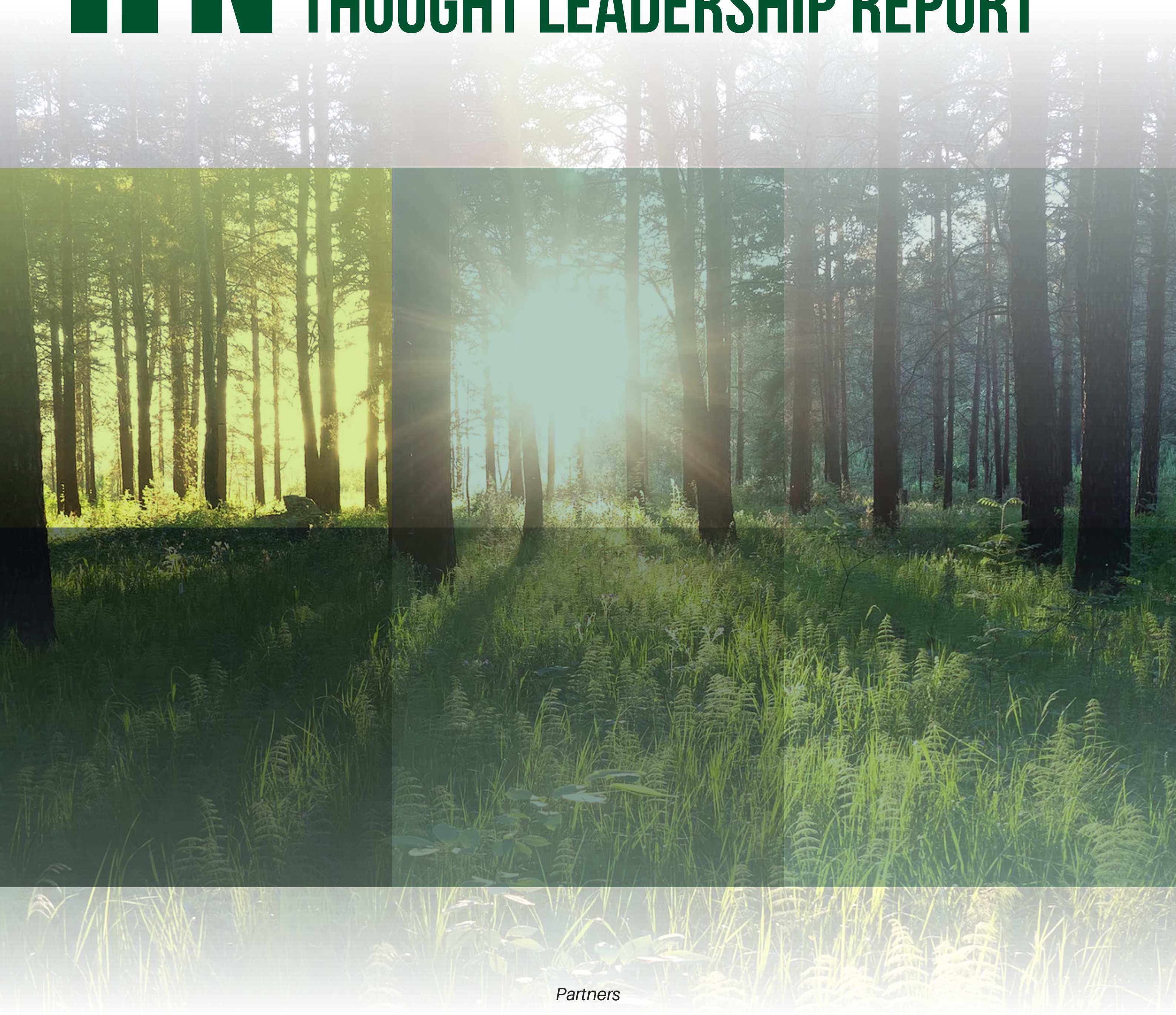
IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT



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Act now!

