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at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.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

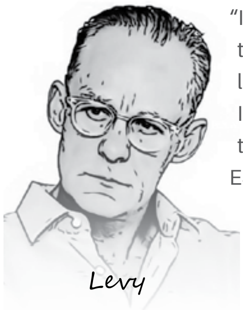
Bashar

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."

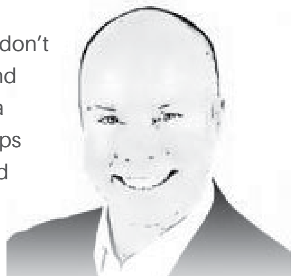
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these 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.

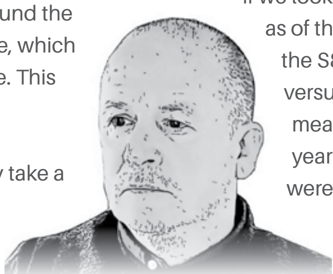
"(In general) getting a real yield that is actually positive is a challenge, and if you're an Islamic investor, then you have further restrictions. You don't have the entire universe available to invest in and so finding something that is going to generate a yield is one thing, finding something that 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.


Reeves

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.


Orzano

"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


Haines

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.

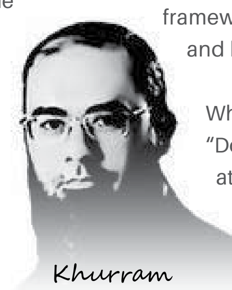
The Islamic Finance Council UK expects US$30-50 billion in capital for green and sustainability Sukuk up to 2025.

"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.

Mohammed

"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."

ESG implementation challenges and risk factors to the Islamic financial services industry

By Ijlal A Alvi,
CEO of International Islamic Financial Market

Authored by

The political, business and financial leaders and policymakers around the world are now either looking into or aggressively working on plans to reduce carbon emissions to net zero by 2050 as per the agreed goals and binding commitments/pledges of the signatories to the December 2015 Paris Agreement.

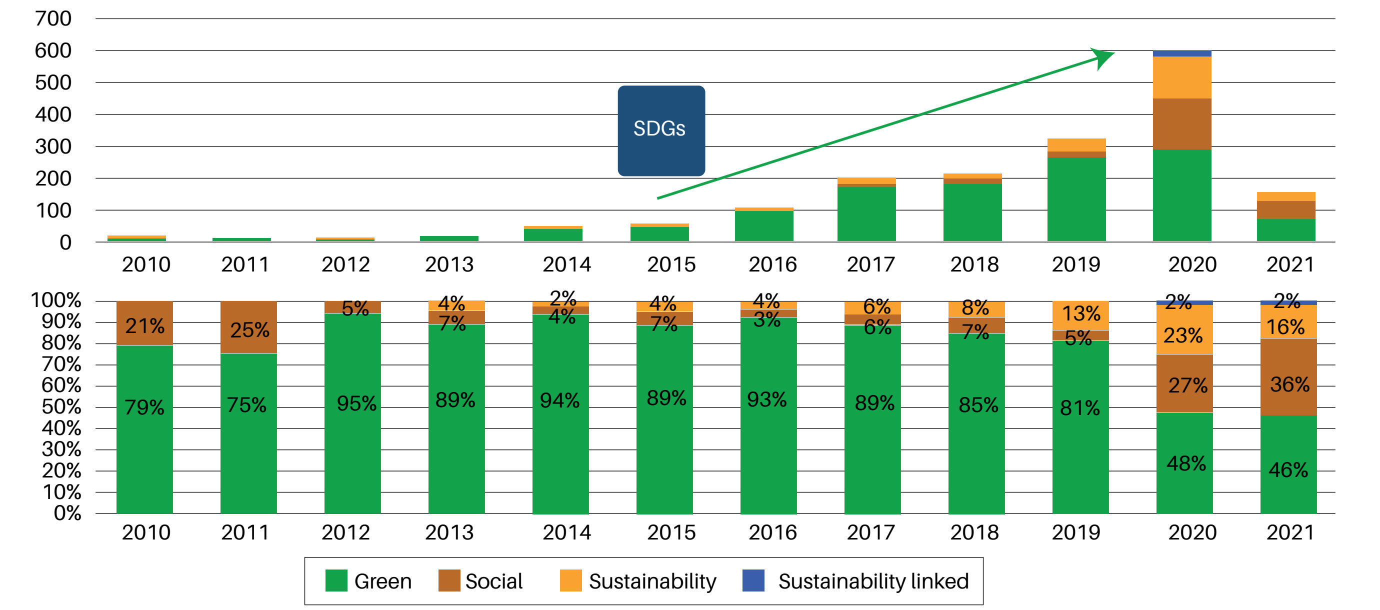
The goals of the recently concluded COP26 [2021 United Nations Climate Change Conference] meeting are to secure global net zero by mid-century, to protect and restore ecosystems, to build infrastructure and agriculture that are resilient, developed countries to make good on their promise to deliver US$100 billion in climate finance a year and to accelerate collaboration. Moreover, financial institutions and corporates in particular have pledged significant investments to develop sustainable strategies and set clear goals to achieve these strategies over the next decades.

