Identification of Environmental, Social, and Governance Risks and Their Impact on the Banking Sector Through Internal Audit

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Abstract

The implementation of the Environment, Social, and Governance (ESG) framework in the banking sector is a crucial element in supporting economic stability and sustainable development. This study aims to analyze in depth the role of internal audit in the process of identifying environmental, social, and governance risks in the Indonesian banking industry. This study applies a qualitative approach with an exploratory and descriptive case study design. Data collection focuses on the analysis of secondary documents, specifically sustainability index reports from independent data research institutions, which are interpreted through deductive reasoning and data triangulation based on an interpretive paradigm to understand the complex institutional context. The results demonstrate that the domestic banking sector faces multidimensional sustainability risks, characterized by substantial performance gaps between large banks and medium- and small-scale banks. The internal audit function plays a strategic role in verifying reporting accuracy, preventing environmental image manipulation practices, and ensuring compliance with sustainable banking regulations. However, the effectiveness of this function is hampered by structural limitations that include a deficit in auditor technical competence in the environmental dimension, limited financial resource allocation, and a lack of comprehensive supervisory support from the board of commissioners. Conclusively, a single internal audit function is inadequate to ensure the full integration of sustainability frameworks in the banking sector. Therefore, this study highlights the urgency of implementing a combined assurance approach that synergizes the roles of internal oversight, external oversight, and strategic management to strengthen the accountability of banking sustainability reporting holistically and collaboratively.

Keywords: Environment, Governance, Internal Audits, Risk Managements, Social

INTRODUCTION

Environmental, Social, and Governance (ESG) is a framework used to assess company performance based on environmental, social, and governance aspects. This concept was formally introduced through the Who Cares Wins report in 2004, which emphasized the importance of integrating ESG factors into capital markets (Liu & Xie, 2024). In the banking context, ESG is crucial because banks play a role not only as financial institutions but also as strategic actors in promoting economic stability and sustainable development (Nasution, Harahap, & Uula, 2023). The implementation of ESG helps banks manage risks more effectively, including liquidity and operational risks.

Furthermore, ESG contributes to improved reputation, stakeholder trust, and investment attractiveness (Nizamuddin, Mushir, & Thakur, 2024). Through sustainable financing practices, such as green credit, banks can also support the sustainable development agenda. However,

research shows that the influence of ESG on bank financial performance varies, depending on the research context and the ESG aspects analyzed (Manurung, Siregar, Fahmi, & Hakim, 2024).

The implementation of ESG in the Indonesian banking sector has experienced significant development, primarily due to regulatory pressure and growing awareness of sustainability issues. The Financial Services Authority (OJK) has required banking companies to submit sustainability reports since January 1, 2019, through POJK No. 51/POJK.03/2017 (Fuqoha & Firmansyah, 2023). Furthermore, several banks have established the Indonesian Sustainable Finance Initiative as a commitment to green financing.

Several large banks, such as BCA, BRI, BNI, and Bank Mandiri, have also begun integrating ESG principles through credit restrictions in certain sectors, ESG rating upgrades, and the establishment of dedicated ESG teams (Panjaitan, 2023). However, ESG implementation in Indonesian banking still faces several challenges. ESG disclosure levels are still in their infancy, requiring strengthening the quality and consistency of reporting. Research also indicates that the influence of ESG on financial performance and market performance is not yet fully consistent (Rizki, Priyambodo, Sukma, & Aryawati, 2023). On the other hand, low sustainability awareness is still evident in financing in environmentally risky sectors, such as plantations, which are linked to forest fires. Therefore, ESG implementation in Indonesian banking needs to be strengthened through regulation, oversight, transparency, and concrete commitments from banking institutions (Delia & Sudrajad, 2024).

Auditing is closely linked to ESG because it serves as an oversight mechanism, guarantees reporting credibility, and supports corporate governance. Audit committees, internal audit, and external audit play a role in ensuring that ESG risk management, regulatory compliance, and sustainability reporting is carried out transparently and accountably (Pernamasari & Chariri, 2024). Good audit quality can also strengthen the relationship between ESG disclosure and company value, as competent auditors can increase stakeholder trust in the ESG information presented.

Furthermore, ESG performance can impact on the audit process and costs. Companies with strong ESG performance tend to have lower business risks and stronger reputations, thus reducing audit costs and audit delays (Narullia, Putri, Prastyaji, & Fadhilah, 2024). However, ESG disclosure can also increase audit complexity because auditors need to assess a wider range of non-financial information. Thus, auditing and ESG are mutually supportive, as auditing enhances the credibility of ESG practices, while a company's ESG quality influences the efficiency and risk level of the audit process (Umar, Firmansyah, Danlami, & Al-Faryan, 2024).

