THE INTERSECTION OF ESG AND PROFITABILITY: A MALAYSIAN BANKING PERSPECTIVE

Euphrasia Pang
Graduate School of Business, Universiti Sains Malaysia,
11800 USM Pulau Pinang, Malaysia
Faiza Saleem
Graduate School of Business, Universiti Sains Malaysia,
11800 USM Pulau Pinang, Malaysia
Email: faizasaleem@usm.my

Abstract

One of the most commonly discussed topics in today's business world relates to Environmental, Social, and Governance ("ESG"). ESG not only concerns business operations but also dives into how business operations impact the environment and the community. ESG is of particular importance to the banking industry as it forms the foundation of a country's economy. This *study looked at how ESG factors (Environmental Factors: Total Waste Consumption ("IETWC") and Total Carbon Emission ("IETCE") relate to the financial performance of commercial banks in Malaysia. The ESG factors are: Overall Gender Diversity ("ISGD"), Training and Development Expenditure ("ISTDE"), and Board Gender Diversity ("IGBGD"). The governance factors are: Board Size ("IGBOD") and Return on Assets ("ROA").* The collected data were analysed using the Correlation Analysis as well as the Multiple Regression Analysis. Overall, the correlation analysis found that IETWC, IETCE, ISGD, and IGBGD have a positive impact on DROA, while ISTDE and IGBOD have a negative impact. It also suggests that the collective environmental and governance factors showed a positive relationship with ROA while the collective social factor showed a negative impact on ROA. The multiple regression analysis, however, showed that only ISGD and IGBGD had a significant relationship with DROA. The findings of this research point to the growing importance of ESG for the commercial banking sector in Malaysia. To ensure sustainability, commercial banks in Malaysia should prioritize their ESG performance.

Keywords: ESG, Financial Performance, Malaysian Banks

Introduction

In the dynamic landscape of contemporary business, the evaluation of firm performance extends beyond traditional financial indicators. It encompasses a broader spectrum of consideration including environmental, social and governance ("ESG") factors (Buallay et al., 2020). ESG started off as an investment philosophy focusing on sustainability and socially responsible practices, while excluding companies with ESG concerns. It was well known as Socially Responsible Investing ("SRI") in the 1970s, and then as Corporate Social Responsibility ("CSR") in the past two decades. Although the term evolved over the years to what is now known as ESG, its primary focus has always been on ethical issues and sustainable business practices (Tiwari et al., 2023). ESG stands for three different pillars: environmental, social and governance. The environmental pillar focuses on ecological impact of an organisation, including how well a company utilises its resources and how the company's business operations impact climate changes (Senadheera et al., 2021). The social pillar addresses areas such as human rights, labour practices, employee trainings, workplace diversity as well as the well-being of the company's various stakeholder group (Sultana et al., 2018).

The governance pillar pertains to corporate structure such as the board of directors and its various board committees, ethics, and transparency (Aldowaish et al., 2022). Some of the most common ESG metrics are carbon footprint, water consumption, waste generation and energy consumption for the environmental pillar; diversity and inclusion, employee training and development, employee safety record and community impact for the social pillar; and board size and diversity, board committees and executive compensation for the governance pillar (Ahmad et al., 2023), each of, which play a crucial role in promoting and maintaining business sustainability.

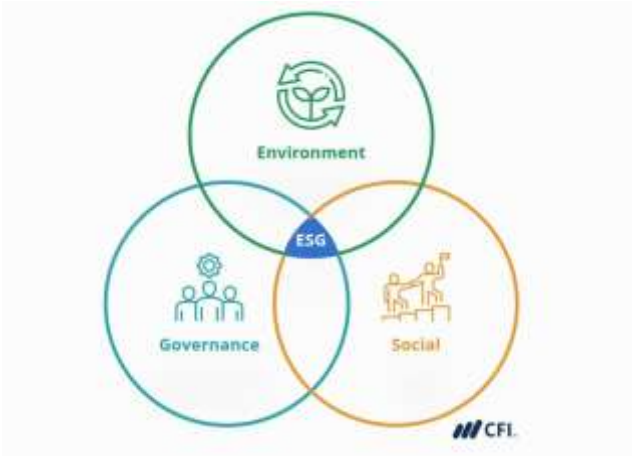

Figure 1: ESG Framework
Source: Peterdy & Miller (2023)

The concept of ESG goes hand in hand with the Triple Bottom Line ("TBL") theory, a purpose driven business concept that seeks to drive positive changes in organisations without compromising financial success (Crace & Gehman, 2022). The TBL theory focuses on the interconnectedness of profits, people and planet ("3Ps"), with the objective of creating a holistic, resilient, and sustainable business approach that aligns with ethical values (Nogueira et al., 2023), which is in line with the concept of ESG which focuses on business sustainability.

