal of Financial Economics* 116, no. 1 (April 2015): 1–22, https://doi.org/10.1016/j.jfineco.2014.10.010.

the previous tests show inclusiveness results on the determinant of portfolio performance. Furthermore, there have been no studies using the Fama and French Six Factor model to understand the behavior of Islamic ESG portfolio. Therefore, this study focuses on testing the portfolio performance based on the latest model of Fama-French (FF Six Factors Model).

A study has also been conducted by Hayat and Hassan (2017)[43] on the relationship between governance and an Islamic label for the company. This study revealed that there is no significant difference in the governance aspect between Islamic and conventional firms. Corporate governance is a part of ESG debates and also an important element of an Islamic listed firm, either for screening mechanisms or company performance. It actually relates to the debt standard in the process of sharia screening which, in the traditional view (e.g. Grossman and Hart, 1982 and Jensen, 1986),[44] is the most powerful tool for improving manager discipline, which in turn can reduce conflict between the manager and shareholders. In the Islamic screening process, a company can be listed as sharia compliant if their amount of debt is below the specified debt threshold (less than 33%). This limitation of debt will perhaps lead to different characteristics of sharia companies to their conventional counterparts (e.g. Bhatt and Sultan, 2012).

Hayat and Hassan (2017) argued that recent evidence indicates that implementing good quality corporate governance will mitigate agency problems, which is in fact in line with the *sharia* principle.[45]

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[42]Eugene F. Fama and Kenneth R. French, ‘Choosing Factors’, *Journal of Financial Economics* 128, no. 2 (May 2018): 234–52, https://doi.org/10.1016/j.jfineco.2018.02.012.

[43]Hayat and Kabir Hassan, ‘Does an Islamic Label Indicate Good Corporate Governance?’

[44]Michael C. Jensen and Richard A. Posner, ‘Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers’, in *Corporate Bankruptcy*, by Richard A. Posner, ed. Jagdeep S. Bhandari and Lawrence A. Weiss (Cambridge: Cambridge University Press, 1996), 11–16, https://doi.org/10.1017/CBO9780511609435.005.

[45]Hayat and Kabir Hassan, ‘Does an Islamic Label Indicate Good Corporate Governance?’

Also, theoretically, Islamic firms should indicate better CG performance. For these reasons, this research also focusses on the issues of whether Islamic companies indicate good corporate governance or not, or, maybe the possibility of including the element of corporate governance into the sharia screening process. Only very few recent studies have attempted to investigate the relationship of the Islamic label as a sharia listed company with corporate governance. Hayat and Hassan (2017) did conduct a study entitled "Does an Islamic label indicate good corporate governance?" and found that there was no significant difference in overall governance between Islamic and non-Islamic S&P 500 firms.[46]

The recent global economic landscape, characterized by economic fragility resulting from a series of global political conditions (i.e. Britain's Exit from the European Union, and the Middle East Crisis), the increased US interest rate, and the US-China Trade war, are likely to have ramifications on the performance of the Islamic financial market. As reported by IFSB in 2017[47], the global Islamic finance industry has undergone a slowdown for two consecutive years because of exchange rate depreciation in major Islamic finance markets, such as Indonesia, Malaysia, Iran, and Turkey. Hence, it is very crucial for the Islamic finance industry to adopt a robust corporate governance policy.

Corporate governance is defined as procedures and processes in which an organization or firm is directed and controlled to help build a good environment of trust, transparency and accountability (OECD, 2015).[48] This definition means that corporate governance is a set of relationships between company management, a board of directors, shareholders, and other stakeholders. In many kinds of literature, it has been reported that the lack of a corporate governance

[46]Hayat and Kabir Hassan.

[47]Islamic Financial Services Industry Stability Report 2017'.

