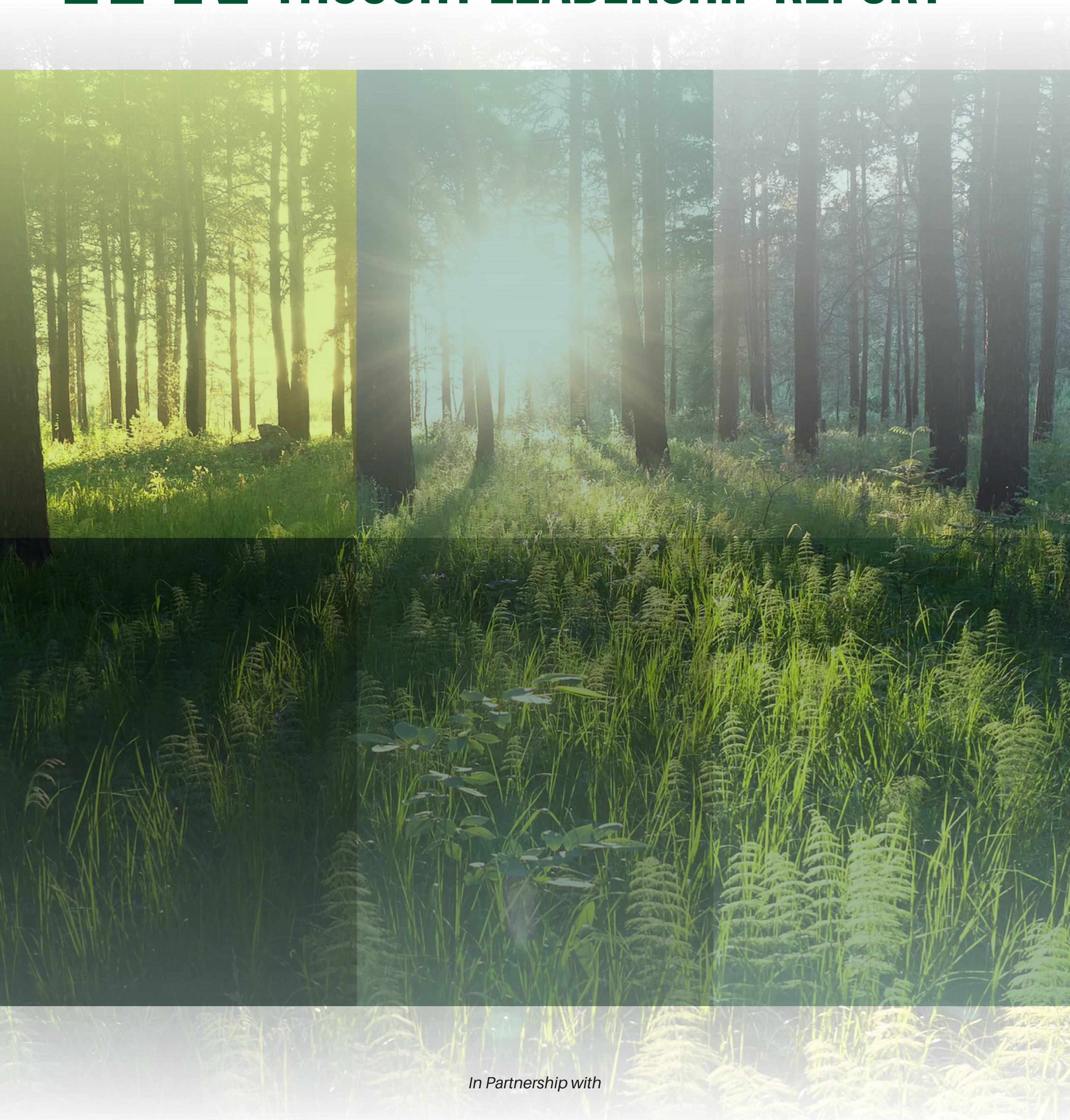
IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT



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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.

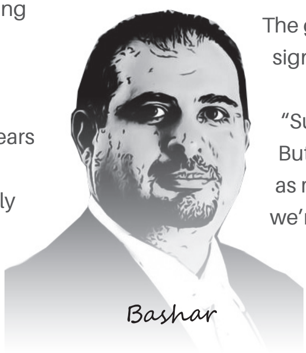
Slow and steady

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.

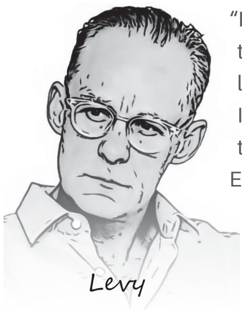
"If I look at how much was issued since 2017, it is less than US$20 billion, which is small compared to the size of the global Sukuk market which is around US$800 billion currently. So, in terms of actual size, the sustainable Sukuk market is still tiny," Bashar explained, adding that over 10% of Fitch's 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."

