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at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.

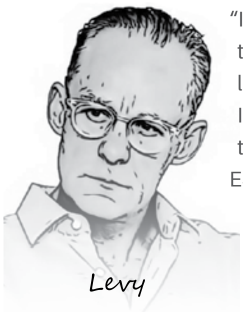
"If I look at how much was issued since 2017, it is less than US$20 billion, which is small compared to the size of the global Sukuk market which is around US$800 billion currently. So, in terms of actual size, the sustainable Sukuk market is still tiny," Bashar explained, adding that over 10% of Fitch's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

Bashar

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

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

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


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."

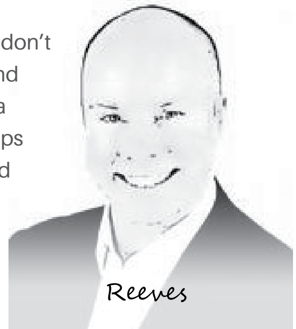
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these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


Reeves

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


Orzano

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


Haines

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

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

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

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

Urgent needs, attractive opportunities

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

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

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

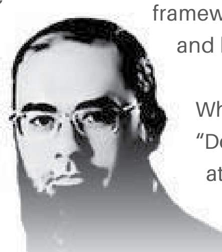
"It has been suggested that we need about US$7 trillion in infrastructure investment annually and between US$1.5 trillion to US$4 trillion every year for energy transition to meet the Paris [Agreement] targets; and with the commitments of the Glasgow Climate Pact, I'm sure

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

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

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

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



Khurram

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."

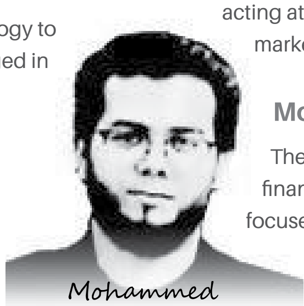
When it comes to regulations and policies, Dr Scott's advice is: "Don't be afraid of regulation – that's the first step. Look internally at your internal processes, have a brief read of the UN SDGs and understand where you fit into the things that the world is talking about at the moment."

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."

Combining ESG and Islamic finance principles in an index framework

Authored by

S&P Dow Jones Indices
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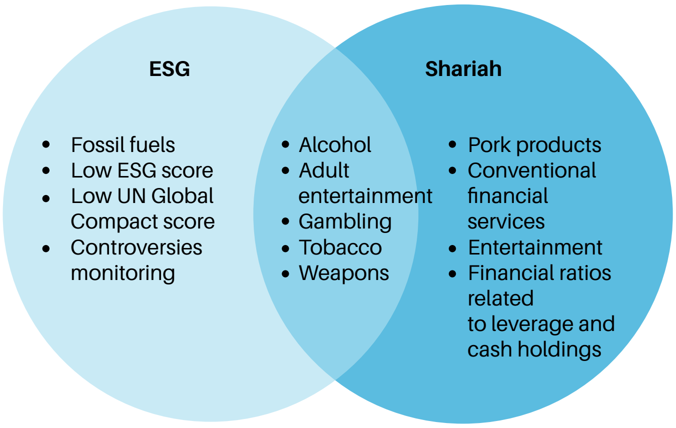
Islamic finance and environmental, social, and governance (ESG) investing are complementary in many ways and hold a number of shared principles. Though broader in nature, ESG strategies often exclude companies involved in such businesses as alcohol, tobacco and gambling that are considered Haram in the Muslim world. However, there are also fundamental Shariah compliance exclusions, such as conventional financial services and pork, that are not considered problematic in general ESG strategies.

This article will explore the similarities and differences of broad-based ESG and Islamic indexing through a real-world example of an innovative index that combines both frameworks — the **S&P Global 1200 ESG Shariah Index**. This index also allows us to examine the impact of applying ESG and Shariah screens on the general investment characteristics of the S&P Global 1200 — a conventional global equity benchmark.

Understanding ESG and Shariah screening criteria

Because Islamic and ESG investors seek to avoid companies involved in certain activities, it is necessary to apply various quantitative screens to identify and exclude companies violating specific ESG or Shariah compliance criteria. While these involve a number of overlapping themes, there are also some distinct areas that only fall in the Islamic or ESG space. Figure 1 provides a general overview of typical screens relevant for ESG and Islamic indices.

Figure 1: Representative ESG and Shariah exclusions



Source: S&P Dow Jones Indices. Chart is provided for illustrative purposes. Screens shown are commonly used in ESG and Islamic index methodologies and do not reflect a specific methodology employed by S&P DJI.

Figure 2: S&P Global 1200 ESG Shariah Index construction

Step 1:
Exclude companies involved in thermal coal, tobacco, controversial weapons or with a low UN Global Compact Score.