[48]Samy Garas and Suzanna ElMassah, 'Corporate Governance and Corporate Social Responsibility Disclosures: The Case of GCC Countries', *Critical Perspectives on International Business* 14, no. 1 (5 March 2018): 2–26, https://doi.org/10.1108/cpoib-10-2016-0042.

framework is one of the causes of economic crisis (Alnasser and Muhammed, 2012;[49] Al-Malkawi, Pillai, and Bhatti, 2014;[50] Dalwai, Basiruddin, and Rasid, 2015[51]). Among notable cases of corporate failure are renowned companies such as WorldCom Inc., Enron, and Lehman Brothers with failure being due to a lack of proper functioning corporate governance (Quadri, 2010).[52] Considering this, various models of corporate governance have been developed to improve the performance and effectiveness of companies (Barca and Becht, 2001). The two major corporate governance models are (i) the Anglo-Saxon model of corporate governance,[53] and (ii) the continental European model of corporate governance[54] (Muneeza, 2013).

The notion of corporate governance was originally based on Agency Theory in 1930. At the time, the focus of this theory was how to solve conflict between the principal and the agent.[55] However, in the next phase, the scholars discussed CG from many different perspectives. For example, some scholars focused on examining the companies and shareholders who act as the

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[49] Sulaiman Abdullah Saif Alnasser and Joriah Muhammed, 'Introduction to Corporate Governance from Islamic Perspective', *Humanomics* 28, no. 3 (24 August 2012): 220–31, https://doi.org/10.1108/08288661211258110.

[50] Husam-Aldin N. Al-Malkawi, Rekha Pillai, and M.I. Bhatti, 'Corporate Governance Practices in Emerging Markets: The Case of GCC Countries', *Economic Modelling* 38 (February 2014): 133–41, https://doi.org/10.1016/j.econmod.2013.12.019.

[51] Tamanna Abdul Rahman Dalwai, Rohaida Basiruddin, and Siti Zaleha Abdul Rasid, 'A Critical Review of Relationship between Corporate Governance and Firm Performance: GCC Banking Sector Perspective', *Corporate Governance: The International Journal of Business in Society* 15, no. 1 (2 February 2015): 18–30, https://doi.org/10.1108/CG-04-2013-0048.

[52] Habeeb A Quadri, 'Conceptual Framework for Corporate Governance in Nigeria – Challenges and Panaceas', 2010, 8.

[53] The Anglo-Saxon model of corporate governance is also known as the 'shareholder model' and focuses on shareholders as the key stakeholders.

[54] The European model of corporate governance, also known as 'stakeholder model', considers other stakeholders as important.

[55] Daniel James, 'The Modern Corporation and Private Property, by Adolf A. Berle Jr. and Gardiner C. Means', n.d., 4.

principal,[56] while other scholars have expanded CG from not only their shareholders but also to include all their stakeholders, either internal or external (Caramolis-Cötelli, 1995[57]; Keasy and Wright, 1997[58]; Roe, 2005[59]; Pintea, 2015[60]). In current CG research, many researchers are expanding CG with emphasis on the positive influence of governance practices on environmental, social, and economic development (Ahmed and Mohammad, 2005 [61] ; Krechovská and Procházcová, 2014[62]; Tophoff, 2007[63]). This study is a part of the current effort to identify the impacts of integrating ESG aspects in investments on portfolio performance, with a focus on sharia-listed companies in Indonesia and Malaysia. This research is crucial as being a sharia-listed company should not only consider the core business and financial ratio, but also good ESG qualities including governance. Indonesia and Malaysia were chosen as the research focus areas since both countries are market leaders in Islamic equity.

[56] Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance', *The Journal of Finance* 52, no. 2 (June 1997): 737–83, https://doi.org/10.1111/j.1540-6261.1997.tb04820.x.

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Most previous studies on ESG and portfolio performance have focused on the developed countries, and relatively less attention has been given to the emerging countries, including the ASEAN countries (especially Indonesia and Malaysia). Therefore, it is important to now discuss ESG combined with sharia screening issues and its relationship to portfolio performance in Indonesia and Malaysia.

Due to the importance of Environmental, Social, and Governance (ESG) factors, *maqasid al-shari'a* of sharia listed companies and also default probability, there is an urgent need to investigate and understand the relationship among ESG factors, Islamic screening, and portfolio performance. This study focuses on analyzing and exploring this relationship with the aim of assisting the stakeholders, regulators, shareholders, management, and investors in achieving their objectives to invest in Islamic ESG firm.

