IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT

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Sustainability: The future of Islamic finance

The call for finance to be a force for good has become more urgent than ever, and the Islamic finance industry is heeding that call. Despite practitioners often being quick to point out the similarities between it and the sustainable finance movement, Islamic sustainable finance remains but a drop in the multitrillion-dollar ethical finance industry. Industry leaders, however, believe we are moving in the right direction, and with the right steps, the industry could deliver more meaningful impact through Shariah instruments with a sustainable core. VINEETA TAN dives deeper.

Slow and steady

Don't let the abbreviations confuse you. Be it ESG [environmental, social and governance], SRI [socially responsible investing] or impact investing, these terms are parked under the wider sustainable finance umbrella and are often used interchangeably albeit with delicate differences. ESG may be a jargon first coined in 2005 but the concept dates back earlier with SRI taking off in the 1960s. Within the Islamic finance sector, however, these concepts are a relatively new phenomenon, with Islamic ESG or Islamic sustainable finance gaining more momentum over the last half a decade or so.

Take green bonds as an example. The first climate awareness bond, or green bond, was issued by European Investment Bank back in 2007. The landmark EUR600 million (US$678.27 million) offering triggered a domino effect which led to an ESG finance market that is worth over a trillion dollars and growing exponentially. The Islamic finance industry, however, trailed behind and only issued its first green Sukuk 10 years later in 2017. From then until July 2020, only 17 green Sukuk issuances have entered the market, and are mostly concentrated in Malaysia and Indonesia.

According to Bashar Al Natoor, the global head of Islamic finance at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.

"If I look at how much was issued since 2017, it is less than US$20 billion, which is small compared to the size of the global Sukuk market which is around US$800 billion currently. So, in terms of actual size, the sustainable Sukuk market is still tiny," Bashar explained, adding that over 10% of Fitch's US$130 billion rated Sukuk outstanding has some elements of sustainable, transition and green, indicating that this theme is more apparent within the dollar space. Malaysia is an exception, with corporates driving the Islamic sustainable agenda in the local currency market.

The growth may be slow, but market practitioners take this as a sign in the right direction.

"Sustainability has always been at the heart of Islamic finance. But I think perhaps in the past we didn't bring it to the fore as much as we're doing now. And one of the reasons that we're doing it now is because in the conventional markets, sustainability, ESG financing has grown enormously in the last 15 years or so, and increasingly so in the last five years. So that depth of funding liquidity that's available in the conventional sustainable markets is something that Islamic finance is becoming increasingly aware of and tapping into. The combination of liquidity plus the fundamental purpose of Islamic finance have come together in the last three or four years," observes Farmida Bi, Norton Rose Fulbright's chair for the Middle East, Europe and Asia and the firm's European head of Islamic finance.

That depth of funding liquidity that's available in the conventional sustainable markets is something that Islamic finance is becoming increasingly aware of and tapping into

The Islamic and sustainable convergence is indeed gaining serious momentum, evident by the numbers.

"I think over the last 12 months, there's been a lot of discussion and the good news is that the discussion has basically crossed into almost every aspect of Islamic finance. Everybody is now talking about [Islamic sustainable finance], which is a good start," Dr Scott Levy, CEO of Bedford Row Capital, opined.

There is indeed a lot of talk, backed by meaningful measures, at the top of the industry and at government levels, with the likes of Malaysia, Indonesia, and several administrations in the Middle East putting together policies and incentives to spur the sector. Malaysia introduced its SRI Sukuk Framework in 2014, Indonesia launched its Green Bond and Green Sukuk Framework in 2017, and the UAE this year released its 10-year sustainable finance framework which features Islamic instruments while Oman is developing an ESG finance framework as well.

However, there is still a lot of work to be done, not only at policy level, but also at issuer level as we move from a mindset of maximizing profits to a mindset of profit with purpose.

Costly compliance

There is a cost to compliance, and this cannot be underestimated.

"In addition to complying with Shariah principles, you also have to comply with green bond principles and there are increasing layers of regulatory frameworks that are being built around Islamic sustainable finance," Farmida explained, adding that tapping the ESG market generally means having to get an ESG rating as well. "All of those are substantial obligations that you have to comply with, compared to going out into the market and issuing a conventional bond. So in order to jump through all of those different hoops, it has to be worthwhile."