Many powerful quotes emerged from COP26 (2021 United Nations Climate Change Conference), which I found to have resonated with the Islamic sustainable finance movement, which extends well beyond climate change. Prince Charles aptly expressed: "Quite literally, it is the last-chance saloon. We must now translate fine words into still finer actions."

This call-to-action perfectly applies to the Islamic finance industry as well which, despite its much-touted synergy with sustainable finance, has been slow to fully embrace environmental, social and governance structures: the first green Sukuk facility was issued 10 years after the first green bond hit the market. During the last decade, impact investments grew exponentially to exceed the trillion-dollar mark, while the Islamic finance industry is still playing catch-up with only a fraction of assets under management marked as sustainability-linked.

It is, however, easy, and dangerous, to dwell on what we lack, for we risk inaction from being stuck in a state of flux. But as the industry's strongest proponents of Islamic sustainable finance have expounded in great detail in this IFN Islamic Sustainable Investing Thought Leadership Report, many industry leaders are proactively advocating for Islamic sustainable finance and more importantly, turning their words into actions as they introduce new products, new frameworks and new initiatives to shift toward purposeful finance. The IFN Islamic Sustainable Investing Thought Leadership Report is an industry-driven initiative to contribute to the industry knowledge body with specially curated exclusive content by market leaders in Shariah sustainable finance, as we venture on this journey together.

The IFN Islamic Sustainable Investing Thought Leadership Report would not have been possible without the support and guidance from the following agencies, which continue to be a formidable force in championing sustainable finance:

- Accounting and Auditing Organization for Islamic Financial Institutions
- Cambridge Institute for Sustainability Leadership
- Climate Bonds Initiative
- Climate Governance Malaysia
- International Islamic Financial Market
- Islamic Development Bank Group
- Islamic Financial Services Board
- Responsible Finance & Investment Foundation
- ShareAction
- United Nations Principles for Responsible Investment

We'd also like to thank our partners for their contributions to this seminal report: it is hoped that their experience and perspectives would provide the global Islamic finance industry with insights to carve its own path toward sustainability. Our gratitude goes to:

- Bedford Row Capital
- Bursa Malaysia
- Cagamas
- CIMB Islamic Bank
- DDCAP Group
- Fitch Ratings
- IBF Net Group
- Kenanga Investors
- Luxembourg for Finance
- Nomura Asset Management
- Norton Rose Fulbright
- Prestige Asset Management
- S&P Dow Jones Indices
- Standard Chartered Bank

Over the last year or so, we have seen a greater mobilization of efforts by industry stakeholders as they come together toward a common cause — which gives us hope that the industry is indeed moving in the right direction to truly embed sustainability into our DNA. It is high time all stakeholders of the Islamic finance industry get our act together, and combine our resources and expertise to make Islamic finance a greater force for good.

In the words of renowned broadcaster and activist David Attenborough at COP26: "We are, after all, the greatest problem solvers to have ever existed on Earth. If working apart, we are a force powerful enough to destabilize our planet; surely working together, we are powerful enough to save it."

Vineeta Tan,
Managing Editor, IFN

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.

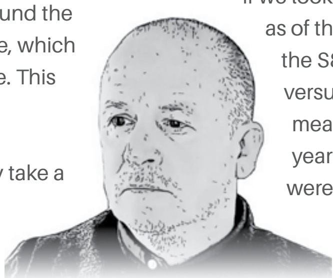
"The commercial necessity of doing so isn't quite clear enough," Dr Levy highlighted. "If [issuers] can tap into the markets the way they have always done and take a very conservative and traditional approach, why do they need to do this? And there isn't yet a commercial imperative in the same way there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

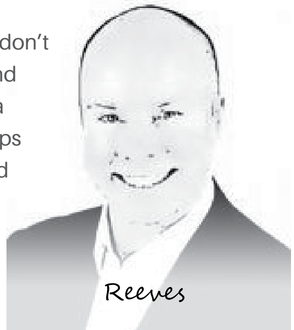
The reality is: it is not easy to use finance for good without risking greenwashing. And it is costly too. These merely compound the concerns conventional issuers have with Shariah finance, which is already perceived as more complicated and expensive. This leads us to ask: is the payoff justified?

