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at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.

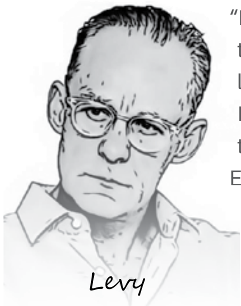
"If I look at how much was issued since 2017, it is less than US$20 billion, which is small compared to the size of the global Sukuk market which is around US$800 billion currently. So, in terms of actual size, the sustainable Sukuk market is still tiny," Bashar explained, adding that over 10% of Fitch's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

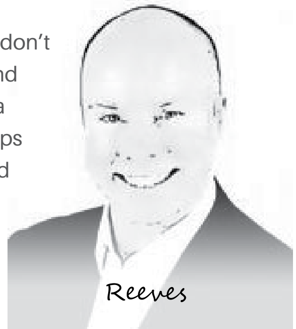
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these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

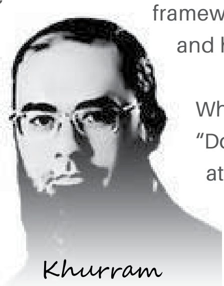
The Islamic Finance Council UK expects US$30-50 billion in capital for green and sustainability Sukuk up to 2025.

"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.



Khurram

"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."

The evolution of Islamic finance: Making the case for Islamic finance as a sustainable and responsible investing alternative

By Rejina Rahim and Suryati Alias, supported by Sabrina Rahim from Nomura Asset Management Malaysia

Authored by

Introduction

The last 22 months since the outbreak of COVID-19 that started in China which rapidly evolved into a global-wide pandemic have seen unprecedented disruption, in ways no work of fiction could have envisioned. In 2020 where we thought we had seen the height of the pandemic, Islamic finance and the general financial markets stayed largely resilient despite the global economic shocks.

In Malaysia in particular, 2020 proved to be a surprisingly good year for the capital markets with Shariah compliant solutions growing at double the pace of the total assets under management (AuM)[1] and contributing greatly to the overall growth. Malaysia also remains the most developed market for Islamic finance as per the IDC–Refinitiv Islamic Finance Development Report 2020.

Islamic finance has grown to a sizeable US$3 trillion industry but pales in comparison with the global financial services market of US$20 trillion[2]. Drilling down to the investment management industry, Shariah compliant assets are still trailing at about US$120 billion in 2019[3] while the global asset management industry is a monster at almost 775 times the size at US$93 trillion and growing another 11% to US$103 trillion as at the end of 2020[4].

The last few years have seen a pickup in demand for sustainable investments, with growth rates of 15% in the past two years (2018–20) for a total AuM value of over US$35 trillion[5] with growth expected to pick up further since the advent of the COVID-19 pandemic has shown the world that a global-wide pandemic's ramifications can be a lot more damaging than any of us had pictured or anticipated.

Despite Islamic finance's many similarities and values with sustainable investments, it is surprising that the product proliferation has not taken up in a big away despite the opportunity presented by the pandemic.

[1] Securities Commission Annual Report 2020

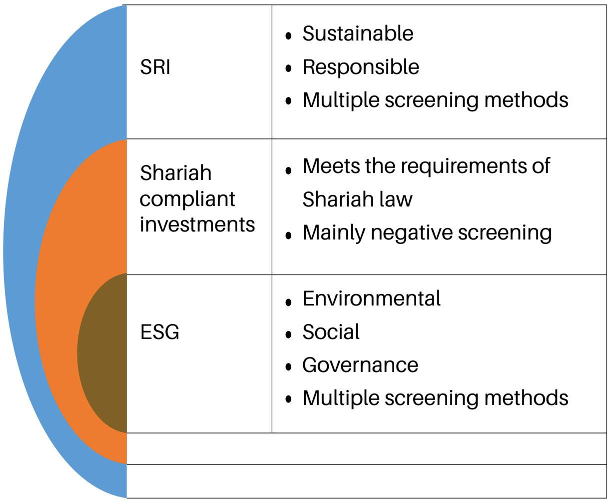
[2] Financial Services Global Market Report 2021: COVID-19 Impact And Recovery To 2030

[3] Global Islamic Finance Report 2020-21

[4] bcg.com Global Asset Management 2021 Report

[5] Global Sustainable Investment Review 2020

Figure 1: Concepts and approaches



Source: Authors' own

The time is ripe for a reset in Islamic finance to move beyond being seen as merely an exclusionary value-based investment approach and embrace its spiritual ideals.