There is a cost to compliance, and this cannot be underestimated

Disclosure is a central challenge Islamic financial institutions face in fully embracing the sustainability agenda. Perhaps the lack of Islamic

financial institutions committing to globally-recognized frameworks such as the UN Principles of Responsible Investment and the UN's Principles of Responsible Banking, which require regular detailed reporting of one's sustainability efforts and impact, is an indication of the severity of this challenge. To date, only a handful of entities have adopted these principles.

"The commercial necessity of doing so isn't quite clear enough," Dr Levy highlighted. "If [issuers] can tap into the markets the way they have always done and take a very conservative and traditional approach, why do they need to do this? And there isn't yet a commercial imperative in the same way there is on the conventional side to put the effort into the reporting that's required."

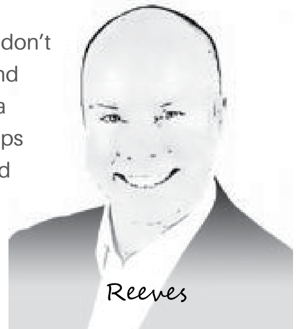
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these various regulatory frameworks and to be providing the data that investors need to demonstrate their compliance under these regulatory frameworks. This is early days but it is important for Islamic issuers to get conversant with these regulatory frameworks."

Making it worthwhile

The reality is: it is not easy to use finance for good without risking greenwashing. And it is costly too. These merely compound the concerns conventional issuers have with Shariah finance, which is already perceived as more complicated and expensive. This leads us to ask: is the payoff justified?

Market practitioners believe so, albeit the fact that it may take a while to realize such gains.

"(In general) getting a real yield that is actually positive is a challenge, and if you're an Islamic investor, then you have further restrictions. You don't have the entire universe available to invest in and so finding something that is going to generate a yield is one thing, finding something that perhaps can generate a positive inflation built in the yield is another. Islamic attributes attached is even more of a challenge and of course increasingly, Islamic investors also want sustainability, they're not different from everybody else. Having a sustainable Islamic investment I think is an incredibly positive and virtuous thing and I think in some respects they it could potentially lead this and certainly the opportunity is there," noted Craig Reeves, the founder of Prestige Funds.



When we compare the performance of conventional and Islamic indices, it does look like conventional edges ahead of its Islamic counterpart. The conventional S&P Global 1200 has modestly outperformed the S&P Global 1200 ESG Shariah. However, according to Michael Orzano, the senior director of global equity indices at S&P Dow Jones Indices, over the longer term, the ESG jurisprudence have led to outperformance and also some reduction in volatility.

"If we look at the trailing 10 years as of the 30th September 2021, the S&P Global 1200 Shariah gained an annualized 14.7% versus 13.1% for the conventional index, which is a pretty meaningful outperformance of over 1.5% per annum over 10 years. Interestingly on the volatility side, standard deviations were a little bit lower for the ESG SRI Index as well, which is interesting as it is a much narrower index," Orzano elaborated, adding: "Long-term outperformance was almost fully driven by the Shariah screens and the

ESG side of it didn't really have a large contribution because by design, the S&P ESG Index is constructed in an industry neutral basis so that it tends to closely track the conventional parent benchmark."

The ability to reach a wider investor base is often the driving reason to turn to Islamic sustainable finance. Beyond that, the trend toward doing good for the planet and people also attracts Islamic finance institutions to capitalize on this swelling demand.

Private capital really is vital and this presents a considerable opportunity for the Islamic capital markets to mobilize funding and is also a very unique opportunity for Islamic finance

"In Europe, you will see green issuances resulting in savings of at least up to 10 basis points as compared to normal issuances. But in the case of Asia, including Malaysia, generally the difference is very marginal," Chung Chee Leong, CEO of Cagamas, Malaysia's national mortgage corporation and the country's largest debt issuer, shared. "In our case, we managed to get two basis points (in savings) for our 2020 issuance. With increased awareness, we will probably see in the future, potentially some savings issuing sustainability Sukuk as compared to regular Islamic offerings." Cagamas in 2020 priced a combined issuance of its inaugural ASEAN Sustainability SRI Sukuk and Islamic medium-term notes totaling RM450 million (US$106.08 million). Proceeds from the SRI paper was used to specifically fund the purchase of eligible Islamic financing for affordable housing.