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



Haines

"(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

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.


Leong

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.


Schwalbenberg

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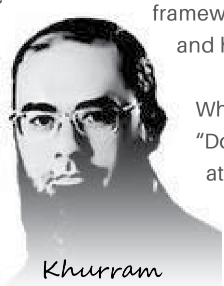
those numbers will then be increased and there aren't sufficient public funds to satisfy this. So, private capital really is vital and this presents a considerable opportunity for the Islamic capital markets to mobilize funding and is also a very unique opportunity for Islamic finance," according to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

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

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

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



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

Turning words into action

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

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

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

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

"We need to think about how do we get staff in Islamic banks to be equipped with the right knowledge? How do we create a future-ready workforce? We need our training and our learning institutions to focus

in this area because this is the future of finance. They need to help develop the next generation of Islamic bankers who understand the dynamics of sustainable finance, who understand climate change, net zero carbon footprint, social finance and inclusion. They need to be fully up to speed with these concepts and not just knowing them, but also owning these concepts and also championing [them]," Khurram strongly believes.

Leveraging tech

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


Mohammed

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

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

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

Moving forward

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

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

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

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"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."


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Islamic finance and sustainability

By Dr Rizwan Malik,
the head of standards implementation and strategic developments, AAOIFI

Authored by

AAOIFI
ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

The flagship event of 2021, the United Nations Climate Change Conference (COP26), hosted in Glasgow in the UK, ended recently. It was the 26th climate change conference that attracted political and business leaders representing 190 countries from around the world to discuss and craft strategies on how we can achieve the goals of the Paris Agreement [1] and the UN Framework to help in the restoration and longevity of the ecosystem that we have been blessed with on earth. While the conference concluded successfully, the feedback on its achievements and agreements remains gloomy. One example is the agreement on limiting global warming to 1.5°C, while a recent United Nations Environmental Programme report stated that nations are on track for a global temperature rise of 2.7°C. Furthermore, in order to achieve the goal of 1.5°C, nations will have to halve annual greenhouse gas emission in the next eight years — something that looks relatively impossible to achieve.

Climate change is just one of the 17 UN Sustainable Development Goals (SDGs), an important initiative launched by the UN in 2015 to transform the world. The 17 goals are divided into 169 specific targets, encompassing the social, economic and environmental elements. Each of the SDGs has its own importance and failing to achieve them will have a detrimental impact on society and the world we live in. Since the introduction of the SDGs, the world in general has paid more attention to the underlying goals and have taken steps to assist in the achievement of the underlying goals. Additionally, with the devastating impact of COVID-19 on the people and institutions in general, achieving the SDGs has become more important than ever. These goals and aspirations that have been translated into the SDGs are fully in line with the objectives of Islamic law (Maqasid Shariah).

The comprehensive framework for the implementation of the SDGs emphasizes the partnerships between multiple stakeholders including those with surplus funds and those who are need of funds. The global Islamic banking and finance industry is no different — in fact the goals that are promoted through the SDGs have their foundations in Islamic law (Shariah) — adherence to which is the prerequisite for any Islamic financial transaction. Additionally, in my humble view, when we discuss the SDGs in the context of Shariah — the emphasis and the accountability on the elements are next to none. These guidelines around sustainability within Shariah were introduced 1,400 years ago in the Holy Quran; when we discuss the environment, it says: "It is He (Allah the Almighty) who has appointed you vicegerent on the earth…" (Quran 6:165). It means that we, as humanity, are entrusted by way of our role as the trustee and custodian of this planet, including all of its natural and economic resources. When we look at the directives on ending poverty — the Holy Quran states: "And you do not encourage one another to feed the poor" (Quran 89:18). On anti-corruption, it states: "…And do not desire corruption in the land. Indeed, God does not like corruptors" (Quran 28:77) and "…And do not commit abuse on the earth, spreading corruption" (Quran 2:60). The concept of

[1] In 2015, at the COP21, for the first time every country agreed to work together to limit global warming, to adapt to the impacts of a changing climate and to make funds available to deliver on these – as a result it was named Paris Agreement.

