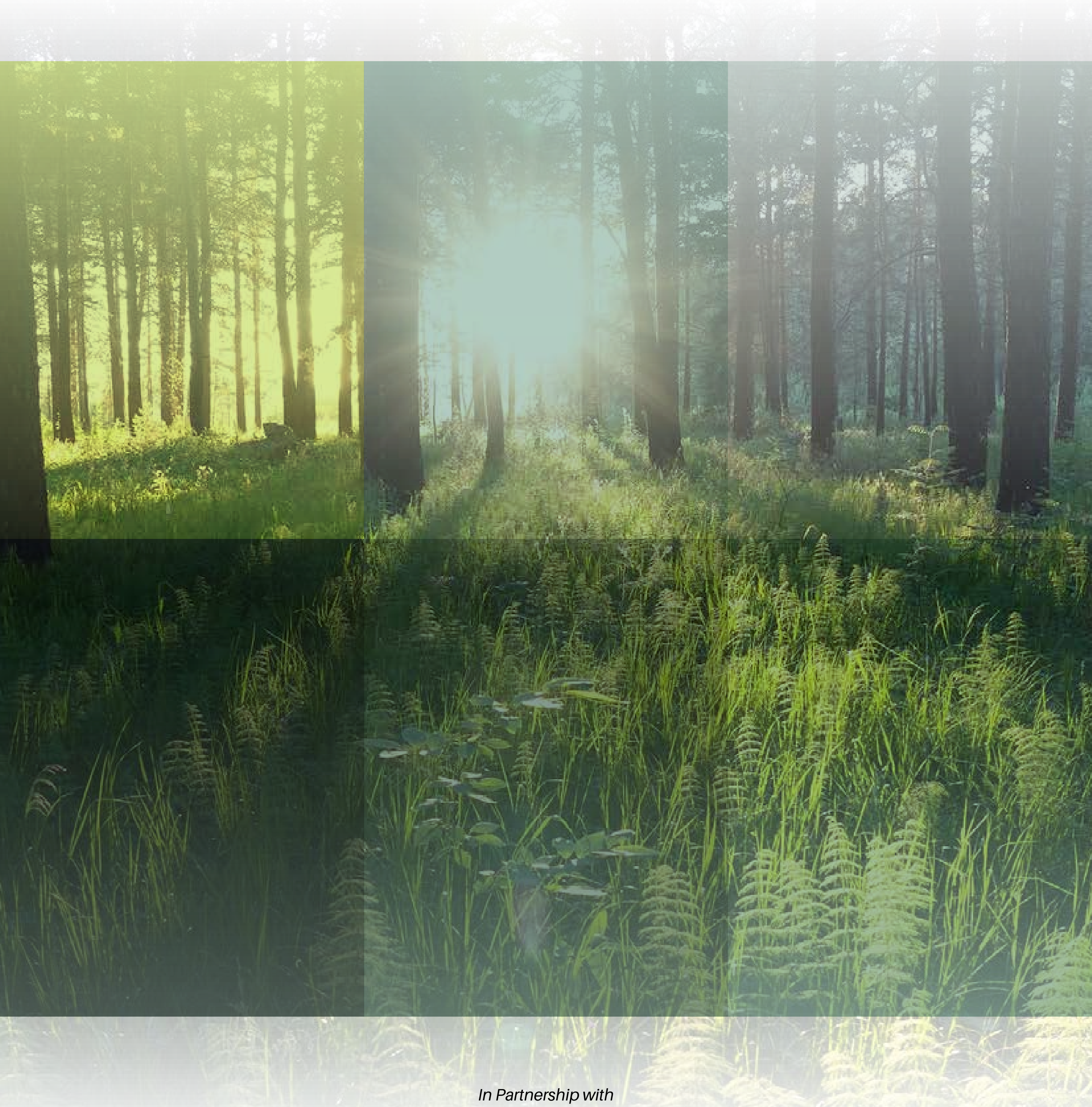
IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT



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PRI Principles for Responsible Investment

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.

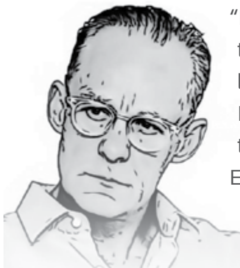
According to Bashar Al Natoor, the global head of Islamic finance at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.

"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



Levy

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.