Urgent needs, attractive opportunities

For the most part, Islamic sustainable finance is here to stay, especially as the pandemic has created an urgent need for funding to recover.

"There is now a much greater focus on how to build back better as we come out of COVID. Many of the people who have been impacted the most by the coronavirus are in Muslim-majority countries and I think when those countries are looking at how they can rebuild that infrastructure, whether that's health, education, employment, there has been in Europe a very big focus on social bond issuances to try and ameliorate the effect of the pandemic. And those are structures and capital flows that these Muslim-majority countries can also tap into as the world generally tries to support development post-pandemic," noted Farmida.

The Islamic Finance Council UK expects US$30-50 billion in capital for green and sustainability Sukuk up to 2025.

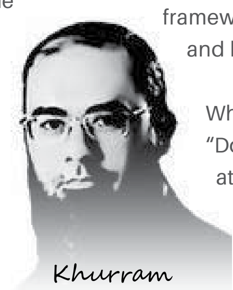
"It has been suggested that we need about US$7 trillion in infrastructure investment annually and between US$1.5 trillion to US$4 trillion every year for energy transition to meet the Paris [Agreement] targets; and with the commitments of the Glasgow Climate Pact, I'm sure

those numbers will then be increased and there aren't sufficient public funds to satisfy this. So, private capital really is vital and this presents a considerable opportunity for the Islamic capital markets to mobilize funding and is also a very unique opportunity for Islamic finance," according to Jennifer Schwalbenberg, the chief governance officer for the DDCAP Group.

The starting point is to understand and be aware of what the conventional [space] is doing, then look at your industry, see where you can capitalize on the things that you already have and then develop the things that you like

COP 26 [UN Climate Change Conference 2021], contentious as it may have been, nonetheless pushed various nations toward some serious climate commitments.

"The UAE was the first in the Middle East to announce their net zero ambition followed by Saudi Arabia and you must acknowledge that it's not easy for these countries. For these countries, which are some of the largest oil-producing countries in the world, to go next zero, they have to invest much more and they have to make much more effort as compared to other countries," said Khurram Hilal, CEO of group Islamic banking at Standard Chartered Bank.



This year's UN Climate Change Conference saw the formation of the Glasgow Financial Alliance for Net Zero, a global coalition of 450 institutions from 45 countries committed to accelerating the decarbonization of the world economy and reaching net zero emissions by 2050. These institutions are not only augmenting their internal policies but also revising their investing and lending criteria for projects focusing on achieving net zero, signaling deep capital flows into the sustainable finance sector.

Turning words into action

So how do we, as an industry, capture these Islamic sustainable opportunities? As Schwalbenberg observed: "We had two weeks of moving intentions and wonderful announcements [at COP 26] but now we need to put that into reality and make it happen. It's no longer about goals and aspirations. It really needs to be about action. And with this, I think there really is a key role in the Islamic finance agenda for green finance, but also transition finance."

Bashar concurs. "I think the starting point is to understand and be aware of what the conventional [space] is doing, then look at your industry, see where you can capitalize on the things that you already have and then develop the things that you like. First is to build awareness, then realization of putting strategies and regulations and frameworks to improve that and then installing that in the system and having an ecosystem and incentivize issuers."

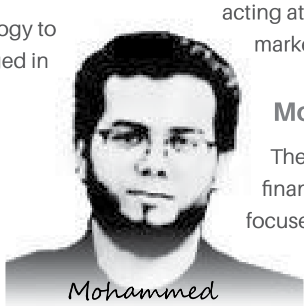
When it comes to regulations and policies, Dr Scott's advice is: "Don't be afraid of regulation – that's the first step. Look internally at your internal processes, have a brief read of the UN SDGs and understand where you fit into the things that the world is talking about at the moment."

At the heart of this movement is the importance of nurturing the right people to drive this change.