B. Research Question

In current practice, to be listed as a sharia company the company must fulfill all of the screening standards determined by the authority. However, in practice, the conditions of *shari'a* companies often do not support the *maqasid al-shari'a*. Hence, by connecting with the market trend, in which developed countries are aware of ESG issues, Islamic firms will find satisfying this standard more achievable. In addition, corporate governance is also an important part of the daily operations of a firm that can guarantee all business operations are conducted in a good, transparent, and accountable manner. Therefore, it is expected that through the integration of Islamic screening with ESG factors, the quality of sharia listed companies, and also the overall Islamic equity market, will be more beneficial to the development of society. This research will encompass the impact of ESG and Islamic screening on a firm's performance and default risk. The following questions will be addressed in this study:

1. Does the Islamic ESG portfolio perform better than either the Islamic portfolio or the ESG portfolio alone?
2. Is the default probability (risk) of the Islamic ESG portfolio improved compared to either the Islamic portfolio or the ESG portfolio alone?
3. Do systemic risk, size, book to market value, profitability, investment, and momentum have better impacts on the Islamic ESG portfolio performance than either the Islamic portfolio or the ESG portfolio?

C. Research Objectives

The main objectives of the study are as follows:

1. To comprehensively explore and examine the impact of double screening (Islamic ESG screening) on portfolio performance compared to single screening (Shariah Screening or ESG screening).
2. To comprehensively explore and examine the relationship between Islamic ESG, ESG, and Islamic Screening with default probability.
3. To explore the impacts of systemic risk, size, book to market value, profitability, investment, and momentum on the Islamic ESG, ESG and Islamic portfolios and to understand if there is any difference in character.

D. Research Contributions

This study has an important contribution to the enrichment of literature on Islamic finance in the areas of Islamic equity and sharia-screening methods in relation to ESG and *maqasid al-shari'a*, and also impacts on portfolio performance. From the theoretical point of view, this study expands and develops existing literature on ESG and Islamic finance, which are currently a focus of many Islamic economic scholars. Previous research[64] has covered discussions on ESG, Islamic index, and *maqasid al-shari'a* and the related portfolio performance and default probability. This study covers new insights gained by relating ESG to Islamic index which will provide a huge contribution to the development of Islamic finance theory.

From the empirical perspective, the study of ESG and Islamic finance is viewed as the most interesting topic in the Islamic finance discipline. Many journal articles have been written by promising Islamic economic scholars, with the majority in this area focusing on trying infuse ESG aspects into Islamic equity. Clearly, the main objectives are to improve the quality of Islamic finance and it's ability to realize the objectives of sharia such that it can move forward from the mathematical formalism practiced today. This study focuses on enriching our understanding of ESG factors in practice in the countries of Indonesia and Malaysia. These two countries have been selected because they are among world leaders in the Islamic capital market. In addition, both countries have their own sharia boards that decide their own sharia screening standards. For a deeper understanding, this study also covers further issues, notably the impact of triple screening on company and portfolio performance.

Finally, from the practical point of view, sharia screening is undoubtedly the most significant aspect of the Islamic capital market that determines whether or not a company is sharia-compliant, and thus, whether or not an investor can buy or sell his or her stock. ESG index has been showing promising growth in the West with companies that are aware of environmental and social issues. There is great potential for Islamic finance stakeholders to integrate Islamic screening with ESG. This study is intended to assist regulators and policymakers in the creation of a new model of sharia screening that covers both ESG and *maqasid al-shari'a* and considers corporate governance as a key component. Aside from this, other researchers

[64] This study focuses on the case of Indonesia and Malaysia as both are recognized as key players in the Islamic finance industry.

could use the outcomes of this study to guide their research in the future.

E. Structure of the Thesis

In order to accomplish the research objectives and to answer the research questions, this thesis is organized into five chapters.

Chapter One provides an overview of the thesis by giving a brief introduction to the importance of Environmental, Social, Governance (ESG) aspects in Islamic finance, and the relationship with portfolio performance. This chapter outlines the background of the study and discusses existing problems as well as the significance and contribution of the study. The research objectives and research questions are also presented. Finally, the scope of the study and the structure of the thesis are also given.