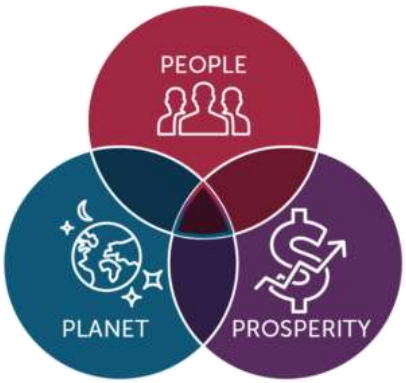

Figure 2: 3Ps / Tripple Bottom Line Theory
Source: University of Wisconsin (2023)

As global crises intensified, governments worldwide started promoting sustainable business practices through ESG regulations (Mavlutova et al., 2021). This forced companies to respond by evolving their ESG landscape, expanding their ESG-focused funds and issuing sustainability reports to communicate publicly their ESG commitments and to ensure the

transparency of their ESG initiatives. Yet, many companies still face ambiguity in defining and reporting their ESG initiatives as there is a lack of universally accepted standards and metrics for the evaluation of ESG performance (Azmi et al., 2021).

In the banking sector, ESG is especially crucial as failures can have a ripple effect on the wider economy (Beltratti & Stulz, 2011). This is evident through the collapse of the Lehman Brothers in 2008 and the fall of the Silicon Valley Bank in 2023, resulting from the failure in identifying, mitigating, and managing of governance related risks. Banks worldwide responded by implementing sustainable lending initiatives, tracking carbon footprints, and promoting diversity and equality among their workforce (Ferretti et al., 2024). Apart from that, banks worldwide have been working towards improving their governance structures by having various committees such as the audit and risk management committees at the board level, thereby ensuring that the banks adhere to ethical standards, are rid of conflicts of interests and are in compliance with rules and regulations (Al-Khouri & Abdul Basith, 2022).

Empirical evidence suggests mixed results in relation to the correlation between ESG and bank financial performance. While Buallay et al. (2020) noted a positive correlation between ESG factors and bank financial performance, El Khoury et al. (2021) noted that the positive effect only holds true up to a certain level of ESG investments. Other studies, however, found no relationship between ESG factors and bank financial performance (Matuszak & Różańska, 2017).