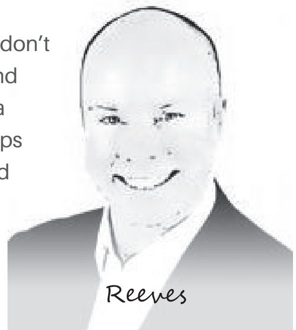
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these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

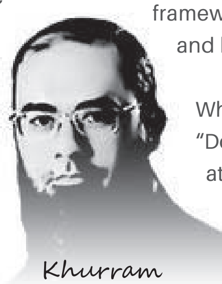
"It has been suggested that we need about US$7 trillion in infrastructure investment annually and between US$1.5 trillion to US$4 trillion every year for energy transition to meet the Paris [Agreement] targets; and with the commitments of the Glasgow Climate Pact, I'm sure

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."

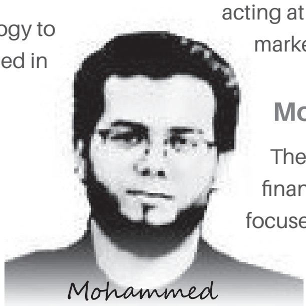
At the heart of this movement is the importance of nurturing the right people to drive this change.

"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.


Mohammed

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."

Luxembourg: A global hub for the development of sustainable Islamic financial solutions

Authored by LuxembourgforFinance — Agency for the Development of the Financial Centre

Islamic finance strives for fairness, the empowerment of all stakeholders, the pursuit of ethical practices and social responsibility — values that sit at the heart of the growing global shift toward sustainable finance. While largely a niche sector, the similar values mean Islamic finance has the potential to rapidly grow and play a more active role in fostering a sustainable future. To this day, few financial hubs are as well positioned to support the international development of Islamic finance as Luxembourg given its historical expertise in Islamic finance and its commitment to developing sustainable finance solutions.

Islamic and sustainable finance — a close connection

The COVID-19 pandemic has acted as a catalyst for sustainable finance, shining a light on the need to ensure that any economic recovery is sustainably minded. This has seen the issuance of sustainable securities double in a couple of years and a growing demand for new and innovative sustainable products — green Sukuk included. Islamic finance benefits from a great opportunity in this regard to combine value creation and the pursuit of environmental, social and governance (ESG) impacts for all stakeholders.

Both offer products that serve Muslim and non-Muslim investors alike and possess strong practices and policies which complement each other. Indeed, contractual equality, ethical governance and responsible investing are core principles of Islamic finance and this holds true for sustainable finance. Islamic finance inherently applies certain practices that are widely used in sustainable financing, such as negative-based screening to avoid specific activities, industries or products that are deemed immoral or unlawful under Shariah law. ESG principles could also be integrated in Shariah compliant products as a complementary methodology by operating inclusion-based screening for specific sectors, products or practices with positive impacts. Although Sukuk remains the preferred financial vehicle for green financing, this could assist in the further development of the social financing sector via products such as Zakat, Sadaqah and Waqf.

With Islamic finance particularly focused on financial inclusion, microfinance is critical for providing access to many communities that lack access to Shariah compliant facilities. Luxembourg, as the leading European domicile for microfinance vehicles (MIVs), is well poised to provide support in this regard. The Grand Duchy accounts for almost a third of global MIVs and more than 50% of global MIV assets under management (AuM).

From a regulatory perspective, Islamic institutions looking to expand internationally can face challenges setting up operations in jurisdictions lacking knowledge or compatibility with Shariah principles. Whether the project in question is setting up a bank, a Sukuk or an investment fund, the supervisory authorities will seek to ensure that all applicable Luxembourg and European legal requirements are complied with. It is important to note that Islamic funds or investments looking to integrate ESG criteria to be marketed as a 'sustainable Islamic fund' or 'ESG Islamic fund' must respect the mandatory requirements of regulations on sustainable finance, in addition to Shariah principles, to be acknowledged as such and avoid greenwashing.

An established sustainable fund industry hub and EU gateway for Islamic asset managers

Given the close connection between Shariah compliant and sustainable finance products, Islamic institutions are no strangers to the growing sustainable finance trend. With the fund industry set to play a predominant role in the transition to a sustainable economy, Shariah compliant products can too play an outsized role; however, this will require specialist financial hubs' expertise to support their growth.

With EUR5.6 trillion (US$6.47 trillion) in AuM and investment funds distributed in 79 countries, Luxembourg is the prime location for investment fund domiciliation and cross-border fund distribution. The country handles more than 56% of cross-border investment funds worldwide. Although a majority of the Islamic funds and Islamic financial assets are still domiciled in the Middle East and in Southeast Asia, Luxembourg has become one of the six largest Islamic fund centers globally with over EUR11 billion (US$12.72 billion)-worth of AuM and is now the world's leading non-Muslim domicile for Islamic investment funds with more than 49 Shariah funds under management.