Chapter Two focuses on the literature review and relevant underpinning theories of investment and portfolio performance, sharia screening, capital structure, stakeholder theory, theory of ESG, and SDGs and Islamic finance. It starts with the theory of investment and portfolio performance and then moves to sharia screening, including the basic concepts and also previous research in sharia screening. This chapter then discusses existing literature of capital structure and its relation to sharia screening. This begins with the underpinning theories of capital structure - MM Irrelevance Theory, Trade-Off Theory, Pecking Order Theory, Signaling Theory, and Market Timing Theory. Next, this chapter discusses the literature on stakeholder theory that has been used as the basis for ESG theory and practice. This chapter also describes the theory of ESG and some previous studies that focused on the relationship with portfolio performance. In addition, the SDGs and *maqasid al-shari'a* are explained in this chapter. Finally, this chapter provides a discussion of the theoretical framework of this study and the hypothesis development based on the indepth literature review.

Chapter Three outlines the research methodology used in this study, specifically the research design and data collection procedure.

This chapter also explains advanced econometric techniques such as independent sample T-Test, Multiple Linear Regression, and also the Moderated Regression Analysis, including model specifications and diagnostic tests. In addition, this chapter describes the variables and operational definitions for both the Fama-French Model and the Merton Model.

Chapter Four details the empirical findings and analyses of this study. The crux of this study is presented in this chapter. It starts with the descriptive statistics of key variables in this study: average return of portfolio, both Indonesia and Malaysia, and portfolio constituent. The discussion then continues to the tests of the different portfolio performances of Islamic Portfolio, ESG Portfolio, and Islamic ESG portfolio in the cases of Indonesia and Malaysia. Following this, testing of the default probability amongst the three portfolios using the Merton Model is discussed. Next, this chapter comprehensively discusses the empirical results from multiple linear regression of each portfolio determinant based on the Fama-French model. Finally, this chapter also reports on robustness tests to provide more reliable and insightful information. The data here was analyzed using SPPS and STATA 13.0 statistical software.

Finally, Chapter Five provides the conclusion and suggestions for further research. It highlights the contribution this study will make to the academic and practical fields. This chapter also provides the research implications, such as theoretical and practical implications. In addition, the author also provides the limitations of the study along with some suggestions for further research.

CHAPTER V
CONCLUSION AND RECOMMENDATIONS

A. Summary of the Research Findings

By conducting a comprehensive analysis of the new area of Islamic finance, namely Islamic ESG screening using the Fama and French Six-Factors Model and the Merton Model, several conclusions have been made and are documented in this chapter.

1. To comprehensively explore and examine the impacts of double screening (Islamic Screening and ESG), compared to single screening (either sharia screening or ESG screening), on portfolio performance in the case of Indonesia and Malaysia.

This study first examined the impacts of Islamic ESG screening on portfolio performance compared to the traditional portfolios, Islamic and ESG. From the statistical testing, this research revealed that there is no difference in portfolio performance between Islamic portfolios and ESG portfolios, Islamic ESG portfolios and Islamic portfolios, and Islamic ESG portfolios and ESG portfolios.

From the descriptive analysis, this study documented an interesting finding; namely, in case of Indonesia and Malaysia the trend of portfolio return move altogether amongst Islamic ESG portfolio, Islamic portfolio, and ESG portfolio. Specifically, in the case of Malaysia, the performance of Islamic ESG is better than the Islamic portfolio and ESG portfolio.

With more comprehensive analysis, from the combination of the portfolio using the Fama and French Six Factors Model, this study determined that in Indonesia there are 9 (nine) portfolio models for Islamic ESG that provide a better return for the investor than the Islamic and ESG portfolios. These include a small firm with low medium BM ratio, a small firm with low BM ratio, a big firm with high BM ratio, and a big firm with low BM ratio. In Malaysia, there are 11 portfolios that provide better performance for the investors. From this, the study could conclude that integrating Islamic standards with ESG values will not cause financial loss for the investor.

From the risk point of view of each portfolio, this study found that Islamic ESG has a lower risk compared to the Islamic portfolio. This finding was obtained from the standard deviation of some portfolio combinations. In summary, there are 16 portfolios variations of Islamic ESG that have a lower risk compared to the Islamic portfolio, in the cases of Indonesia and Malaysia.

Therefore, this finding provides empirical evidence that there is no adverse impact of Islamic ESG on portfolio performance. Therefore, Islamic screening must move beyond its current model and into integration with ESG values.