The OIC and multilateral institutions like the IsDB are strongly supporting the environmental, social and governance (ESG) initiatives to overcome the global warming challenges caused by greenhouse gas emissions. Furthermore, a number of institutions offering Islamic financial services and corporations have incorporated the concept of green finance and designed internal policies and strategies to achieve sustainability which will lead to creating not only value for stockholders but also taking part in the development of sustainable Islamic green finance.

Moreover, as per the DDCAP Group article contribution in the International Islamic Financial Market 10th Edition Sukuk Report, as the volume of conventional sustainable issuance is reaching unprecedented levels and momentum continuing to increase, the Islamic capital markets (ICMs) would be prudent to heed this as a call to action to increase their own activity in this space. While the past 10 years have seen increased focus on green and social impact Sukuk, ICMs should begin to focus on sustainability issuances. The focus should be on reducing negative environmental impact while promoting social and governance consideration; ICMs can more efficiently mobilize capital toward responsible and sustainable causes.

The following green social sustainable (GSS) bond issuance charts mainly covering the period of 2019 to 2020 clearly indicate the shift toward the issuance of GSS securities to raise capital and provide sustainable investment opportunities.

Chart 1: GSS bond growth – issuance (US$ billion equivalent)



Source: Environmental Finance, 11th March 2021

Moreover, a study by Refinitiv reported that sustainable finance issuance is at new highs with around US$360 billion of sustainable bonds being issued in the first nine months of 2020, up 96% on the same period in 2019, as well as a record US$155 billion of sustainable bonds raised in the third quarter of 2020. Of these sustainable bond issuances, 49% were made by corporates, which was a 35% increase on the same period in 2019.

As per Refinitiv, the cumulative ESG Sukuk issuance amounted to US$15 billion by the third quarter of 2021. Total ESG issuance reached US$5 billion in 2020 and is on track to set a new record in 2021. The increasing sustainable Sukuk issuance is promising development and it shows that issuers and investors are giving preference to sustainable financing opportunities.

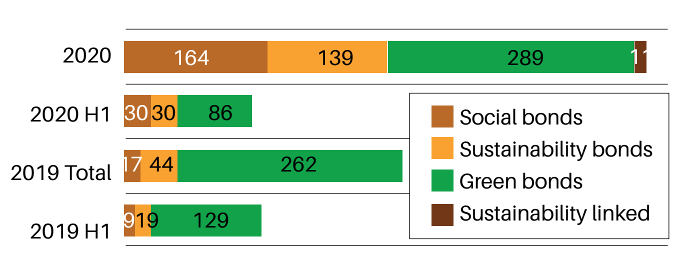
Carbon castoffs

As per the International Renewable Energy Agency, delaying action to tackle global warming could add trillions of dollars to the tally of worthless assets, hence the Islamic financial services industry needs to double up its efforts to achieve meaningful ESG implementation goals and avoid high stranded assets.

As per Bloomberg news, global regulators such as the European Central Bank are stepping up pressure on lenders to prepare for stress tests next year that will show just how vulnerable the industry is to climate change. The regulators also plan to study the link between profits and carbon risk in banks' portfolios. Moreover, various media houses have reported that other global regulators and perhaps regional regulators are planning to carry out a similar ESG stress testing exercise.

One of the global regulatory bodies, the International Organization of Securities Commissions Sustainable Finance Task Force, has published its final report dated the 2nd November 2021 on recommendations for sustainability-related practices, policies, procedures and disclosures in the asset management industry.

Chart 2: GSS bond growth – issuance (after COVID-19) (US$ billion equivalent)



Source: Environmental Finance, 30th January 2021

ESG key risks

Although there are many challenges which the industry has to overcome to achieve the desired level of ESG implementation goals, however, in this article the focus will be only on ESG or sustainability-related risks and the impact on the supply chain especially to suppliers based in developing countries which generally have greater reliance on fossil fuel either as a producer or a user.