Islamic finance is not merely a value-based investment approach that excludes interest-bearing instruments, gambling and alcohol. There are clear references of humankind's duty toward the environment found in multiple verses in the Quran such as Surah Ta-Ha (20), verses 53–54 where it clearly states that Allah has created the earth where all nature is one and one must use nature intelligently and not abuse it. Social justice is another important element of the Quran addressing the treatment of orphans and women fairly and embracing diversity as God made it clear in Surah Al-Hujurat (49), verse 13 that God made us into males and females and made us into different tribes so that we learn to know about each other.

Within this paper, we will be using sustainable and responsible investment (SRI) as an overarching term to encompass both environmental, social and governance (ESG) as well as Islamic or Shariah compliant investments (see Figure 1). The 2000s onwards have seen considerable growth in the Shariah space yet the division of Islamic assets is very much focused on banking assets and Sukuk which are still very much within the domain of the institutional and bankable. Socially-conscious products like Waqf are still a very insignificant contributor to the overall Islamic assets.

What are the universal values of Shariah compliant investments?

There are essentially five main principles:
1) Support for activities that benefit society
2) Prohibition of activities and practices that promote unjust gains, thus prohibition against interest-bearing instruments
3) Sharing of risk and rewards on an equitable basis
4) Transparency of contract and sanctity of the contract, and
5) Prohibition of activities harmful to the individual and society such as alcohol, gambling, weapons and pork.

Figure 2: Quick comparison of the three main themes

Items	SRI	ESG integration	Islamic finance
Themes	Sustainable and responsible	Environmental, social and governance	Shariah compliant
Screening	Both negative and positive	Both negative and positive	Negative
Main markets	Global	Global	Middle East and Southeast Asia
Asset under management[6]	Global funds: 2016: US$23 trillion 2020: US$35 trillion Four-year CAGR: 11.5%	Global funds: 2016: US$10 trillion 2020: US$25 trillion Four-year CAGR: 24.9%	Malaysian funds: 2016: RM150 billion (US$36.14 billion) 2020: RM217 billion (US$52.28 billion) Four-year CAGR: 9.7% Global funds: 2016: US$97 billion 2019: US$120 billion Three-year CAGR: 7.4%

The Quran's teachings further support moderation and balance to contain human excesses and the main themes found within the Quran are equity, balance and responsibility. These values are also the same to be found within ESG and SRI. The only major difference would be the fact that Shariah investments, in their current form, are still largely exclusionary-based rather than embracing a more holistic viewpoint that the Quran and the religion require of followers.

Looking at the compound annual growth rate (CAGR) numbers available, it does appear that Islamic compliant funds trail somewhat to ESG and SRI funds. Inversely, that also means that the potential for growth of Islamic compliant products is equally as good as that of SRI and ESG, if Islamic compliant funds can pivot, and show that they also meet the requirements of sustainability in general and not just be seen merely as a value-based investment.

The overlap between ESG principles and Shariah compliant finance has long been remarked upon. Given the clear overlaps, convergence would be timely and act as the trigger for Shariah investments to move into the mainstream, especially in areas that can address social economic issues. A recent example was seen when the Malaysian government issued the retail Sukuk Prihatin to help the underserved weather the COVID-19 pandemic economic impact; it was oversubscribed by 33%.

One of the key issues in being a practitioner of both SRI and Shariah compliant products would be how does one address the crossover in terms of products and investors?

[6] Global Sustainable Investment Review 2016 & 2020, Securities Commission Annual Report 2016 & 2020 and Global Islamic Finance Report 2020-21

Global ESG assets surpassed US$35 trillion in 2020 and are on track to exceed US$50 trillion by 2025, denoting one-third of the US$140 trillion in projected total AuM globally [7]. The pandemic and race to net-zero emissions helped send interest into orbit, with the surge reshaping the financial industry. If these numbers are any indication, then the total addressable market for Shariah compliant investments should not be limited to merely the 1.8 billion Muslims globally.