2. To explore and examine comprehensively the impact of Islamic ESG on the Default Risk of the Portfolio.

The basic question that needed to be answered was, 'in Islamic ESG investments, does the average probability default of portfolio differ?' It is natural that Islamic ESG would have a better financial performance since, in the screening procedures, the firm must pass the quantitative standards, such as low debt-equity ratio, low non-halal income, and so on. Therefore, by being listed as sharia, the firm indicates that they do not have any financial problems, thus the default probability is lower than non-sharia listed companies.

ESG also has some specific criteria. To be categorized as an ESG firm, the firm should have good environmental awareness, a social impact, and good governance. Just like Islamic screening, this screening gives the ESG firm a lower risk than its counterparts. Considering this, if Islamic and ESG are combined into a screening model, what happens to the default probability of the firm?

Using the Merton Model, this study calculates the default probability of each company, and then finds the average default probability of each portfolio. From the analysis, it was revealed that the Islamic ESG portfolio, in Indonesia and Malaysia, has lower default risk compared to the Islamic portfolio and the ESG portfolio. In the case of Indonesia, the average default probability (PD) is 0.0503%, which is much lower than the Islamic portfolio's PD of around 4.78%. In Malaysia, the PD for the Islamic ESG portfolio is 0.057% compared to 0.714% for the Islamic portfolio and 1.932% for the ESG portfolio.

In addition, from statistical testing, this study revealed that the PD of Islamic ESG differs significantly with Islamic portfolios for both Indonesia and Malaysia. This finding suggests that Islamic ESG screening will provide benefits for the investor since they will have portfolio constituents that are in good financial condition. This study is very interesting in the fact that it challenges previous studies that found there was no different risk between Islamic ESG and Islamic portfolio.

Therefore, this study observes that blending Islamic screening with ESG is a positive thing for the future of Islamic finance. This screening will provide benefits for the investor if they select firms listed as Islamic-ESG firms as their portfolio constituents. By selecting these Islamic ESG firms, investors will face lower default probability.

3. To explore the if impact of systemic risk, size, the book to market value, profitability, investment, and momentum on Islamic, ESG and Islamic ESG portfolios differs.

Next, this study examined the determinants of the return of Islamic portfolio, ESG portfolio, and Islamic ESG portfolio between the years 2011 until 2018 to detect if there are any different characters amongst the portfolios. In this investigation, six variables were chosen based on Fama and French's Six Factors Model, namely Market Risk Premium, Size of the firm, B/M ratio, Profitability, Investment, and Momentum. We analyzed the relationship between portfolio return with the six independent variables using multiple linear regression. Our objective was first, to find the impact of each dependent variable on the portfolio return. Second, to see the different characteristics of each portfolio with each variable. And finally, to see if any difference in character is displayed among the portfolios, in Indonesia and Malaysia, using the Fama and French Six Factor model.

This study found that for all portfolios types, namely Islamic, ESG, and Islamic ESG portfolios, MRP, SMB, and HML are the most powerful variables to impact on portfolio return. In more detail, MRP and Size have positive relationships with portfolio return, whereas HML has a positive impact in Indonesia but a negative impact on Islamic portfolio in Malaysia. This study also interestingly found that Islamic ESG portfolio are less sensitive to systemic risk (MRP), size of the firm, and also B/M value.

In addition, this study also revealed that momentum only has an impact on Islamic portfolio, while RMW only has an impact on Islamic ESG portfolio. The other results showed no significant impact, especially for CMA on portfolio performance. This finding supports the previous argument that Islamic ESG has a lower sensitivity to the risk. Therefore, it would be beneficial to adopt Islamic ESG screening.

From the statistical analysis, the study also found empirical evidence that the capital market in Malaysia is less sensitive to systemic risk than Indonesia. This is indicated by the lower beta of the three types of the portfolio (Islamic, ESG, and Islamic ESG portfolio) than was observed in the Indonesian portfolio. Similar observations were made for size; combining portfolios based on size has a lower impact in Malaysia than Indonesia. This suggests that, in the broader prespective, the capital market in Malaysia is more stable than Indonesia. This finding may be reflected in Malaysia's whole macroeconomic condition whereby Malaysia has better economic stability.