Farmida

Costly compliance

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

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

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

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

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

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

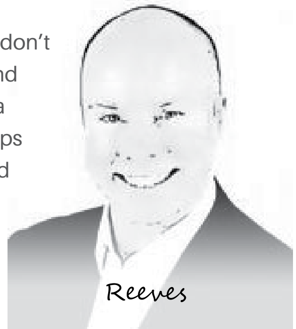
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these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

Making it worthwhile

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

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

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



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

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

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

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

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

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

Urgent needs, attractive opportunities

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

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

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

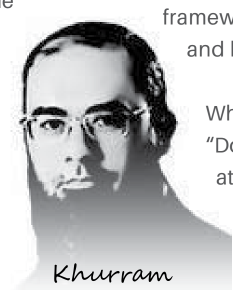
"It has been suggested that we need about US$7 trillion in infrastructure investment annually and between US$1.5 trillion to US$4 trillion every year for energy transition to meet the Paris [Agreement] targets; and with the commitments of the Glasgow Climate Pact, I'm sure

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

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

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

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



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

Turning words into action

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

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

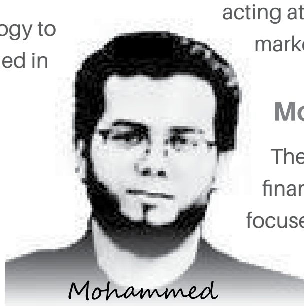
When it comes to regulations and policies, Dr Scott's advice is: "Don't be afraid of regulation – that's the first step. Look internally at your internal processes, have a brief read of the UN SDGs and understand where you fit into the things that the world is talking about at the moment."

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

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

Leveraging tech

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



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

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

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

Moving forward

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

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

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

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

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

Corporates and Islamic issuers are already lining up their ducks.

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

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

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

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

The PRI and responsible investment

Authored by PRI | Principles for Responsible Investment

The rise in responsible investment is irrefutable. Its development has spanned decades from the 1970s when strong voices for responsible corporate practices began to influence the global discourse, to the launch of the first socially responsible mutual fund in the US in 1971, to 1997 when the Kyoto Protocol convened world leaders to set goals on addressing global warming [1]. Today, new investments in sustainable funds reached a record high in 2020 at US$51 billion (more than double the previous record set in 2019 [2]) and at the time of writing, the world is eagerly awaiting concrete commitments, actions and accountability from the financial sector at the 2021 United Nations Climate Change Conference or more commonly referred to as COP26.

As part of the Principles for Responsible Investment (PRI)'s contribution to this thought leadership report, we will explore where we construe positive, growing areas of overlap between responsible investment and Islamic finance, how investors that follow the principles of Islamic finance or Shariah law are represented in our signatory base, the state of the market and how further convergence can benefit real-world impacts. While the PRI has not developed a house view on nor expertise in Islamic finance, we draw upon insights from our own observations and signatory activities to explore this area.

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership [3]. Examples of ESG issues and subsequent investment risk factors include climate change and pollution (E), modern slavery and working conditions (S), and corruption and tax strategies (G). Responsible investment can be approached by considering ESG issues when building a portfolio (ESG incorporation) or improving real-world outcomes (known as active ownership or stewardship).

The PRI is the world's leading proponent for responsible investment. Launched in 2005 by a 20-person investor group, there are now over 4,500 signatories (categorized as asset owner, investment manager or service provider) to the six principles with a combined signatory assets under management (AuM) of more than US$120 trillion — over half of the world's investable capital. The six aspirational principles range from incorporating ESG issues into investment analysis to seeking appropriate disclosure on ESG issues from invested entities. Discussions with signatories have firmly progressed from 'why' to 'how' since the PRI's inception and we have supported them on their journeys accordingly. This is mirrored by increased action on climate change, building awareness of social issues as accelerated by the COVID-19 pandemic and a growing focus on real-world outcomes. Policy and regulatory pressures have similarly mandated accelerated responsible investment considerations and there is an increasing call for reliable company ESG data and disclosures across the industry.

The relationship between responsible investment and Islamic finance

Islamic finance can be defined as a way to manage money which keeps within the moral principles of Islam. Like the responsible investment industry, the Islamic finance industry is rapidly expanding with a total of US$2.88 trillion in assets by the end of 2019 and expected growth to US$3.69 trillion by 2024 [4].