ESG or financial stability risks

The most common and identifiable risk factors which need to be evaluated and addressed are financial risks and non-financial risks. The ESG non-compliant entities and their counterparties could be exposed to the following financial risks:

- Credit risk: which means that there could likely be a probability that ESG non-compliance may result in loss due to a default
- Market risk: which may lead to trading loss, and
- Liquidity risk: loss due to liquidity shortage.

The aforementioned financial risk factors will have a negative impact on a non-compliant entity's assets, financials and earnings; the liquidity risk will require monitoring and assessment due to the changing dynamics as the financial industry move toward sustainable finance.

In addition to the financial risk factors, the following non-financial risk factors may also have a negative impact if not tackled:

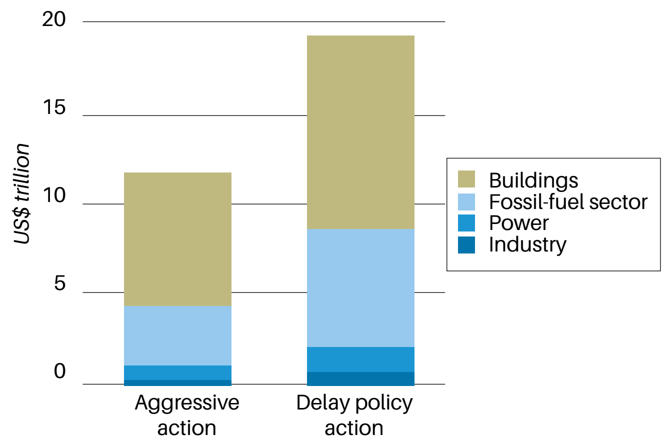
- Operational risk: loss due to operational failures, and
- Business strategy risk: loss of basis for a business model.

In both cases, the common and equally important ESG risk factor is the loss of reputation or reputational risk.

The most crucial process and step needed to measure ESG risk is the assessment of the current ESG exposures and this includes the consideration of ESG risks while evaluating capital adequacy as well as calculating regulatory and economic capital.

The ESG risk factors and changing regulatory landscape are a clear indication that Islamic financial institutions need to not only be aware of the aforementioned key risk factors but also start working on their portfolios toward sustainable finance.

Chart 3: Value of stranded assets



Note: The forecast amount of stranded assets from 2016 through 2050 is in a scenario in which global warming is limited to under 2ºC.

Source: International Renewable Energy Agency

ESG implementation and its impact on supply chain

As per a Standard Chartered Bank report titled 'Carbon Dated – The net-zero supply chain revolution', governments are striving to deliver net zero by 2025 to avoid an environmental catastrophe, but without the direct engagement of businesses the efforts may fail. Multinational companies (MNCs) in turn are feeling the pressure as 73% of their total emissions are with their supply chain which make their task even more challenging and difficult.

The report also stated that the interplay between these businesses and their MNC partners will be a defining factor in the global race to net zero.

As per the study conducted by the bank, the following revelations indicate the challenges ahead especially to non-ESG compliant suppliers:

- For 67% of MNCs, reducing supplier emissions is the first step in their net zero strategy, underlining the importance of supply chains in carbon transition.
- About 78% of MNCs say they will start removing slow-to-transition suppliers by 2025 (including 15% who have already started this process).
- MNCs expect to cut around 35% of their current suppliers as they respond to net-zero pressures.

The study found that almost a third of MNCs are already taking a zero-tolerance approach to their supply chain, swiftly removing suppliers that endanger their transition. The bank's economic model reveals what this means for the businesses in 12 key fast-growing markets of Asia and Africa which are at the center of OECD supply chains and it provides a US$1.6 trillion export opportunity for early movers that align with MNCs' net-zero plans.

The report also mentioned that the collaboration between MNCs and their suppliers, particularly smaller suppliers, is key to making net zero a reality.

Conclusion

As highlighted in the article, the level of preparedness in terms of assessing the ESG or sustainability risk factors and taking the necessary steps to overcome the challenges, particularly those relating to ESG financial and operational risk factors, will be key to meeting the UN Sustainable Development Goals (SDGs). Moreover, the regulatory recommendations and requirements to financial institutions need to be addressed to achieve the common goal of the net-zero emission target by 2050 as well as to keep stranded assets to a minimum level.

The other challenge highlighted in this article is the net-zero supply chain revolution where collaborative efforts involving MNCs, suppliers (particularly based in OIC countries) and the financial intermediaries are necessary to avert a shift of business to suppliers based in the developed world as these suppliers are likely to achieve the required sustainability targets.