The role of internal audit is becoming increasingly important as ESG issues encompass environmental, social, and governance risks that are not always reflected in financial statements. Internal audits can help companies assess the effectiveness of controls, ensure compliance with sustainability regulations, and provide recommendations for improving ESG practices (Hossain, Qi, Marie, Omran, & Chen, 2025). However, internal audit involvement in the ESG agenda still needs to be expanded so that the audit function focuses not only on financial aspects but also on long-term sustainability risks. External audits also play a role in assuring ESG reports, increasing the credibility of the information presented by companies (Wang, Sun, Dong, & Zhang, 2025).

ESG assurance can reduce information asymmetry between companies and stakeholders, particularly investors, regulators, and the public. Furthermore, the involvement of qualified external auditors can help mitigate the risk of greenwashing, the practice of presenting sustainability information that does not reflect the actual situation (Alkurdi, Al Amosh, & Khatib, 2024). Therefore, auditing is a crucial part of building transparency, accountability, and trust in ESG implementation.

The relationship between auditing and ESG can be explained through several complementary theories. Agency theory is a key theory because it explains the role of audits in reducing information asymmetry between management and stakeholders (Cai et al., 2024). In the ESG context, high-quality audits help improve the transparency and reliability of sustainability reporting. Companies audited by reputable auditors, such as Big Four firms, tend to have more relevant ESG disclosures because the audit process encourages management accountability (Gesso & Lodhi, 2025).

In addition to agency theory, legitimacy theory also explains that audits help companies gain and maintain public trust through transparent ESG reporting (Hammami & Hendijani Zadeh, 2020). Stakeholder theory emphasizes that quality audits respond to stakeholders' needs for clear, accurate, and reliable ESG information (Bamahros et al., 2022). Thus, audits serve not only as an internal oversight tool but also to meet social demands and maintain corporate relationships with investors, regulators, the public, and other stakeholders.

Signaling theory explains that a quality audit provides a positive signal to the market regarding the credibility of a company's ESG report (Azahra & Hasnawati, 2024). When ESG reports have undergone an adequate audit or assurance process, stakeholders tend to perceive the information as more reliable. This can increase investor confidence and strengthen a company's reputation, especially in a business environment that increasingly demands sustainability transparency (Khanchel & Lassoued, 2025).

Meanwhile, resource-based theory views ESG as an intangible asset that can create value for a company. Good ESG disclosure reflects a company's ability to manage resources, risks, reputation, and stakeholder relationships (Cai et al., 2024). Therefore, audits are necessary to ensure that ESG information is presented fairly and is not used solely as an image tool. Overall, these theories demonstrate that auditing plays a crucial role in strengthening the credibility, transparency, and strategic value of ESG.

Research on the role of internal audit in identifying ESG risks in the banking sector holds significant potential because banks face complex risks, strict regulations, and high demands for public trust (Suwitoyo, Tarjo, & Anggono, 2021). As intermediary institutions, banks need to manage credit risk, operational risk, market risk, and sustainability risk in an integrated manner. In this context, internal audit plays a crucial role in assuring the effectiveness of risk management and internal controls (Rahma & Wijayanto, 2024). However, the implementation of internal audit in banking is not always effective without the support of a risk-based audit approach, a clear risk management framework, and adequate auditor capacity. The integration of ESG into banking risk management is becoming increasingly important because ESG disclosure can impact on a bank's financial performance, reputation, compliance, and long-term stability (Jamaluddin, Hermanto, & Fidiana, 2024). ESG risks, such as environmental, social, governance, and greenwashing risks, have not been specifically studied within the banking internal audit function.

Most research still focuses on traditional risks, such as credit, market, and operational risks (Nastiti & Cupian, 2024). Therefore, this topic deserves further research due to the gap between regulatory needs, the complexity of banking risks, and internal audit capabilities in systematically identifying ESG risks (Citraningtyas, Widagdo, & Ika, 2024).

Based on the accumulation of information obtained through theoretical studies, empirical studies, and factual phenomena, it is known that the development of large companies has the potential to have a significant impact on social and environmental aspects, as well as the potential for poor governance. ESG is an innovation to measure the compliance of companies and agencies with environmental and social aspects and ensure good governance. In this process, the role of internal audit is no less important than the implementation of ESG itself; the goal is to ensure ESG implementation is in accordance with regulations and reported transparently. Based on this conceptualization, this study aims to analyze the role of internal audit in identifying ESG risks in the banking sector in Indonesia.

RESEARCH METHODOLOGY

This research was conducted using a qualitative approach and a case study. This method considers the suitability between the research objectives and the characteristics of the phenomenon being studied. In line with this research objective, the analysis conducted focuses on the role of internal audit in identifying ESG risks in the Indonesian banking sector.