1 ESG Investing Comes of Age | Morningstar
2 Sustainable investments hit record highs in 2020 (cnbc.com)
3 What is responsible investment? | Introductory guide | PRI (unpri.org)
4 How To Integrate Islamic Finance With ESG Goals? (halaltimes.com)

At its core, we can infer that there are some powerful areas of overlap between responsible investment and Islamic finance.

Both approaches look to promote certain social 'goods' and look to align broader objectives with financial returns while avoiding harm to the people or the planet (avoiding or decreasing 'negative outcomes'). The clearest overlap lies in the use of similar processes around screening or excluding certain activities. The exclusion of certain sectors which is fundamental to Islamic finance ranges from alcohol to gambling and weaponry as these are considered unethical and injurious according to Shariah. This practice is aligned to the screening approach which many ESG investors take [5]. Exclusionary screening — including Shariah screens or UN norms-based screens — is not a requirement of PRI membership [6] but remains a common approach to responsible investment. Among the PRI's signatory base, most listed equity and fixed income investors use some form of positive, negative or norms-based screening as part of their holistic investment process or for specific funds [7]. For those who completed the PRI's reporting 'Listed Equity' module in 2021 [8], 57% used screening as a stand-alone strategy. Within screening practices, negative screening is the most popular (as reported by 482 signatories compared with 389 signatories for positive screening) — directly reflective of the screening process used in Islamic finance. We can see similar trends for fixed income, with the actual number of signatories applying ESG screens growing over the years and negative screening as the most common approach.

Differences do exist

Differences between responsible investment and Islamic finance naturally exist. While responsible investment places a strong emphasis on active ownership and engaging with companies on ESG issues, within Islamic finance this practice is perhaps not as widespread (although "there are no issues from a Shariah compliance perspective to steer a company to further improve Shariah compliance or economic performance" [9]). Islamic finance avoids investments in companies with excessive leverage while this is not typically made explicit in responsible investment. Responsible investment is a holistic approach that aims to include any material ESG factor. A report by Thomson Reuters and the Responsible Finance Institute suggests that "Islamic finance has only ideologically incorporated rather than practically incorporated environmental issues in investment … The financial institutions that set the 'just' and 'unjust' Shariah lines for Islamic finance have prohibited negative actions, but also need to focus on encouraging good practices [10]". This, it elaborates, could be achieved by encouraging positive ESG screening.

Thinking about E, S and G coverage specifically, it has been suggested by S&P Global Ratings that the similarities between Islamic finance and responsible investment are more visible in the 'E' and 'G' space, owing to the presence of green Sukuk and the additional layer of governance required in Islamic finance, while the 'S' factor has historically been less visible. Specifically, "while the underlying principles are socially focused and several instruments already exist, they have not been leveraged in modern Islamic finance in a transparent, systematic manner … At present, there are limited public disclosures on how Islamic banks or issuers of Sukuk are dealing with social issues "[11].

The state of the market: Regulations and policies abound

The PRI has a regulation database which documents existing and evolving sustainable finance policies around the world [12]. Of the policies identified by PRI, 96% have been developed since 2000. This pace is only increasing — the PRI has identified 159 new or revised policy instruments so far in 2021, more than the whole of 2020. Looking at countries in the OIC, the UAE has seen the introduction of the ESG Disclosure Guidance for Listed Companies and the Guiding Principles for Sustainable Finance, which aim to "facilitate the UAE's transition to a more sustainable and diversified economy, in part through mitigating the risks of reduced global demand for oil, as well as addressing the physical and financial risks of climate change". In Malaysia, we have seen the introduction of the Sustainable and Responsible Investment Roadmap for the Malaysian Capital Market. Meanwhile, the Nigerian Sustainable Banking Principles were introduced in 2012 and the Egyptian Code of Corporate Governance was updated in 2016. In Indonesia, the Financial Services Authority published the Roadmap for Sustainable Financing in December 2014. These — among many others — act as strong vehicles to leverage the powerful role of Islamic finance as we collectively work toward positive sustainability outcomes.

In addition to the number of regulations, there has been growth in the number of existing and potential green taxonomies worldwide, including the EU Taxonomy, South Africa's Green Finance Taxonomy as well as the UK's Green Taxonomy. The Shariyah Review Bureau is "studying the EU green taxonomy and the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) to inform the development of a new ESG offering aimed at Islamic financial institutions" [13]. This is seen as the first initiative with Islamic finance which will directly examine how the EU Taxonomy can be applied when considering Islamic law. The Malaysian central bank launched a risk assessment framework in 2018 which integrates Shariah principles, TCFD standards and ESG criteria, following on from the Sustainable and Responsible Investment Sukuk Framework in 2014. The IsDB, meanwhile, has released a Sustainable Finance Framework which "aims to boost commitment towards sustainability through the potential issuance of Sukuk to finance sustainable investments".