The Schroders 2019 Global Investor Study provides support for the possibility that the current offerings within the Shariah compliant space are not sufficient to meet investors' investment needs and thus move into SRI or ESG. The study finds that 66% of Asian respondents to this survey said they would always consider sustainability factors when selecting an investment product, higher than the 57% globally who agreed with this statement. An even higher percentage felt this way in Indonesia (76%). The figure for the UAE was also above average, at 62% (individual country-level data not available for other predominantly Muslim countries). Furthermore, Middle Eastern and Asian respondents also felt more strongly than their global peers that climate change will impact their investments. With the obvious overlap between SRI and Shariah compliant investments, the potentiality of growing the Islamic investor base should be explored.

The Malaysian fund management industry's AuM are RM905 billion (US$218.03 billion) in size with a lot of the growth seen in the industry AuM contributed by the Islamic side which had a 20% growth in 2020 as compared with 10% of the total AuM [8]. If Shariah compliant funds are already attracting better growth, layering it with a social agenda should attract and expand the current investor base.

The Malaysian government, in trying to future-proof its government-linked investment institutions, earlier came out with the PERKUKUH [9] initiative which is a medium-term strategic plan that focuses on good governance, social inclusivity and environmental sustainability. With a coordinated and focused plan, we personally believe that both the demand and supply of SRI-friendly products will rise in the next few years, changing corporate behavior for the better as well as increasing the breadth and depth of the capital markets.

A recent survey by MAMBU that appeared in an IFN report mentioned that in a survey of 2,000 Muslim youths, 70% required online presence and 80% insisted on accessibility. Digital convenience is the obvious way to go but the Muslim world is also the one which is poorer with less access to banking convenience and poorer digital infrastructure. However, sometimes less is more. Indonesia with a less developed banking infrastructure has used mobile penetration in ways that has profited the general population as can be seen from one of their homegrown unicorns, Gojek.

The Indonesia start-up ecosystem sets a great example of the need to look at utilizing digitization and the e-commerce market to do better and be more inclusive to all segments of society. The rise of digitization and the ease of access through mobile phones are giving rise to new opportunities within the global markets. Brighter spots in the Islamic world arising from technology can be particularly seen in markets such as Indonesia which has over 11 unicorns currently [10]. E-commerce in Indonesia encompasses everything from Halal food, clothes and Wudhu-friendly makeup to banking and investments which are all available from its e-commerce sites. Other more structured and regulated markets like Malaysia can take a leaf from Indonesia's book in terms of its flexible approach in dealing with the rise of digital adoption by the masses.

Figure 3: Main differences between Islamic and ESG investing

Description [11]	Islamic	ESG
Certified by Shariah boards	Yes	No
Strict assessment of capital structure (ie interest, debt ratio)	Yes	No
Screening of environmental issue using a specific standard	No	Yes
Active ownership practices (ie active engagement with investee companies)	No	Yes
Significant difference between the benchmarks, country and sector allocations	Exclusion of the traditional financial sector, high leverage companies and non-permissible business. Relatively smaller investment universe.	Relatively bigger investment universe.
Asset size and geographic concentration	Smaller size than ESG. Most of it in commercial banking and concentrated in the Middle East and Malaysia.	Bigger asset size than Islamic. Most of it is traced to asset managers and asset owners. Mainly in the western regions.

What are the most significant differences between the two approaches, from a fund management perspective?

Sustainable funds generally employ some level of exclusions in determining the investable universe. Common exclusions in the US include gambling, alcohol, pornography, civilian weapons manufacturing, tobacco and fossil fuels. Some of these screens, such as gambling, alcohol and pornography, are more common in funds labeled 'socially responsible', 'faith-based' or 'values-based' investing strategies. Values-based investing strategies are typically aligned with a specific set of morals or ethics, such as Catholic funds or Shariah compliant funds. [12]

Despite the similarities with SRI and ESG, we are not seeing demand for Shariah compliant funds growing as strongly as SRI and ESG as per the CAGR numbers seen in Figure 2. We have observed that despite the