Step 2:
Exclude companies with S&P DJI ESG Scores in the bottom 25% of their GICS Industry group globally.

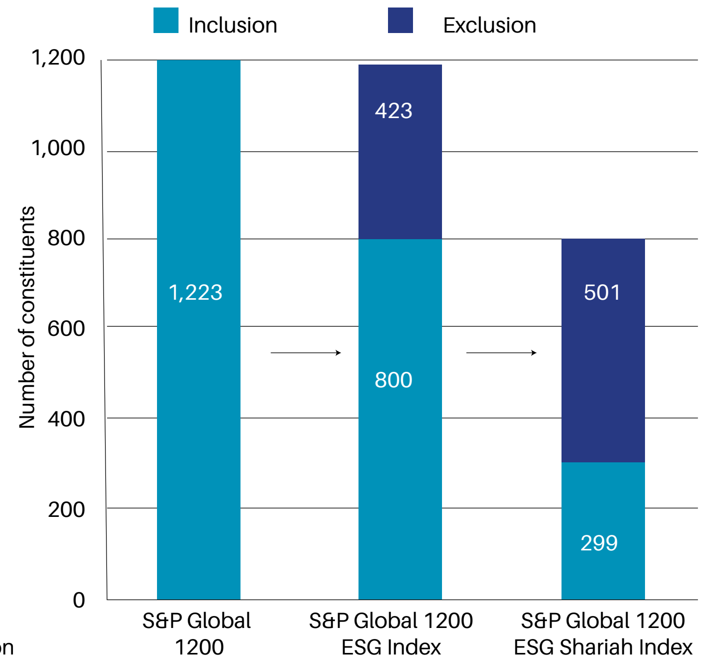
Step 3:
Rank companies by the S&P DJI ESG Score within each GICS Industry group.

Step 4:
Starting with the company with the highest S&P DJI ESG Score, select companies for inclusion from the top down, targeting 75% of the industry group by market cap.

Step 5:
Exclude companies with > 5% of revenue in non-Shariah compliant business activities*

Step 6:
Exclude companies failing Shariah compliance financial ratios

Step 7:
Weight remaining companies by float-adjusted market capitalization



*Source: S&P Dow Jones Indices. Data as of the 30th September 2021. Chart is provided for illustrative purposes. *Non-compliant business activities per S&P Shariah Indices include alcohol, adult entertainment, advertising of non-Shariah compliant products/activities, conventional financial services, gambling, media and entertainment, pork products, tobacco and trading of gold/silver as cash on a deferred basis. For further details, see the S&P Global 1200 Shariah Index Methodology.*

It is important to note that while many ESG indices apply all of the aforementioned criteria — including several published by S&P Dow Jones Indices — the S&P Global 1200 ESG Index takes a more inclusive approach, as it is designed to serve as a broad alternative to conventional global benchmarks. Given this, it does not exclude companies with involvement in alcohol, gambling or adult entertainment (these areas are often chosen for exclusion by investors for ethical reasons). Likewise, while an alternative framework provided under the Dow Jones Islamic Market Indices excludes companies that produce weapons, the S&P Shariah Indices do not exclude all companies involved in weapons production. The combined approach allows the exclusions to meet the needs of both ESG and Shariah requirements in a comprehensive way.

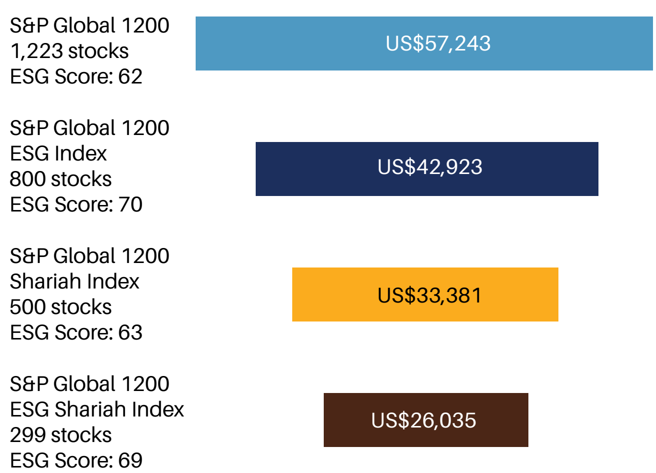
The S&P Global 1200 ESG Shariah Index — an overview

Introduced in August 2019, the S&P Global 1200 ESG Shariah Index is designed to be a measure of large-cap global equities meeting both ESG and Shariah standards. From a technical standpoint, the index is constructed by including members of the S&P Global 1200 ESG Index that pass rules-based screens for Shariah compliance as defined by the S&P Shariah Index Series. Figure 2 describes the index construction process.