"We need to think about how do we get staff in Islamic banks to be equipped with the right knowledge? How do we create a future-ready workforce? We need our training and our learning institutions to focus in this area because this is the future of finance. They need to help develop the next generation of Islamic bankers who understand the dynamics of sustainable finance, who understand climate change, net zero carbon footprint, social finance and inclusion. They need to be fully up to speed with these concepts and not just knowing them, but also owning these concepts and also championing [them]," Khurram strongly believes.

Leveraging tech

And just as the Islamic finance industry is using technology to advance their cause, technology should also be leveraged in our journey of Islamic sustainability.



"Technology can definitely play a significant role in achieving environmental and social goals. We have instances of application of blockchain technology and Islamic social finance, such as the use of digital identities for monitoring the end-use of the contents of funds, as well as the preservation or development and proper use of Waqf or Islamic endowments for achieving various societal goals. Most of such goals find a place in the UN Sustainable Development Goals (SDGs)," according to Mohammed Alim, CEO-designate of IBF Net Group.

IBF Net is currently working on miniaturizing the Islamic economy, with a focus on Islamic social and sustainable finance using blockchain technology, and has launched several projects to this end. One of the projects is the Confluence platform which seeks to measure the impact of projects from the standpoint of Shariah and the UN SDGs.

"The platform combines the performance of the given projects against these metrics using an algorithm and produces a score or a classification scheme. This score reflects the impact of the projects using the lens of Shariah objectives, as well as the SDGs as perceived by the stakeholders. Given the availability of tools for measurement of environmental and social impact, for example carbon footprint, our platform identifies and adopts a suitable method for measurement and conversion of such impact into social cryptos. In this case, products can earn or liquidate such cryptos, which represent both types of impact acting at an exchange to alter their risk return impact profile in the market," Mohammed explained.

Moving forward

The notions of sustainability and ethics are not new in Islamic finance, although it is only in recent years that the industry is focused on harnessing and delivering sustainable impact in a more formal and structured manner. To many, this is the future of Islamic finance.

"This trend is a growth trend and I think this has already been cemented in the past three years; even at the height of COVID-19, we saw this segment growing, and I think this will continue in the short to medium term at least. If the government's strategies and milestones and objectives are really pursued in a very dedicated way, we could see more transformation of this segment, even in the long term, where it becomes a significant part of the industry," Bashar opined.

The push is also seen from the demand side, encouraging the supply side.

"We're definitely seeing a high level of demand from clients around the world for both ESG and for Islamic indices. Both of these are big areas of focus for us as an index provider. There have been significant inflows into ESG index products, including ETFs [exchange-traded funds] around the world over the past year, and we've also started to see Islamic ETFs in the US and Canada really gather momentum," Orzano shared. "I think the investment community is really just starting to think about combining broad-based ESG and Shariah investing together. I think we're likely to see a lot of new product development in the space over the next few years."

Schwalbenberg concurred: "I think as the strength of this agenda in the market increases, and that momentum builds, we will see the different institutions increasing their offerings and their options to the market. And it will be organic because as the sustainable finance sector grows and the products and services and practices become more prevalent, institutions will become more cognizant of this and they will realize they will miss opportunities and be at a disadvantage if they don't participate. Islamic sustainable finance will be recognized as the new normal and commitment will follow."

Corporates and Islamic issuers are already lining up their ducks.

"We see a lot of our traditional energy clients setting up new projects in a sustainable and renewable way and we are expecting a number of projects that were conventionally financed now being refinanced in a sustainable way going forward. So as a firm, we are expecting to do a lot more sustainable finance, certainly in the conventional markets, but hopefully much more in the Islamic markets as well," Farmida shared. It is learned that Cagamas and Standard Chartered are each preparing to introduce new products. Chung, CEO of Cagamas, revealed that the firm is looking to issue green Sukuk while Standard Chartered is working on expanding its Islamic green mortgage offering, Islamic social finance tools and Islamic ESG wealth management services, and is building on creating sustainability solutions for the wider Halal market including Islamic sustainable supply chain instruments.

As the multitrillion-dollar Halal industry continues to grow in its own space and globalize, I think it is important that they harness the socially responsible funding mechanism

"I think it's a great opportunity for growth that and we have this great upside in front of us," Khurram explained. "As the multitrillion-dollar Halal industry continues to grow in its own space and globalize, I think it is important that they harness the socially responsible funding mechanism, mechanisms of Islamic finance and strive to give holistic Halal solutions to faith-conscious clients.