Research Framework

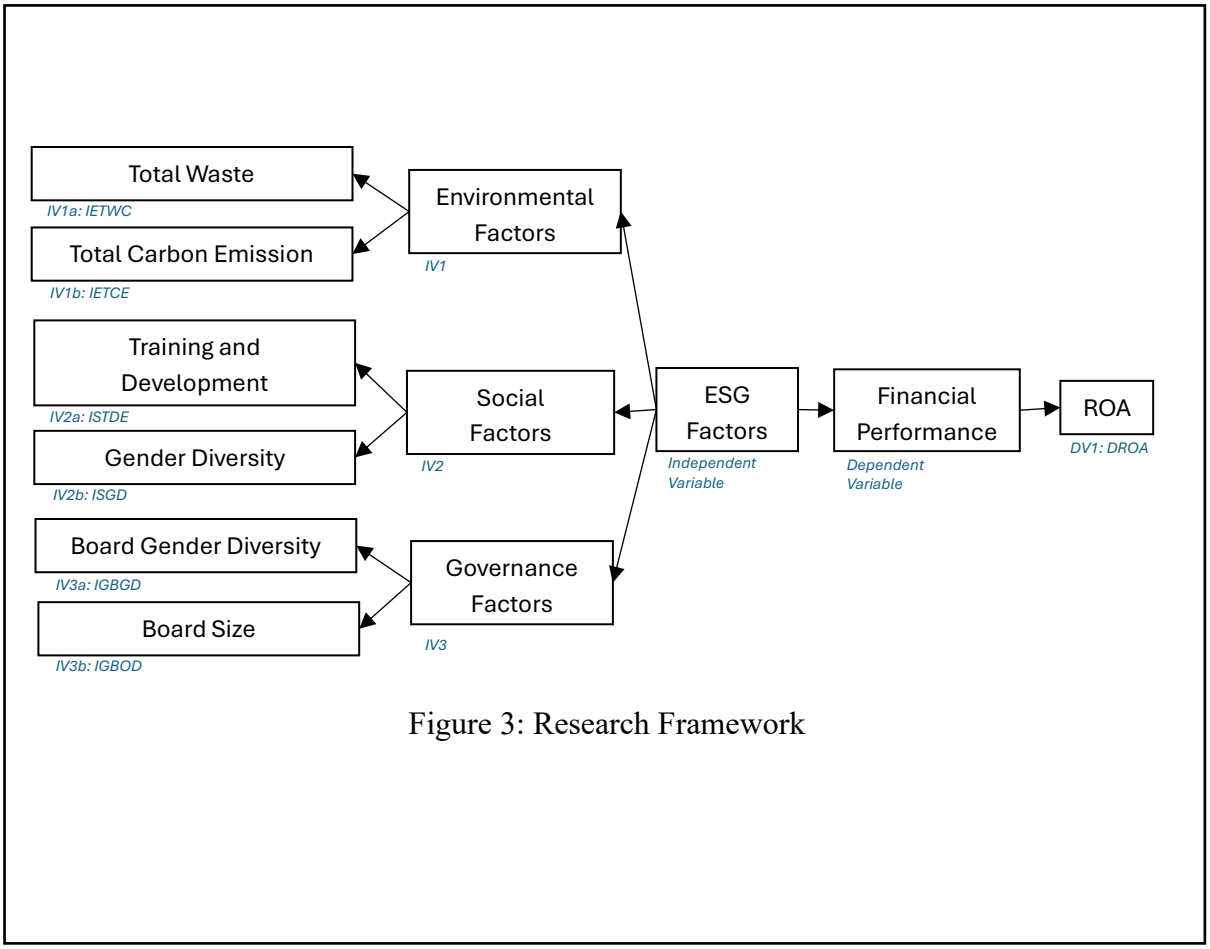

Figure 3: Research Framework

Research Hypotheses

Table 1 Hypotheses

No.	Hypotheses
Ha0	There is no relationship between Total Waste Consumption and ROA.
Hb0	There is no relationship between Total Carbon Emission and ROA.
Hc0	There is no relationship between Training and Development Expenditure and ROA.
Hd0	There is no relationship between Gender Diversity and ROA.
He0	There is no relationship between Board Gender Diversity and ROA.
Hf0	There is no relationship between Board Size and ROA.

Data Analysis

This study used logarithmic transformations in data analysis as the data extracted from the sustainability reports, annual reports and financial statements of the banks are skewed and does not follow a normal distribution, but the Correlation and the Multiple Regression analysis assumes a normally distributed data. By applying logarithmic transformations, the outlier in the dataset becomes less influential, thereby giving a more accurate result.

1. Descriptive Statistics

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
IETWC	56	12.025	1.327	8.780	14.397
IETCE	56	10.114	0.800	8.600	11.462
IET	**56**	**11.069**	**0.975**	**8.865**	**12.808**
ISTDE	56	17.211	0.931	15.425	18.778
ISGD	56	-0.530	0.083	-0.916	-0.460
IST	**56**	**8.341**	**0.440**	**7.465**	**9.096**
IGBGD	56	-1.397	0.471	-2.833	-0.811
IGBOD	56	2.233	0.148	1.946	2.565
IGT	**56**	**0.418**	**0.252**	**-0.318**	**0.693**
DROA	**56**	**-4.583**	**0.478**	**-6.215**	**-3.037**

2. Correlation

Table 3: Correlation (Environmental, Social, Governance – Individual)

	IETWC	IETCE	ISTDE	ISGD	IGBGD	IGBOD	DROA
IETWC	1.000						
IETCE	0.659	1.000					
ISTDE	0.640	0.847	1.000				
ISGD	-0.349	-0.598	-0.642	1.000			
IGBGD	0.422	0.355	0.175	-0.093	1.000		
IGBOD	0.318	0.374	0.406	-0.472	0.067	1.000	
DROA	0.076	0.041	-0.048	0.271	0.342	-0.268	1.000

Environmental: From an individual correlation perspective as shown in Table 4.2, a positive but very weak correlation exists between IETWC and DROA, as suggested by the correlation coefficient of 0.076. This shows that as IETWC increases by 1%, DROA will increase by 0.076%. The findings of this study is consistent with that of Bartolacci et al. (2016) and Bogdan et al. (2022) who found no identifiable relationship between the two variables, but is in contrast with that of Gull et al. (2022), Simionescu et al. (2020) and Iwata & Okada (2011) who found a negative correlation between waste consumption and financial performance. Besides, a positive but very weak correlation exists between IETCE and DROA, as seen by the correlation coefficient of 0.0412, suggesting any 1% increase in IETCE leads to an increase in DROA by 0.0412%. The finding of this study is in line with that of Busch et al. (2022), Khunkaew et al. (2023) and Lui et al. (2021) who found a positive relationship between carbon emission performance and financial performance, but is in contrast with the findings of Adu et al. (2022), Miah et al. (2021) and Laskar et al. (2022) who found a negative correlation between the variables. From a collective environmental factors point of view as shown in Table 4.3, a positive but weak correlation exists between the collective IETWC and IETCE factors, and DROA, as represented by the correlation coefficient of 0.069 suggesting an increase in collective environmental factors by 1% could increase DORA by 0.069%.

Social: From Table 4.2, a negative but very weak relationship is found between ISTDE and DROA, as seen by the correlation coefficient of -0.0484. This suggests that an increase in ISTDE by 1% causes DROA to decrease by 0.0484%. The results of this study is in contrast with the findings of Tarigan et al. (2018); Nurfadilah et al. (2022); Kafetzopoulos (2023); Ogbari et al. (2018); Latukha et al. (2022) and Kehinde (2012) who found a positive relationship between training and development and financial performance. Aside, a positive but weak correlation exists between ISGD and DROA, as suggested by the correlation coefficient of 0.2709. This shows that any increase in ISGD by 1% increases DROA by 0.2709%. The results are similar to that of Ferrary & Deo (2022), Laskar et al. (2023) and Oboreh et al. (2022) who found a positive relationship between firm overall gender diversity and firm financial performance, but is in contrast to the findings of Adams & Ferreira (2009) who found a negative correlation between the variables. From a collective social factors point of view as shown in Table 4.3, a weak and negative relationship exists between the collective ISTDE and ISGD factors, and DROA, as represented by the correlation coefficient of -0.026, suggesting an increase in collective social factors by 1% could decrease DROA by 0.026%.

Governance: Analysing the factors individually as seen in Table 4.2, a positive but weak correlation exists between IGBGD and DROA as suggested by the correlation coefficient of 0.3423, indicating any 1% increase in IGBGD could lead to a 0.342% increase in DROA. The result of this study is supported by the findings of Mohsni et al. (2021), Khunkaew et al. (2023), del Mar Fuentes-Fuentes et al. (2023) and García-López et al. (2024) who also found positive correlation between board gender diversity and firm financial performance, but is in contrast with that of Kabir et al. (2023), Husted & Sousa-Filho (2019) and Wang et al. (2024), who claimed that having women on the board only increases market based performance instead of firm financial performance. A negative but weak correlation is noted between IGBOD and DROA, as seen from the correlation coefficient of -0.268, indicating an increase in IGBOD by 1% could lead to a decrease in DROA by 0.268%. The findings of this study is in line with that of Bogdan et al. (2022), Cao et al. (2021), Naseem et al. (2017), Zhou et al. (2018), Husted & Sousa-Filho (2019), Hamid & Purbawangsa (2022) and Bansal & Singh (2021) who found that an increase in board size could lead to better firm financial performance, but is opposite the findings of Orozco et al. (2018) and Yan et al. (2021) who shared that an increase in board member may reduce the contribution per director, thereby leading to a decrease in firm financial

performance. From a collective governance factor point of view, a weak and positive relationship exists between the collective IGBGD and IDBOD, and DROA, as seen by the correlation coefficient of 0.241, indicating an increase in the collective governance factors by 1% could increase DROA by 0.241%.

3. Multiple Regression Analysis

Table 4: Multiple Regression (Combined)

	Coef.	Std. Err.	P-Value
IETWC	- 0.014	0.049	0.781
IETCE	0.089	0.117	0.451
ISTDE	0.049	0.103	0.638
ISGD	1.959	0.756	0.013
IGBGD	0.340	0.111	0.004
IGBOD	- 0.687	0.348	0.054
_cons	- 3.110	1.064	0.005
R-square	0.262		
no. of obs	56.000		
no.of group	8.000		
DV; DROA			

From Table 4.4, noted that at 5% level of significance and 95% level of confidence, only ISGD and IGBGD have significant relationships with DROA, as evidenced by the p-value of 0.013 (<0.05) and 0.004 (<0.05) respectively, while IETWC, IETCE, ISTDE and IGBOD have insignificant relationships with DROA, as evidenced by the p-value of 0.781 (>0.05), 0.451 (>0.05), 0.638 (>0.05) and 0.054 (>0.05) respectively. Therefore, the null hypotheses Hd0 and He0 are rejected, while null hypotheses Ha0, Hb0, Hc0 and Hf0 are accepted.