Compositional impact of S&P DJI ESG and Shariah screens

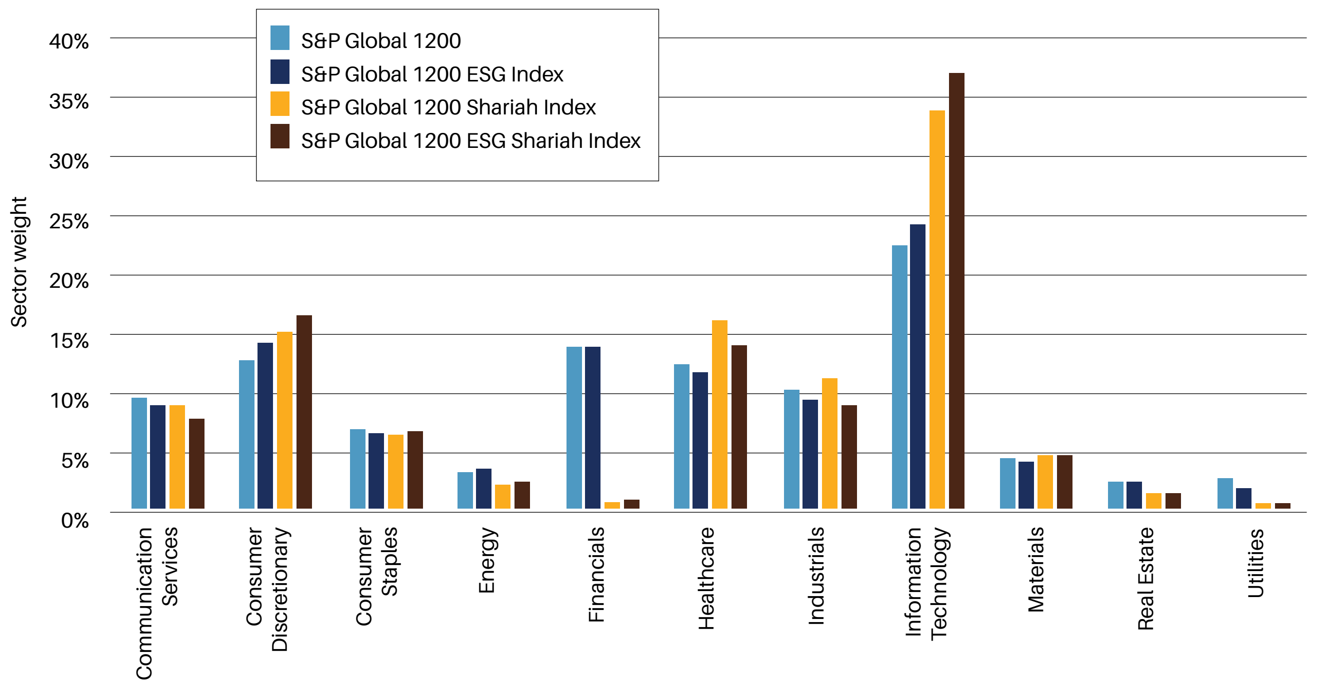
As illustrated in Figure 3, the application of ESG and Shariah screens results in a narrowing of the index universe, but also an increase in ESG performance. As of the 30th September 2021, the S&P Global 1200 ESG Shariah Index included 299 companies, representing about 45% of the market cap of the benchmark S&P Global 1200. It is noteworthy that the Shariah screening resulted in a significantly greater portion of the exclusions by market cap and stock count than that caused by the ESG methodology.

Figure 3: Impact of ESG and Shariah exclusions (float-adjusted market cap in US$ billions)



Source: S&P Dow Jones Indices. Data as of the 30th September 2021. The ESG score is calculated as a weighted average of each index constituent's S&P DJI ESG Score. Chart is provided for illustrative purposes.