"We need more innovation, we need more solutions in this space. This is an open field for all banks, all partners to come in and play their role."

Islamic finance and sustainability

By Dr Rizwan Malik,
the head of standards implementation and strategic developments, AAOIFI

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The flagship event of 2021, the United Nations Climate Change Conference (COP26), hosted in Glasgow in the UK, ended recently. It was the 26th climate change conference that attracted political and business leaders representing 190 countries from around the world to discuss and craft strategies on how we can achieve the goals of the Paris Agreement [1] and the UN Framework to help in the restoration and longevity of the ecosystem that we have been blessed with on earth. While the conference concluded successfully, the feedback on its achievements and agreements remains gloomy. One example is the agreement on limiting global warming to 1.5°C, while a recent United Nations Environmental Programme report stated that nations are on track for a global temperature rise of 2.7°C. Furthermore, in order to achieve the goal of 1.5°C, nations will have to halve annual greenhouse gas emission in the next eight years — something that looks relatively impossible to achieve.

Climate change is just one of the 17 UN Sustainable Development Goals (SDGs), an important initiative launched by the UN in 2015 to transform the world. The 17 goals are divided into 169 specific targets, encompassing the social, economic and environmental elements. Each of the SDGs has its own importance and failing to achieve them will have a detrimental impact on society and the world we live in. Since the introduction of the SDGs, the world in general has paid more attention to the underlying goals and have taken steps to assist in the achievement of the underlying goals. Additionally, with the devastating impact of COVID-19 on the people and institutions in general, achieving the SDGs has become more important than ever. These goals and aspirations that have been translated into the SDGs are fully in line with the objectives of Islamic law (Maqasid Shariah).

The comprehensive framework for the implementation of the SDGs emphasizes the partnerships between multiple stakeholders including those with surplus funds and those who are need of funds. The global Islamic banking and finance industry is no different — in fact the goals that are promoted through the SDGs have their foundations in Islamic law (Shariah) — adherence to which is the prerequisite for any Islamic financial transaction. Additionally, in my humble view, when we discuss the SDGs in the context of Shariah — the emphasis and the accountability on the elements are next to none. These guidelines around sustainability within Shariah were introduced 1,400 years ago in the Holy Quran; when we discuss the environment, it says: "It is He (Allah the Almighty) who has appointed you vicegerent on the earth…" (Quran 6:165). It means that we, as humanity, are entrusted by way of our role as the trustee and custodian of this planet, including all of its natural and economic resources. When we look at the directives on ending poverty — the Holy Quran states: "And you do not encourage one another to feed the poor" (Quran 89:18). On anti-corruption, it states: "…And do not desire corruption in the land. Indeed, God does not like corruptors" (Quran 28:77) and "…And do not commit abuse on the earth, spreading corruption" (Quran 2:60). The concept of

[1] In 2015, at the COP21, for the first time every country agreed to work together to limit global warming, to adapt to the impacts of a changing climate and to make funds available to deliver on these – as a result it was named Paris Agreement.

Zakah (compulsory charity) is to alleviate poverty and to ensure that society is balanced. We will be held accountable if our neighbors go to bed hungry as well as for any extravagance and if the natural resources are wasted. These are only a few examples but the rulings on quality education, equality and reducing inequalities, clean water and protecting life on land and water are plenty.

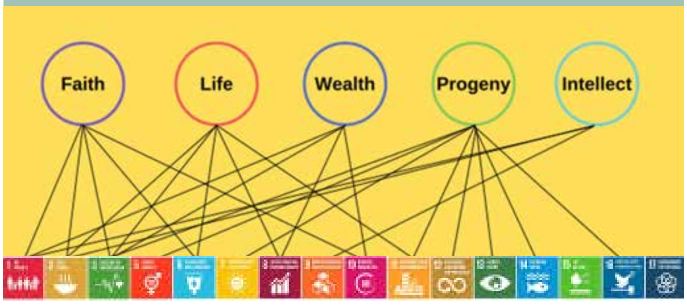
Additionally, the guidelines provided by the divine rulings are far more comprehensive than the SDGs. Also, when it comes to accountability, the difference between divine rulings and conventional guidelines like the SDGs is that the latter are man-made while the former are from the Creator, who will hold mankind accountable for their actions during their lifetime and penalized for not adhering to them in the hereafter.