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[5] Malaysia brings Islamic finance and ESG together | Euromoney

[6] The PRI is, however, expecting that investors undertake due diligence as defined in UN norms (i.e. UNGPs) to manage human rights risks and impacts. This will become a requirement via the PRI's reporting framework over the coming years.

[7] How To Integrate Islamic Finance With ESG Goals? (halaltimes.com)

[8] Listed equity snapshot 2017 – 2020 | PRI reporting data | PRI (unpri.org)

[9] Islamic-Finance_09.20_2020-09-14-164738.pdf (gibam.com)

[10] ESG and Islamic Finance collaboration could be major revenue boost for sustainable investment: report (responsible-investor.com)

[11] Islamic Finance And ESG The Missing 'S' | S&P Global (spglobal.com)

[12] Regulation database | Policy | PRI (unpri.org)

[13] Efforts underway to adapt EU green taxonomy and TCFD for Islamic finance (responsible-investor.com)

A surge in sustainability-minded products

In September 2021, it was announced that a Tier 2 sustainability Sukuk facility was 12 times oversubscribed [14], with an orderbook in excess of US$4 billion. Several green Sukuk (in which issuers use the proceeds to finance investments in renewable energy, environmental assets, transition or infrastructure projects) have been issued, including the US$600 million green Sukuk issued by Majid Al Futtaim in 2019. The amount is still minimal compared with the global green bond market that saw US$168 billion of issuances in 2018, but it is growing. Refinitiv data showed that ESG Sukuk issuance reached a record value of US$4.6 billion in 2020. Green Sukuk allow issuers to access not only the pool of conventional investors interested in green projects, but also Islamic investors [15]. Overall, it has been argued that green Sukuk structures "can facilitate green investment since the Islamic community already has a large experience of dealing with energy project financing and might subsequently be more comfortable when dealing with non-carbon-based green energy financing [16]".

In the sovereign wealth fund space, the Public Investment Fund (Saudi Arabia) has "hired five international banks as members of an environmental, governance and social (ESG) panel for its medium-term capital-raising strategy" [17]. Meanwhile, Khazanah Nasional, a PRI signatory, is due to issue its first social impact bond [18].

The COVID-19 pandemic has perhaps been a 'catalyst' for the surge in sustainable Sukuk and investment funds. It has been predicted that the "global economic slowdown caused by the pandemic will lead to greater numbers of social instruments being launched by Islamic financial institutions to tackle issues such as mass unemployment [19]... With the growth of sustainable and ESG investments across various Islamic finance asset classes, this strategic alignment will unlock new long-term investment trajectories and trends for Islamic finance and ESG investors, while enabling Islamic financial institutions to discover new business opportunities".

The PRI's OIC signatories

Aligned with the aforementioned convergence, we have also seen an uptick in the number of signatories to the PRI which are based in OIC countries, some of whom are partially or fully mandated to invest in a Shariah compliant manner. Some of our first signatories in OIC countries included KEHATI – the Indonesian Biodiversity Foundation (Indonesia), Hawkamah Institute (the UAE) and Access Bank (Nigeria). As of October 2021, the PRI has 52 signatories which have their headquarters in an OIC country (with a combined AuM of US$419 billion), compared with 37 in 2020. These numbers can be construed as symptomatic of a growing convergence — or at the very least interest — between ESG investing and Islamic finance.

Every year, PRI signatories are required to complete our internally developed reporting framework to demonstrate their responsible investment activities. Signatories complete a series of organizational and asset-class level modules and are scored accordingly. The completion of our reporting framework by a growing number of Islamic investors will allow us to gain more insight into current practices, offer tailored support and enable us to showcase particular Islamic finance characteristics which may be considered leading practice for the broader responsible investment industry. In addition, completing the reporting framework is a valuable in-house learning tool for signatories and allows for peer comparison.

In order to provide a glimpse of how our own signatories — as direct investors and practitioners — view the interplay between responsible investment and Islamic finance, we have showcased three case studies.

Conclusion

We are living in a climate crisis and many individuals globally are exposed to modern slavery practices, growing inequality and a lack of basic human rights. While public bodies have traditionally been viewed as the key levers to solving these crises, the past few years have confirmed the role which the financial sector must play to close the funding gap required to meet the UN Sustainable Development Goals — estimated at US$2.5–3 trillion annually in developing countries alone [20]. Not only is invested capital key to creating and enabling solutions to these challenges, but investing with ESG considerations is now strongly evidenced to correlate with positive financial returns [21]. As such, as the inflow of capital into responsible investment products proliferates, it seems natural that Islamic investors can play a leading role due to their fundamental, unquestionable and preexisting alignment to many responsible investment principles and criteria. Ultimately, Islamic finance can only "broaden its investor portfolio by connecting those overlapping core values to access the large amount of (responsible investment) funds available in global markets [22]".

We continue to see growing interest from Islamic finance investors in the PRI and hope to welcome many more to our signatory base. In addition to aligning to an internationally-recognized set of principles and demonstrating a commitment to responsible investment, the PRI can offer asset-class specific guidance and toolkits, access to the PRI's collaboration platform (learn, engage and collaborate with companies, policymakers, academics and investors), annual reporting which demonstrates responsible investment development, events and tailored support through access to experts across numerous responsible investment topics.

PRI Principles for Responsible Investment

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Case Study One: BIMB Investment

An Islamic fund management company: Islamic finance and responsible investment

The convergence between Islamic finance and responsible investing has become clearer. Responsible investing exhibits similar facets to Islamic finance where both are values-based approaches, strong on risk management and aim to eliminate poverty through humanitarian welfare. In November 2020, Securities Commission Malaysia (SC) launched the Waqf-Featured Fund Framework which aims to facilitate the offering of funds with Waqf features. Following the launch of this framework, BIMB Investment introduced its first Waqf-featured unit trust fund, Makmur myWakaf Fund, which integrates Shariah compliant environmental, social and governance (ESG). The fund aims to channel half of the potential monthly income distribution for Waqf purposes. The development of Waqf is a significant contributor to social development, greater public good and wealth distribution.

As an Islamic fund manager that integrates ESG into our investment process, we leverage on the Arabesque S-Ray tool to identify Shariah ESG-compliant equities. The platform's data engine evaluates companies' sustainability performance across a spectrum of ESG dimensions to create a suite of proprietary scores including S-Ray ESG, UNGC and Temperature, in addition to the Preference Filter that allows for the screening of companies to align with our Islamic values.

We began our journey toward sustainability in 2015, having recognized that sustainability is a rising global trend which greatly influences the financial and investment sectors. We observed that ESG factors were becoming mainstream and there was an opportunity to integrate ESG into our investment process. This led us to form a strategic partnership with Arabesque Asset Management, enabling us to pioneer artificial intelligence and big data technology. We then took the lead among fund managers to become a signatory of the UN Principles for Responsible Investment in 2019.

We are currently seeing the emergence of equity crowdfunding (ECF) and peer-to-peer (P2P) financing platforms. This is because there is a huge funding gap in the market for SMEs. ECF and P2P are established to provide funding to SMEs through their digital platforms which bridge the gap between issuers (borrowers) and investors (lenders). We see this as an opportunity to expand our investables by incorporating responsible investing into the investment universe.

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Case Study Two: SEDCO Capital

A global asset management firm

SEDCO Capital has approached responsible investment from its background as a Shariah compliant investor, stressing the similarities in the objectives and methodologies of both investment strategies.

In 2014, we were the first Shariah compliant and the first asset management firm in Saudi Arabia to become a signatory of the UN Principles for Responsible Investment. We have integrated both methodologies and referred to the integration as Prudent Ethical Investing (PEI). Besides ethical considerations, PEI bridges Islamic and responsible investment approaches by stressing the importance of due diligence and transparency of investment structures, processes and reporting and thus relating to environmental, social and governance (ESG) integration and active ownership principles. We will discuss key elements and potential benefits of PEI in this article.