This research objective requires exploration and descriptive research without statistically examining the relationships between variables (Bolanda, Juwita, Andaru, Ghaisani, & Fajarsari, 2026). In line with this research objective, a qualitative approach is considered the most appropriate and allows researchers to holistically understand the role of internal audit in a complex institutional context. This type of research, a case study, was chosen because the phenomenon being studied is relatively new and has not been widely researched previously. With a case study, researchers can realistically analyze what occurs in depth within the research object. This approach can provide findings that accommodate the varied contexts of the research location while remaining within the primary objectives of this study (Pasaribu & Soeratin, 2024).

The chosen approach is also supported by the characteristics of the data collected in this study. This study examines ESG, a relatively rare practice, the data used in this study refers to the 2024 KataData ESG Index (KESGI) report. In this report, ESG risks such as greenwashing, social risks, and governance risks cannot always be quantified numerically. Therefore, an in-depth interpretation of the KESGI report is required, which can be strengthened by empirical evidence from previous research and theoretical concepts gathered from literature analysis.

This method allows researchers to conduct comprehensive data interpretations. Qualitative analysis is also considered appropriate, considering that ESG implementation in Indonesia is still in its early stages, which means secondary data is not yet strong enough to support quantitative analysis (Sanjaya, Atmadja, & Darmawan, 2025). To ensure the validity and credibility of the findings, this study will consistently apply deductive reasoning and triangulation of qualitative data obtained from reports and relevant scientific articles. This analysis was also chosen considering the complexity of ESG, which encompasses interrelated environmental, social, and governance aspects and does not always align formal reports and the reality on the ground (Harseno, 2025).

The paradigmatic foundation of this research is the interpretive paradigm, which views social reality as something socially constructed and needs to be understood through the perspectives of the actors involved. This paradigm aligns with the theories underlying the research, namely agency theory, legitimacy theory, stakeholder theory, and signaling theory, all of which emphasize the importance of interpreting the relationship between audit, ESG, and stakeholders in the institutional banking context (Muarif, 2025).

RESULTS AND DISCUSSION

The financial sector, particularly banking, plays a strategic role in driving economic growth that is not solely profit-oriented but also based on sustainability principles. As key intermediary institutions, banks have the capacity to drive other sectors through financial products such as credit and financing, while simultaneously promoting the implementation of responsible governance, social inclusiveness, and a green economy. In this context, measuring sustainability performance is becoming increasingly relevant as a comprehensive evaluation tool for the national banking industry.

The Katadata ESG Index 2024 serves as an assessment instrument that measures the extent to which banking companies in Indonesia have integrated environmental, social, and governance aspects into their business practices. This assessment involved 46 banking companies that had published sustainability reports as of June 2024. The following graph presents the median scores of the banking sector based on each ESG component, providing a comprehensive overview of the position and maturity of the Indonesian banking industry on its journey towards sustainability.

Based on the Katadata ESG Index 2024, the overall median score (KESGI) for the Indonesian banking sector was recorded at 47.87 out of a scale of 100. This figure reflects that, on average, the sustainability performance of the national banking industry remains at a medium level and has considerable room for further improvement, particularly in terms of the completeness and quality of sustainability reporting. The Environmental aspect recorded the highest median score among all aspects, at 61.84. This indicates that most banking companies have been quite consistent in reporting environmental indicators, such as energy use, greenhouse gas emissions, waste management, and water use.

This achievement indicates that the banking sector's awareness of environmental issues is starting to develop well, although reporting related to environmental costs is still very minimal, with a median score of 0.00. In the Social aspect, the banking sector's median score was 46.98. The Community sub-aspect achieved a relatively good score of 71.53, considering that almost all companies have sustainability programs for their surrounding communities. However, the Product Development Responsibility sub-aspect remains very low with a score of 17.85, primarily due to the lack of structured reporting on customer satisfaction. Governance and the Green Economy are the two aspects with the lowest median scores, at 40.10 and 39.69, respectively. The low Governance score is due to the lack of reporting on company certification, while the low Green Economy score reflects that green credit distribution (KKUB) is still highly concentrated in large banks, resulting in an uneven distribution of performance across the banking industry.

Environmental Aspect

The Environmental aspect recorded the highest median score compared to other aspects in the Katadata ESG Index 2024, at 61.84. Several sub-aspects even demonstrated excellent performance, such as Environmental Complaints (100.00),

Water Use (99.22), Energy Use (79.94), and Emissions (74.60). This achievement indicates that the banking sector's awareness of environmental reporting obligations has begun to develop quite well, making this aspect one of the relative strengths of the national banking industry within the sustainability framework.

However, behind this achievement, there are very significant gaps that cannot be ignored. The Environmental Costs sub-aspect recorded a median score of 0.00, meaning that more than half of banking companies do not report any environmental-related expenses at all, such as waste management costs, energy efficiency, or environmental impact remediation.

Furthermore, the Environmentally Friendly Materials sub-aspect only scored 50.00, reflecting the lack of standardized and uniform internal reporting standards across the industry. Furthermore, there is a significant performance gap between large banks and small- and medium-sized banks, indicating that environmental reporting practices have not yet become a widespread institutional culture.

Social Aspect

The Indonesian banking sector's Social Aspect recorded a median score of 46.98 in the Katadata ESG Index 2024. Overall, this aspect's performance is moderate, with significant variation across sub-aspects. The Community sub-aspect scored the highest at 71.53, reflecting that nearly all banking companies have sustainability programs for their surrounding communities and are serious about responding to customer complaints, with an average complaint resolution rate of 98%.

Meanwhile, the Employment sub-aspect scored 48.28, and the Product Development Responsibility sub-aspect scored the lowest at 17.85, making it the most critical gap in the banking sector's social dimension. The most fundamental structural gap lies in the low quality of Product Development Responsibility reporting, particularly regarding customer satisfaction, which has not been reported in a structured and standardized manner by most companies.

On the Employment side, although several large banks, such as BNI, have provided training for 99% of their employees, similar practices are not yet widespread across the industry. There are also gaps in reporting on workforce diversity and inclusivity, including the representation of women and employees with disabilities, which have only been consistently reported by a handful of large banks. This gap indicates that social reporting remains selective and does not reflect the overall condition of the industry.

Governance Aspect

The Governance aspect recorded a median score of 40.10 in the Katadata ESG Index 2024, making it one of the lowest-performing aspects in the Indonesian banking sector. This score is formed by two main sub-aspects: Board of Directors Diversity, with a median score of 50.22, and Certification, with a much lower median score of 30.00. The Board of Directors Diversity sub-aspect recorded relatively better results, with more than 50% of the banks assessed reporting direct involvement of C-level staff in ESG oversight, while the average involvement of women in leadership was recorded at 18%.

The most fundamental gap in the Governance aspect lies in the low score of the Certification sub-aspect (30.00). This figure reflects that the majority of banking companies do not yet have or have not yet reported relevant international certifications, such as ISO 27001 for data security, ISO 37001 for anti-bribery management systems, and ISO 9001 for quality management.

Only leading banks such as CIMB Niaga and BRI consistently report ownership of these certifications. Regarding Board Diversity, despite its improved score, reporting on female representation and diversity of backgrounds in leadership is not yet uniform and standardized across the industry, indicating a significant gap between large banks and small- and medium-sized banks.

Green Economic Aspect

The Green Economy aspect recorded the second-lowest median score in the Katadata ESG Index 2024 for the banking sector, at 39.69. This low score directly reflects the condition of the Financing sub-aspect, which also only scored 39.69, the only sub-aspect that makes up the Green Economy dimension of this assessment.

Although 78% of banks included in the assessment have established sustainable financing programs, or Sustainable Business Activity Credit (KKUB), the distribution of green credit disbursement remains highly unequal and dominated by large banks, resulting in a low overall median score for this aspect.

The most fundamental gap in the Green Economy aspect is the gap between the existence of KKUB programs and the quality of their reporting. 22% of banks do not have a sustainable financing program at all, while the majority of those that have disbursed KKUB have not reported detailed, measurable, and standardized data. Small and medium-sized banks tend to score significantly below the industry average, indicating that green credit disbursement has not yet become a widespread and systematic practice across the national banking ecosystem.

CONCLUSION

This study concludes that the Indonesian banking sector faces multidimensional and interrelated Environmental, Social, and Governance (ESG) risks, with a wide gap in sustainability performance between large and medium-sized banks, thus triggering systemic reputational risk. Internal audit has been shown to play a highly strategic role in identifying ESG risks curbing greenwashing practices, verify the accuracy of sustainability data, and ensure compliance with OJK regulations.

However, the effectiveness of this function remains hampered by structural limitations, including a lack of technical competence among auditors on environmental issues, limited resources, and suboptimal governance support from the board of commissioners. As its primary implication and contribution, this study recommends a transition to a combined assurance approach, a collaborative synergy between internal audit, external audit, and management, to address the weaknesses of a single internal audit function.

This study directly advances the field of banking risk management by expanding the scope of audits, which have traditionally focused on traditional risks (Credit, Market, and Operational), toward a holistic integration of long-term sustainability risks. For further research directions, future research is suggested to focus on quantitative ESG risk measurement, testing the causal relationship between internal audit effectiveness and sustainability performance, and expanding comparative empirical studies to the context of other developing countries.

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