Having said this, the SDGs are an excellent starting point for us to achieve the objectives of Shariah, to quantify and place targets around achieving the objectives that are beneficial for all.

The global Islamic banking and finance industry is fully supporting the SDGs and, in this regard, various institutions that are part of the Islamic economics, banking and finance industry have introduced measures and initiatives that help in the achievement of these goals. Multilateral institutions like the IsDB are fully committed to the SDGs; the IsDB has launched multiple initiatives in line with the need of its member countries. This includes its inaugural green Sukuk in 2019 raising EUR1 billion (US$238.95 million) for sustainable projects in its member countries and a US$2.5 billion sustainability Sukuk issuance in 2021 with proceeds to be allocated to finance/refinance green and social development goals in line with the IsDB's sustainability framework.

Financial institutions have tailored their strategies to promote the SDGs and sustainable developments — this include banks that have placed targets in financing projects that are socially responsible and are undertaking measures to protect and safeguard the natural resources. This includes financing projects that promote healthcare, job creation, education, renewables, etc. Additionally, investors are more conscious of the factors impacting sustainable development and some would like to invest in line with their values. As such, investors have demanded their investment to be environmental, social and governance (ESG)-compliant in addition to being Shariah compliant — thereby moving away from being just Halal (lawful) to Tayyib (pure/preferred). If we are to consider stock market investment, in the past investors would seek stocks to be Shariah compliant in line with the underline methodology; however, lately there has been far more focus on adding an additional layer in making sure that the stocks are also ESG-compliant and contribute positively to society at large — moving also the Shariah compliant screening industry from just negative screening[2] to positive screening [3]. Although we need to move from being just Shari ah compliant to achieving the objectives of Shariah, however, investor appetite and wider market acceptability are important for this industry to grow — because after all if the viability is not there the best products will just sit on the shelves and collect dust. Shariah scholars have also shown a keen interest in this and have extended their support to make available different types of portfolios (just Shariah compliant or SDGs-compliant) so investors have a choice to invest in line with their values and to make a difference (impact-based investments).

Figure 1: SDGs and elements of Maqasid Shariah



Source: https://www.stratigos.com/post/zakat-and-sdgs

The regulators and the standard-setting bodies within the Islamic finance industry are also mindful of the industry developments that are happening in the area and are supporting its growth by issuing guidelines and rulings in this regard. In particular, AAOIFI has issued a very comprehensive standard titled 'Corporate Social Responsibility (CSR), Conduct and Disclosure for Islamic Financial Institutions' in 2009. The standard aims to provide both mandatory and recommended standards to implement CSR in all aspects of an Islamic financial institution's activities and provide guidance on the disclosure of CSR information to the Islamic financial institution's stakeholders. AAOIFI is also mindful that there have been a lot of developments in the sector since the issuance of this standard, and as a result the AAOIFI Governance and Ethics Board is currently working on developing and issued a standard on sustainable financing, which is expected to be issued in 2022.

While the SDGs are important to achieve the long-term sustainability of society and mankind at large, it is equally important to ensure that there is a fair and balanced treatment among the nations. The developed nations, which to date happen to be responsible for the highest emissions globally (G20 countries in particular), should play an active role in reducing their emissions and positively contribute to the environment rather than placing additional pressure on the developing countries (where the means for income may be limited) to lower their emissions. For example: G20 nations are responsible for 80% of global emissions and if they reduce it by 55%, the targets put forward by the COP26 and Paris Agreement can be achieved. Similarly, the capitalist divide between the rich and the poor, where 20% of the people control 80% of global wealth, is the widest in developed economies. There is a need for a better model of wealth distribution. In particular, there should be the adoption of a system that promotes socioeconomic justice and the well-being of all through integrated moral values; elimination of poverty; social justice and equality, as well as risk-sharing.

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[2] Avoiding investing in unethical or Shariah non-compliant stocks

[3] Investing in stocks that are socially responsible