A commonality for Shariah compliant and socially responsible investment (SRI) approaches is the exclusion of activities considered unethical, so-called sin sectors such as, inter alia, tobacco, alcohol, gambling and defense sectors. A few years ago, academic research still considered sin-sector exclusions as a source for potential underperformance and limitation to the risk-adjusted returns of diversified portfolios (such as Adler and Kritzman (2008) or Fabozzi, Ma and Oliphant (2008)). While still supporting the initial paradigm, newer research such as Blitz and Swinkels (2021) suspects that a loss in expected returns from sin stocks might arise in the future. This could materialize if exclusion policies reach the scale needed to significantly raise the cost of capital of sin stocks. We believe that market developments in previous years support the notion of challenging the underperformance assumption or even indicate a turnaround. Anecdotal evidence supports the indication of sin stock underperformance, for example tobacco stocks relative to the broad stock market in the last five years. While ESG integration has recently overtaken exclusionary (also called negative) screening as the largest responsible investment approach, the overall size of the assets managed according to responsible investment

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criteria has substantially grown, reaching 35.9% of global assets under management in 2020 according to Global Sustainable Investment Alliance (2021).

A differentiating element of Islamic finance is the incorporation of balance sheet screening, such as, inter alia, leverage, cash, interest-bearing assets and receivables. A 2017 study published by Christian Gueckel, Chief Risk Officer of SEDCO Capital, showed that balance sheet ratios have been a reason for risk-adjusted outperformance of Shariah compliant portfolios driven by biases toward quality and growth factors. Furthermore, the exclusion of the financial sector and a resulting overweight of technology and healthcare stocks contributed to the outperformance of Islamic portfolios relative to the market.

The integration of ESG criteria as a differentiating element of SRI approaches, which was previously not part of Islamic finance approaches, is predicted to positively contribute to expected corporate financial and stock (risk-adjusted) performance. Many meta studies on the relationship of ESG and corporate financial and stock level performance show overwhelming evidence for positive contribution of ESG integration (for example, Whelan et al. (2021)). Evidence from our investment practice shows that the positive performance impact of ESG integration, particularly environmental and social considerations, has grown in recent years.

In conclusion, we see PEI as an evolution of both Islamic finance and SRI approaches, which share many similarities. Key elements such as sin-sector exclusions, balance sheet screening and ESG integration result in objective, measurable advantages for investors beyond preferences and investor beliefs.

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Case Study Three: TVM Capital Healthcare

Convergence, growth and innovation between responsible investment and Islamic finance

TVM Capital Healthcare seeks strong commercial value creation through responsible investing in sustainable, well-governed healthcare companies in the MENA and Southeast Asian regions. In pursuit of the double bottom line objective of generating attractive financial returns and impact, the firm implemented an environmental, social and governance (ESG) framework on fund and portfolio levels as early as 2012.

It seems hard to believe now, but there was a time when responsible investment and Shariah compliant investing were seen as limitations for the optimization of financial returns. Clearly, investors' mindsets have changed dramatically. We argue that these investment philosophies ultimately pursue very similar objectives. The convergence of both responsible investing and Islamic finance lies in appreciating that the values that drive investors, irrespective of their faith, often lead to similar investment goals. Both — a responsible investment approach and Islamic finance models — aim to create societal benefits and actively avoid public harm, all the while generating economic growth. This fundamentally intrinsic convergence is causing more engagement toward widely accepted standard methodologies, including screening criteria.

Thus, on the one hand, Islamic finance's screening criteria are complemented by a set of principles that may well be used by non-Shariah compliant companies to evaluate the societal impact of an investment. On the other hand, Islamic finance is gradually paying more attention to areas where financial institutions can act to encourage what is right within their own defined theological sphere, hence stressing on positive (as opposed to a mere negative) screening. By way of example, certain Islamic finance institutions are now consciously incorporating climate concerns into their Shariah compliant products based on the fundamental principle of stewardship where humans are entrusted with the Earth by God and must therefore protect the environment.

Fund managers and lenders who understand the needs of different categories of investors will reap the fruits of their agility. They will nonetheless need to factor in strategies to effectively monitor responsible investment and Shariah compliant investment restrictions as scrutiny on compliant investment is becoming tighter. The subject of responsible investing has won tremendous trajectory and attention, not least thanks to the stewardship of the UN Principles for Responsible Investment and other bodies which advocated for standards and measures, which currently are in the process of being standardized and expanded globally — and someday, financial reporting and ESG or sustainability reporting will have merged completely. This holistic view on investing ultimately serves the aim to create societal benefit, actively avoid or minimize environmental impact and have good returns at the same time — which is in the core interest of responsible and Islamic finance investors alike.