This strong expertise is also a key factor and enabler to the success of the financial hub and to its growth as the leading global sustainable investment hub. Sustainable funds' net assets accounted for 11% of total net assets and the Grand Duchy captured almost half of total net flows across all European domiciles in 2020. Further, almost a third of the total net assets in sustainable funds at the end of 2020 were already domiciled in Luxembourg, making it the ideal location for ESG Shariah compliant mutual funds intended for international distribution to retail and institutional investors.

Located at the heart of Europe and sharing borders with France, Belgium and Germany, Luxembourg serves as a key gateway to Europe for Islamic financial institutions looking to set up Shariah compliant products and services

A leading private equity and venture capital hub, Luxembourg provides various alternative investment fund products which can also be structured in full compliance with Shariah law. Flexible structures such as the Specialised Investment Fund (SIF) or the Reserved Alternative Investment Fund (RAIF), which allow for a wide variety of different investment strategies, can be used for Shariah compliant private equity, property or other alternative investment schemes. These structures, used either for Shariah compliant funds or for conventional funds, have proven highly successful with Middle Eastern investors.

The specificities of the SICAR (investment company in risk capital) as a venture capital investment vehicle makes it well suited for Islamic finance investments in and through Luxembourg. Luxembourg securitization vehicles (SVs), on the other hand, provide a flexible and tax-neutral regime for financial products. One of the driving factors of the popularity of Luxembourg SVs among Islamic investors is the wide range of eligible assets (other than interest-bearing assets) which can be securitized. Luxembourg SVs have been used in several Murabahah and Ijarah structures.

A solid European capital market infrastructure for Islamic investors

The capital market sector represents a key manner in which to foster the transition to a sustainable economy and will likely be a key sector where the convergence of ESG and Islamic finance can materialize through green or sustainable Sukuk. The Luxembourg Stock Exchange (LuxSE) is already a prime listing location for Sukuk in Europe and it has been the case since the first European Sukuk facility was listed by Malaysia on its platform in 2002. Ever since then, 21 sovereign and corporate Sukuk have been listed on the LuxSE. Since 2002, the aggregate amount raised through Sukuk at the LuxSE has reached EUR7.9 billion (US$9.13 billion).

An increasing portion of the Islamic debt securities are green Sukuk and sustainability-linked Sukuk in general are expected to grow significantly in the coming years. As a matter of fact, several green Sukuk were already issued by Malaysia, one of the leading global Islamic financial hubs. Luxembourg is also an ideal place for listing sustainable securities and is therefore well equipped to support growth in green Sukuk listing globally. Luxembourg indeed became the first country to have opened a stock exchange platform exclusively dedicated to sustainable securities in 2016, the Luxembourg Green Exchange, now listing more than half of the sustainable securities in the world, and more than 1,000 bonds with a volume of more than EUR500 billion (US$578.03 billion).

Bringing Islamic finance to the globe

But pre-existing synergies between ESG and Shariah compliant finance alone will not be sufficient for Islamic financial players to become global leaders. Islamic investors looking to expand globally will need to rely on experts trained in both sustainable and Islamic finance to conceptualize highly adaptable strategies and investment methodologies. Despite its outsider position in the Muslim world, Luxembourg has built a long-standing reputation over the last 25 years as a major Islamic finance center in Europe with consolidated expertise to support the development and structuring of Islamic finance products for global investors. The Luxembourg financial sector supervisory authority (CSSF) and the insurance sector regulator (CAA) have many years of experience in the authorization and supervision of Shariah compliant fund and insurance structures.

Connections here date back to 1983 when Luxembourg acted as a pioneer in Europe for Islamic insurance with the establishment of Solidarity Takafol, the first authorized Islamic insurance firm in the bloc. Luxembourg was also the first European market to list a Sukuk facility in 2002 and the first sovereign state to issue a euro-denominated Sukuk facility in 2014. Additionally, the Grand Duchy's central bank became the first European central bank to join the IFSB and was one of the founding members of the International Islamic Liquidity Management Corporation. Luxembourg has since developed a deep understanding of Shariah compliant financial solutions, combined with a long history of cooperation with Muslim countries and communities. The CSSF, for example, signed MoUs with Qatar and Abu Dhabi in 2015 and 2017 respectively to provide mutual assistance and exchange of information in the sector.

The Grand Duchy furthermore benefits from an extensive double tax treaty network with many Middle Eastern and Southeast Asian markets given its active role as an investment hub for Islamic companies and individuals. Located at the heart of Europe and sharing borders with France, Belgium and Germany, Luxembourg serves as a key gateway to Europe for Islamic financial institutions looking to set up Shariah compliant products and services.

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