[7] Bloomberg Intelligence ESG 2021 Midyear Outlook Report

[8] Securities Commission Annual Report 2020

[9] PERKUKUH focuses on good governance, boosts long-term prospects https://www.mof.gov.my/en/news/press-citations/perkukuh-focuses-on-good-governance-boosts-long-term-prospects

[10] Credit Suisse ASEAN Unicorn-Scaling New Heights 5 October 2021 report

[11] CFA Institute: Sustainable, Responsible and Impact Investing and Islamic Finance–Similarities and Differences

[12] Integrating Sustainable Investing: The Landscape of Opportunities, Josh Charlson, CFA, Alyssa Stankiewicz, 26 July 2021, Morningstar

consistent stronghold of Islamic finance, Islamic finance in its present form has not been able to break into the global mainstream and remains sidelined to just a few Muslim countries. Its attractiveness as an alternative to conventional investments, compared with that for SRI compliant investments has been poor despite the rise in awareness of social inequity, climate change in the last few years due to the rise of social media and ease of access to information. This paper is by no means exhaustive and can only superficially examine the reasons why the expansion of Islamic finance into going back to its spiritual roots is timely and crucial.

Islamic finance with its religious roots dating back over 1,443 years ago has to be innovative to successfully compete in the modern world. Its equitable base of social equity, respect for nature and holistic view of the market economy has not been fully explored by existing practitioners. Islamic finance has not positioned itself to move beyond growing the Sukuk market and Islamic banking. Growth with regards to Islamic investments is still difficult as the investment universe remains narrow. It would be a waste if the growing focus on climate change, social inequality and racial diversity, themes so strongly found in the Quran, is not taken advantage of to make the world a better place for all.

Malaysia, which is a global leader in Islamic finance, is pivoting toward SRI and its central bank has just recently released a climate change taxonomy that will see the Malaysian financial markets comply from July 2022. The capital market taxonomy by the Malaysian capital market regulator, the Securities Commission (SC) is expected to also be released later this year. The SC's recently launched Capital Markets Master Plan 3 which will cover the years 2021 to 2025 aims to utilize SRI and Islamic finance pillars as a means to draw more capital to sustainable businesses to achieve its main objective of accelerating economic growth through a sustainable and inclusive manner.

One of the greatest arguments for merging the concepts of SRI and Shariah compliant investments would be with regards to stronger long term performance. Performance is and will always remain an important element for any investor. The question that needs to be asked is if ESG and Shariah compliant investments can actually deliver greater performance impact together.

An analysis of the 6,554 companies in Refinitiv's EIKON global database shows an average 5.9% higher ESG score for Shariah compliant companies. Companies in the real economy get a bigger ESG lift from Shariah compliance screening [13]. This study by Refinitiv clearly shows that the potential for a broadening of product development would possibly entice back those investors whose sustainability agenda was not previously met. SEDCO in Saudi does Prudent Ethical Investing which marries ESG and Shariah. Islamic finance is expected to grow to US$4 trillion in 2030.

Suggestions for Islamic fund management to embrace SRI as part of Shariah should not be dismissed easily as it is clear that the financial screenings of Shariah helps in screening for better financially managed companies while SRI and ESG work in dealing with the megatrends affecting the world such as tech and disruption, climate crisis and pandemics as well as geopolitics. Investors will typically tend to veer toward the agnostic and focus on returns, so from a product development

[13] Refinitiv: Islamic Finance ESG Outlook 2019 - Shared Values

side, the performance element cannot be ignored. However, education and awareness must also come into play to educate the end investor on long term performance which is much more sustainable ecologically rather than short-term performance that is purely driven by greed and profits which is not sustainable nor ecological. Compensation of the capital markets should similarly be aligned to longer-term sustainability. Only once all these elements come together shall we see a stronger demand for truly sustainable products in their truest form.

If we were to examine Shariah compliant investments from the much-talked-about 17 UN Sustainable Development Goals (SDGs) point of view, Islamic finance has massive potential to address the 'S' element strongly within the ESG framework, and within the 17 SDGs themselves, Islamic finance has the potential to address most of them through financing, banking and investing in businesses and initiatives.