Turning to the characters of each portfolio, this study used panel regression with dummy interaction to reveal that for Market Risk Premium (MRP) there are no different characters amongst all types of the portfolio in Indonesia and Malaysia. This indicates that in facing systemic risk, all portfolios have the same response. This is the expected situation since systemic risk is the risk that cannot be removed by diversification. Thus, the basic argument in portfolio diversification is supported.

In addition, this study documented an interesting result for the size, or SMB, variable in which the

Islamic ESG portfolio is not Small-Micro Caps portfolio. This can be seen from the regression result where the beta coefficient for SMB of Islamic ESG portfolio is lower than either the Islamic portfolio or the ESG portfolio. Therefore, the size effect hypothesis is not fully reflected in Islamic ESG portfolio.

In regards to B/M ratio, this study discovered that Islamic ESG has lower sensitivity to B/M ratio in Indonesia, while in Malaysia there are no different characters amongst the three types of portfolios. In addition, analysis of the profitability variable showed that Islamic ESG has lower response to profitability fluctuation than the other portfolio. This finding supports the basic argument of Stakeholder Theory, which argues that the objective of the firm is not only profit maximization but to cover the goals of all stakeholders. In the case of Indonesia, Investment and Momentum are the other variables that have low impact on portfolio performance; however, this was not the case for Malaysia. The findings provide evidence that Islamic ESG has better characters with all of the six variables used by Fama and French.

Through statistical testing using the Fama-French Six Factors variables, this study has revealed that Islamic ESG portfolio has better performance than Islamic Portfolio and ESG portfolio in both Indonesia and Malaysia. This has been indicated by the relationship of each variable namely MRP, SMB, HML, RMW, CMA, and UMD.

Lastly, to support the findings, this research also performed testing on portfolio integration in Indonesia and Malaysia. The objectives were to support the previous findings argument, that there is a significant impact of Islamic ESG screening on portfolio return. To do this, this study performed VAR analysis to see the long-run equilibrium between Islamic portfolio, ESG portfolio, and Islamic ESG portfolio.

The results of this analysis revealed that for both the Indonesian and Malaysian cases there is a high correlation amongst portfolios. This finding indicates that the portfolio return of Islamic, Islamic ESG, and ESG move together. All positive signs of correlation indicate that Islamic ESG is performing close to the other portfolio. In addition, from the IRFs result we can argue that the innovations in Islamic ESG and ESG portfolios are rapidly transmitted to the Islamic portfolio in the case of Indonesia where the response is very similar. This result shows that there is no difference in behavior of the return between Islamic portfolio and the other portfolio. Therefore, integrating Islamic screening with ESG screening will not impact on the return generated for the investor. Moreover, this integration will provide a better impact of Islamic finance on the society due to the agreement with *maqasid al-shari'a* principles.

B. Research Implications

1. Contribution to Knowledge

First of all, this study contributes to the existing body of Islamic finance literature, which contains a limited amount of studies on ESG screening, Islamic screening, and their relationship with portfolio performance analyzed using the Fama-French Six Factor Model and the Merton Model. The existing discussions on ESG in Islamic finance literature are more theoretical and very much abstract. Hence, the findings of this study are expected to provide new evidence and valuable insights to enhance our understanding of the topic of Islamic ESG and

Portfolio Performance based on Fama-French, specifically for the Muslim market economy.

Second, this study applied the Fama French (FF) Six Factors Model and the Merton Model. This has never been done by previous research on Islamic ESG portfolio performance. In addition, this study does not simply use the FF Six Factor Model but also takes into consideration further testing, such as the use of Panel Regression with interaction, to confirm the results. Therefore, it is expected that the bulk dimensions of Islamic ESG portfolio performance used in this study are more meaningful and powerful.

Third, another contribution to the literature is a comprehensive empirical analysis of Islamic ESG portfolio performance based on some underpinning theories. Hence, the study is related to the portfolio performance with many theories such as Stakeholder Theory, Capital Structure Theory, and Agency Theory. This study broadens Islamic finance literature in the subjects of ESG, Islamic finance, and portfolio performance in terms of tools and instruments used. Thus, it is expected that the findings are more reliable and can provide the optimal results.