The regression equation is:

DROA = -3.110 + 1.959 ISGD + 0.340 IGBGD

This regression equation reveals that holding all variables to a constant zero, DROA would be -3.110. It also shows that holding all else constant,

i. Any 1 unit increase in ISGD would cause DROA to increase by a factor of 1.959; and

ii. Any 1 unit increase in IGBGD would cause DROA to increase by a factor of 0.340.

The results of this findings suggest a positive and significant correlation between environmental, social and governance factors collectively, and DROA. The findings of this study are in line with Fu & Li (2023) who found a positive and significant impact between ESG and financial performance, while concluding that the findings will be useful for firms and government departments in formulating relevant policies. This was concurred by Deng (2022), Jung & Yoo (2023), Aydogmus et al. (2022), Chen et al. (2023) and Hamdi et al. (2022) who found that high ESG performance promises financial return for the firm, which leads to improved ROA. However, it was rebutted by Loew & Cordovez (2023) who found no significant correlation between ESG factors and ROA. It also suggests that although environmental, social and governance factors work hand-in-hand to improve business sustainability, thereby improving firm financial performance.

Acceptance of Hypotheses

Table 5: Summary of Findings [Hypotheses]

The summary of acceptance or rejection of hypotheses are tabled below:

Hypotheses	Results
Ha0 There is no relationship between Total Waste Consumption and ROA.	Accepted
Hb0 There is no relationship between Total Carbon Emission and ROA.	Accepted
Hc0 There is no relationship between Training and Development Expenditure and ROA.	Accepted
Hd0 There is no relationship between Gender Diversity and ROA.	Rejected
He0 There is no relationship between Board Gender Diversity and ROA.	Rejected
Hf0 There is no relationship between Board Size and ROA.	Accepted

Conclusion, Limitations and Suggestions

The results of this research supports the triple bottom line theory, since the research found that the overall environmental factor (representing planet) and overall governance factors (representing people) had a positive impact on the financial performance (representing profits) of the banks.

Besides, the research also suggests that gender diversity, whether overall or at the board level, plays a significant role in impacting the ROA of commercial banks in Malaysia. Having gender diversity in leadership can bring about diverse perspectives and experiences to the decision-making process within the banks since it encourages a wider range of factors to be considered. This can potentially lead to better risk management, more innovative solutions, and improved strategic decisions, all of which are more inclined to the needs and preferences of the diverse stakeholder groups. Besides, gender diversity at board level is also increasingly seen as a sign of effective corporate governance since it allows better oversight, reduces group think and enhances accountability. Additionally, having a diverse workforce fosters a more inclusive organisational culture whereby individuals feel valued and respected regardless of their gender or other characteristics, which could lead to higher employee morale, increased job satisfaction, greater employee engagement and talent retention. Not only that, by promoting and prioritizing gender diversity amongst their workforce, banks would be seen as a good corporate citizen that are committed to fairness, equality, and social justice, thereby enhancing their reputation among customers, investors and other stakeholders who value and appreciate ethical business practices and diversity initiatives. Finally, gender diversity at board level is a mandatory requirement for listed companies in Malaysia. Any lack of board gender diversity makes the banks incompliant with the listing requirements, which could lead to legal risks. Although there have not been any specific penalties outlined, it is possible that any non-compliance with the listing requirements could affect the bank's reputation or could cause the banks to be delisted from the Malaysian Stock Market, which could consequently impact the financial performance and even the going concern of these banks. Hence, the research findings established can be considered by the ESG team managers in arriving at a better ESG risk management plan in the future. Additionally, this study was analysed using the multiple regression analysis and was limited to only the period from which ESG reporting was made mandatory for all publicly listed entities in Malaysia, without considering the impact of the Covid-19 pandemic. To have a clearer picture of the impact of ESG factors on financial performance of the banks in Malaysia, future researchers may consider studying the relationship between the variables over a longer period and using panel regression model, which allows researchers to capture details on the pre- and post- mandatory disclosure performance and pre- and post- pandemic performance of the banks in Malaysia. Apart from modifying the current research to improve accuracy of

results, the current research topic could also be extended to cover the relationship between ESG Factors and financial performance of different types of banks across the globe. This would provide a more holistic view of the actual relationship between the variables. Lastly, the study of the impact of ESG factors and financial performance should not be limited to just the banking sector. It could be extended to include other financial institutions such as insurance companies, asset management and investment holding companies to give a better view of how ESG factor impacts the entire financial sector, which is the foundation in driving economic growth and stability.

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