Addressing the 'E' element in ESG: Everyone is talking about climate change

The recent Intergovernmental Panel on Climate Change (IPCC) report's warning of 1.5 degrees of global warming in the next 20 years and the 26th UN Climate Change Conference of the Parties or COP26 in Glasgow have put the topic of climate change at the forefront of all major media of late.

The flagship standard for SRI, the Principles for Responsible Investment, now has over 2,000 signatories responsible for over US$80 trillion in assets. SRI is complementary with many shared principles of Shariah such as being a good steward to society and the environment while Islamic economic thought is heavily based on the concepts of fairness and justice. As a result, the Islamic economic system is largely value-driven and fits within the principles of sustainability. [14]

The COVID-19 pandemic has shown cracks in our society and socially-inclusive policies are made more pertinent than ever now. Islamic finance transactions should promote equality, social justice, inclusivity and economic prosperity. And above all, Islamic finance must demonstrate accountability and transparency.

The Malaysian central bank, Bank Negara Malaysia, recently issued a Climate Change and Principle-based Taxonomy (CCPT). The CCPT recognizes the impact and importance of identifying and managing climate risks. More than 50 natural disasters have occurred in the past 20 years which resulted in financial losses of more than RM8 billion (US$1.93 billion) and affected the lives and livelihoods of over three million people in Malaysia through displacements, injuries and death.

If climate- and environmental-related risks are not recognized and managed, they may lead to substantial financial consequences not just for businesses and households but also financial institutions which provide financing or investment to those exposed to such risks.

There is a US$115 trillion opportunity for energy transition by 2030[15]. David Attenborough, the famous environmentalist, in a recent documentary on climate change had a map which shows how the planet would look like in 2050 and scenes from the movie Dune comes to mind where most of humankind will be climate change refugees if action is not taken to address the warnings in the IPCC report. With the certainty of the planet getting warmer, so will other risks like pandemics rise.

There seems to be a rising number of news reports coming out globally on zero pledges. But the whole ecosystem to support such zero pledges is still not yet there, particularly in the less developed world. There is little talk on a zero-carbon supply chain for example and thus why more collaborative and collective work by all, especially in expanding Islamic finance, to consider the wider concepts of SRI needs to be done and done now.

Elon Musk had mentioned earlier this year about allowing Bitcoin to pay for his Tesla cars which caused Bitcoin to shoot up and yet had to retract this later given the pressure he faced when criticised about the rise in crypto mining which is bad for the environment. So how do we move from here as SRI investors while being Shariah compliant? A common rhetoric we have noticed is that it is not possible to do 'E' without the 'S' and 'G'. We truly believe the answer lies in how SEDCO in Jeddah has done it through its approach of Prudent Ethical Investing and we hope more influential institutional investors will similarly embrace such a merger of ideas for the betterment of all.

For those not convinced that the expansion of Shariah investments should be so diversified, we need to remember that inequality of wealth is a common trigger for wars and revolution as can be seen through the history of mankind. China's recent pullback on its major tech giants is Premier Xi Jinping's mission to redistribute wealth for all or what he has termed as "common prosperity for all". This message echoes the socialist and populist regimes rising due to inequality in Europe in the early 20th century. We are already seeing the culling of certain ethnic groups globally and with technology and social media, the speed of unease will gather momentum very fast if the financial and capital markets do not address the idea of sustainability for the greater good. The idea of a circular economy needs to be embraced by all stakeholders and cannot just be within the purview of the government and regulators.

Conclusion

It is important to ensure that the evolution of Islamic finance is something that brings value and not just a rubber stamping exercise as can now be seen in the ESG space where one of the biggest proponents of green investing, Deutsche Bank's investment management arm DWS, has been accused of greenwashing. A recent study by Master Action actually puts DWS in the top four for ESG.

Investors and consumers alike are a lot more aware of what is going on in the world, thus the term 'stakeholders' is no longer limited to shareholders, clients and vendors. The stakeholder economy is a lot more holistic and in order for Islamic finance and its Shariah compliant investments to remain relevant and compelling for the sustainable future, the time to pivot toward SRI is now.

[14] Rethinking Sustainability: Islamic Perspectives by Odeh Rashed Al-Jayyousi, 6 March 2020

[15] https://www.wsj.com/articles/the-115-trillion-price-tag-to-cut-global-emissions-11619375103