Fourth, this study examines issues of Islamic ESG, Islamic, and ESG portfolio performance in a sample of different countries, Indonesia and Malaysia. Studying Indonesia and Malaysia is very critical for the future development of Islamic finance as these two countries are the market leaders of the Islamic capital market of the world. In addition, these two countries have their own sharia standards formulated by their own sharia advisory councils. The breakdown of the sample into different countries provides more valuable insights and more informative results.

Finally, the results of this study have laid down the groundwork upon which a more detailed evaluation of Stakeholder Theory in the Islamic worldview can be conducted. The Stakeholder Theory can be applied as an umbrella theory of the Islamic screening that has been practiced in Indonesia and Malaysia, but with modifications. The Stakeholders of Islamic firms are not only the well-known conventional parties, such as customers and suppliers, but also the God in which mankind has a responsibility to when doing business. In addition, the findings also provided evidence that the Fama-French Theory is also relevant for the investment analysis. Hence, the assumption that the portfolio is not only affected by the systematic risk as stated by the Fama-French Theory has been approved. In contrast, the CAPM model for analysis of the Islamic, ESG, or Islamic ESG portfolio is not fully relevant, since there are other determinants of performance, such as SMB, HML, and Momentum.

2. **Contribution to Practitioners and Regulators**

Knowledge of the impacts of Islamic ESG screening and portfolio performance is very important for practitioners and regulators. Several contributions of this study to the industry and regulators are as follows:

First, this study provides a scientific argument on the visibility of the Islamic ESG model in Islamic finance. Islamic ESG is believed by many Islamic finance practitioners as the future trend of Islamic finance. The main reasoning for this is that the current practices of Islamic finance are still far from achieving the objective of realizing *maqasid al-shari'a*.

Second, in the case of the Islamic capital market, we can see that the difference between Islamic investments and non-Islamic investments is only in the screening methods. If we check the screening model of Islamic finance, it is apparent that the focus is on mathematical formalism and does not cover any social issues. Therefore, by integrating ESG values, which are concerned with the issues of environment and society, with Islamic screening an investor can contribute significantly to society. Therefore, it is a very urgent agenda of practitioners and policymakers to introduce a new model for Islamic stock screening, namely the Islamic ESG standard.

Third, this study provides empirical evidence that, in the investors point of view (the micro-level), Islamic ESG screening will not impact on the return gained by the investor. Moreover, in case of risk, the Islamic ESG portfolio model has a lower risk. Therefore, this finding will be important to the basic argument for the implementation of Islamic ESG, as a part of sustainable finance, by policymakers.

Fourth, this study revealed that using Islamic ESG screening as the basic consideration in portfolio construction provides better investment results for investors. Accordingly, by implementing Islamic screening and ESG screening, investments will generate a higher income compared to use of a single screening method (either Islamic of ESG). The findings of this study can be used as the argument that *"doing well business will provide good financial performance"*.

C. Limitations of the Study

Although this study has made advances in investigating and arriving at certain results on the subjects of return and risk of the portfolio and its determinants, there are some limitations of this study.

1. The proxy used in measuring performance is limited to market-based measurement, namely the Fama and French model.
2. This study is limited to determining the relationship between portfolio performance and six variables, as stated by Fama and French.
3. This study is limited in the availability of the sample and the completeness of the data.

D. Future Research Recommendations

After going through the issues of performance of Islamic ESG, Islamic, and ESG portfolios, it certainly has opened up more room for further research related to these issues. In this regard, we highlight several recommendations for future research.

First, this study mainly focuses on the performance of the portfolio with the Fama and French model, known as market-based model, rather than using all of the measurement models of portfolio performance. Further research can extend the analysis by incorporating CAPM (market model), the Sharpe, Jansen, and Treynor Ratio (risk-adjusted based model), and also other models, such as the *maqasid al-shari'a* model and so on. In addition, future research could also consider developing its own model of screening to obtain new insights into Islamic ESG.

Second, future research could also look into the other determinants of portfolio performance, such as macroeconomic variables and other fundamental factors.

Third, further research could embark upon more samples, not only Indonesia and Malaysia, but also comparison to other ASEAN countries such as Singapore, Thailand, and the Philippines.

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