Figure 4: Comparative sector weights



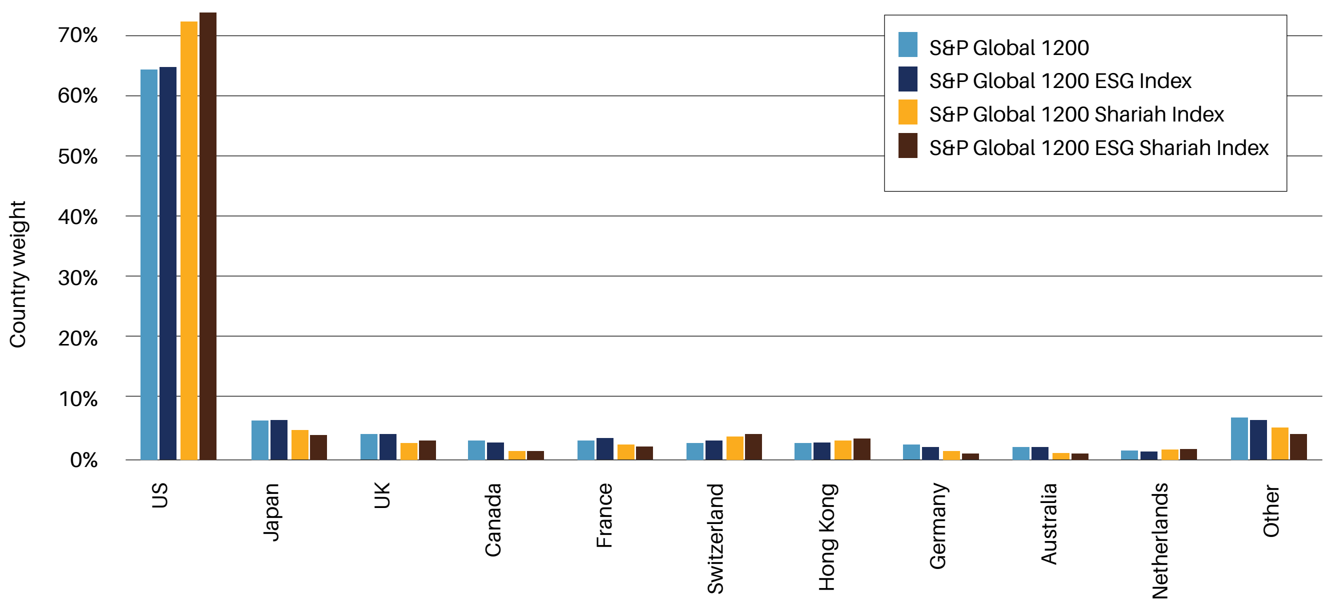
Source: S&P Dow Jones Indices. Data as of the 30th September 2021. Chart is provided for illustrative purposes.

As depicted in Figures 4 and 5, the S&P Global 1200 ESG Index has similar sector and country weights as the benchmark S&P Global 1200. However, the introduction of the Shariah screening results in a near elimination of the financials sector and significant overweighting to information technology in the S&P Global 1200 ESG Shariah Index. Because the information technology sector is overweight in the US market and the financials sector is relatively underweight, the S&P Global 1200 ESG Shariah Index also has meaningfully higher exposure to the US compared with the conventional S&P Global 1200.

Performance analysis

By design, the S&P Global 1200 ESG Index maintains similar risk/return characteristics compared with the benchmark S&P Global 1200. However, because the Shariah screening introduces differences in sector and

Figure 5: Comparative country weights



Source: S&P Dow Jones Indices. Data as of the 30th September 2021. Chart is provided for illustrative purposes.

Figure 6: Risk/return characteristics				
Period	S&P Global 1200	S&P Global 1200 ESG Index	S&P Global 1200 Shariah Index	S&P Global 1200 ESG Shariah Index
Annualized returns (%)				
1 year	28.46	27.81	24.42	23.8
3 years	13.23	13.96	17.09	17.87
5 years	14.12	14.6	17.04	17.32
10 years	13.11	13.23	14.84	14.71
Risk (standard deviation) (%)				
3 years	17.99	17.81	17.48	17.21
5 years	14.46	14.34	14.16	13.96
10 years	13.21	13.19	12.79	12.63
Risk-adjusted return				
3 years	0.74	0.78	0.98	1.04
5 years	0.98	1.02	1.2	1.24
10 years	0.99	1	1.16	1.16

Source: S&P Dow Jones Indices. Data as of the 30th September 2021. Past performance is no guarantee of future results. Index performance based on total return in the US dollar. Table is provided for illustrative purposes and reflects hypothetical historical performance.

country exposures relative to the benchmark, the returns of the S&P Global 1200 ESG Shariah Index have been more differentiated. Over the past year, the S&P Global 1200 ESG Shariah Index underperformed primarily due to its underweight to financials. However, over longer time periods, the index outperformed due to its relatively high exposure to outperforming sectors such as information technology and healthcare. An overweight to the US also contributed to outperformance.

Conclusion

As the Islamic investment community increasingly seeks to integrate ESG considerations into the investment process, the need for indices that merge Shariah and broad-based ESG has developed. The S&P Global 1200 ESG Shariah Index aims to meet this need while serving as a unique dataset to examine the interconnections between Islamic finance and ESG.

For more information about S&P Dow Jones Indices ESG and Shariah index solutions, please visit: **www.spglobal.com/spdji/.**

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Disclaimer

The S&P Global 1200 ESG Shariah Index was launched August 28, 2019. The S&P Global 1200 Shariah was launched March 19, 2014. The S&P Global 1200 ESG Index was launched May 6, 2019. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance.