CHAPTER 1

INTRODUCTION

1.1 Background

Sustainability is one of the basic pillars in which organizations are based to assure their survival and continuity because of the strong relationship between sustainability and human well-being, standard of living, and progress (Tawfik, Kamar, & Bilal, 2021). The initial concept of sustainable development was introduced for the first time in 1987 in the Brundtland Report (also entitled 'Our Common Future'). The report gave an accurate assessment of the state of the environment as well as the dissemination of the most widely used definition of sustainable development, namely "Sustainable development meets the needs of the present without compromising the ability of future generations to meet their own needs" (Al-Dhaimesh & Al Zobi, 2019). The report incorporated environmental issues into the notion of sustainable development, implying that organizations could no longer regard the environment as an infinite source of natural capital from which they could draw without generating any risk.

Corporate sustainability has grown throughout the years, gaining significant importance from corporations, stakeholders, academics, researchers, and politicians over time, and companies are increasingly being pressured to disclose corporate sustainability reports (Ellili & Nobanee, 2022). The standard of sustainability disclosure by corporations, the Global Reporting Initiative (GRI) was founded in 1997 as an international independent organization that assists businesses, governments, and other organizations in communicating their influence on major sustainability issues, namely climate change, human rights, and corruption. The GRI standard aims to establish a system for companies to be held accountable for adhering to the principles for responsible environmental products (Al-Dhaimesh & Al Zobi, 2019). GRI has been used as a standard for companies to publish the corporate sustainability report ever since.

Nowadays, companies are known to be competing in attracting customers and investors for their company. With the recent awareness about the environment conditions, investors have chosen sustainability as a criterion to consider when configuring their investment portfolio, resulting in the emergence of sustainability indices linked to the financial market (Ching, Gerab, & Toste, 2017). This is no different for banks. In a research conducted by Coleton (2020), it is mentioned that recently, banks have begun to recognize that there are sustainability risks as a result of pressure from customers and investors, as well as regulators, and have begun to support the development of a more sustainable economy by incorporating sustainability factors into their risk management models and governance frameworks. This statement is supported by the research that has been conducted, which revealed that bank's sustainability strategies are motivated by a variety of factors, including creating business opportunities and supporting businesses that have a positive social, environmental, and reputational impact (Coleton, Font Brucart, Gutierrez, Le Tennier, & Moor, 2020).

Various studies have been conducted to figure out the importance of sustainability disclosures to the financial performance of a company. Based on qualitative research conducted by Kasbun (2016), there is still inadequate evidence to prove that companies that disclose or report on economic, social, and environmental sustainability have a better financial performance compared to those that do not report on sustainability in any form (Kasbun, Teh, & Ong, 2016). This might be due to the lack of sufficient implementation and consistent sustainability reporting of the object of the research. Azzam, AlQudah, Abu Haija, & Shakhatreh, (2020) also suggested that sustainability disclosures are positively and significantly linked with financial performance, indicating that sustainability disclosures create an incentive for individuals and organizations to engage more with the company, resulting in higher profits. Furthermore, most of the research conducted in this field indicated that sustainability disclosures either positively affect an organization's financial performance (Brooks & Oikonomou, 2017; Moufty, Clark, & Al-Najjar, 2021; Tawfik et al., 2021), or having no significant effect at all (Ching et al., 2017; Ellili & Nobanee, 2022).

A more limited results were found for the effect of environmental disclosures on financial performance of a company. Environmental information disclosure positively affects financial performance of a company (Wang, Wang, Wang, & Yang, 2020). Haninun, Lampung, & Lindrianasari (2018) agreed with this statement, also stating that the environmental performance is an indication of a company's environmental awareness and a method of allocating resources as a type of attention to the environment. The research also concluded that environmental disclosure is a strategy for companies to achieve their goals and influencing stakeholder's attitudes. However, this result contradicts the findings of Nor, Bahari, Adnan, Kamal, & Ali (2016) and Ellili & Nobanee (2022) who concluded that environmental disclosures had no significant relationship to the financial performance of a company.

The following are some probable explanations for the research findings. First, companies might obtain many intangible benefits by disclosing environmental information, such as improved branding, more product sales, and lower stock market financing costs, all of which would help financial performance. Second, several visible benefits, such as government subsidies and tax deductions related to environmental conservation, can also increase financial performance (Wang et al., 2020).

Based on the discussion above, the author conducted this research to determine the effect of environmental disclosures on banks' profitability, measured by Return on Assets (ROA), Return on Equity (ROE), and operating margin. This study provides three contributions to previous literature. First, this study will be concentrated on the environmental disclosures, as opposed to majority of the previous research which focused on Corporate Social Responsibility (CSR). The environmental disclosure could be used to cover or reflect the fact that actual environmental performance of the banks is still unknown (Xiaohua Meng, Saixing Zeng, Xuemei Xie, 2018). Second, this research uses The GRI Standards (2016) as the determinant for the environmental disclosures index, which has not been used yet by previous studies. Lastly, this study examines the impact of environmental disclosures on the financial performance in the banking sector, while most previous studies were mainly conducted for companies which activities directly affecting the environment. Hence, research focused in the banking sector, where its activities are not related directly with the environment, could be helpful in understanding the mechanism of environmental disclosures on financial performance and illustrating the effect of environmental disclosures.

1.2 Problem Formulation

Based on the background of the problems described above, the problem formulations to be examined are:

1. Do environmental disclosures affect banks' profitability measured by Return on Assets (ROA)?
2. Do environmental disclosures affect banks' profitability measured by Return on Equity (ROE)?
3. Do environmental disclosures affect banks' profitability measured by Operating Margin?

1.3 Research Objectives

Furthermore, the objectives of this research are as follow:

1. To find out the effect of environmental disclosures on banks' profitability measured by Return on Assets (ROA).
2. To find out the effect of environmental disclosures on banks' profitability measured by Return on Equity (ROE).

3. To find out the effect of environmental disclosures on banks' profitability measured by Operating Margin.

1.4 Research Benefits

This study aims to increase understanding and become a source of knowledge for readers, especially in the effect of sustainability disclosures on the profitability of banks in Indonesia. Other benefits are listed below:

1. It is hoped that from this research, researchers could gain more insight regarding the topic of sustainability disclosures, especially for banks in Indonesia.
2. For banks that are the object of this research, it is hoped that by knowing the effect of environmental disclosures on their profitability, it can be used as an aid in helping decision making regarding the matter.
3. For investors, it is hoped that the results of this research can be used as a tool in knowing the effect of environmental disclosure on the banks' profitability, and to assist investors in making decisions whether or not to invest in banks in the future.
4. For the government of Indonesia, it is hoped that this research can be used as an input in determining the regulations and policies regarding the sustainability disclosures of banks in Indonesia

5. For the GRI standards, the world's most widely used standards for sustainability reporting, it is hoped that the result of this research can be used in developing, integrating, and setting of the standard.

1.5 Writing Systematic

This research is broken down into five parts. The first chapter discusses the background, problem formulation, research objectives, benefits of the research and the research systematic itself. The second chapter reviews the previous literature done within the scope of sustainability disclosure effects on bank financial performance. This is then followed by a theoretical study that contains theoretical frameworks and hypotheses formulated to conduct the research.

Then, the third chapter discusses the research methodology, describing the method used in the research by providing an explanation of the research variables, population and sample of the research, data collection sources and methods, and data analysis techniques. The fourth chapter then discloses the results and arguments obtained from the research. Finally, the fifth chapter consists of conclusions, limitations and suggestions arising from this research, aimed at interested parties.