Zakah (compulsory charity) is to alleviate poverty and to ensure that society is balanced. We will be held accountable if our neighbors go to bed hungry as well as for any extravagance and if the natural resources are wasted. These are only a few examples but the rulings on quality education, equality and reducing inequalities, clean water and protecting life on land and water are plenty.

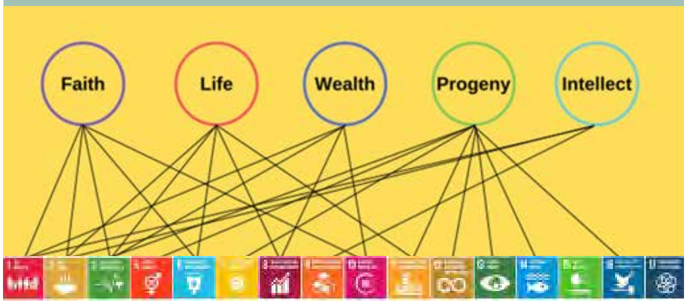
Additionally, the guidelines provided by the divine rulings are far more comprehensive than the SDGs. Also, when it comes to accountability, the difference between divine rulings and conventional guidelines like the SDGs is that the latter are man-made while the former are from the Creator, who will hold mankind accountable for their actions during their lifetime and penalized for not adhering to them in the hereafter.

Having said this, the SDGs are an excellent starting point for us to achieve the objectives of Shariah, to quantify and place targets around achieving the objectives that are beneficial for all.

The global Islamic banking and finance industry is fully supporting the SDGs and, in this regard, various institutions that are part of the Islamic economics, banking and finance industry have introduced measures and initiatives that help in the achievement of these goals. Multilateral institutions like the IsDB are fully committed to the SDGs; the IsDB has launched multiple initiatives in line with the need of its member countries. This includes its inaugural green Sukuk in 2019 raising EUR1 billion (US$238.95 million) for sustainable projects in its member countries and a US$2.5 billion sustainability Sukuk issuance in 2021 with proceeds to be allocated to finance/refinance green and social development goals in line with the IsDB's sustainability framework.

Financial institutions have tailored their strategies to promote the SDGs and sustainable developments — this include banks that have placed targets in financing projects that are socially responsible and are undertaking measures to protect and safeguard the natural resources. This includes financing projects that promote healthcare, job creation, education, renewables, etc. Additionally, investors are more conscious of the factors impacting sustainable development and some would like to invest in line with their values. As such, investors have demanded their investment to be environmental, social and governance (ESG)-compliant in addition to being Shariah compliant — thereby moving away from being just Halal (lawful) to Tayyib (pure/preferred). If we are to consider stock market investment, in the past investors would seek stocks to be Shariah compliant in line with the underline methodology; however, lately there has been far more focus on adding an additional layer in making sure that the stocks are also ESG-compliant and contribute positively to society at large — moving also the Shariah compliant screening industry from just negative screening[2] to positive screening [3]. Although we need to move from being just Shari ah compliant to achieving the objectives of Shariah, however, investor appetite and wider market acceptability are important for this industry to grow — because after all if the viability is not there the best products will just sit on the shelves and collect dust. Shariah scholars have also shown a keen interest in this and have extended their support to make available different types of portfolios (just Shariah compliant or SDGs-compliant) so investors have a choice to invest in line with their values and to make a difference (impact-based investments).

Figure 1: SDGs and elements of Maqasid Shariah



Source: https://www.stratigos.com/post/zakat-and-sdgs

The regulators and the standard-setting bodies within the Islamic finance industry are also mindful of the industry developments that are happening in the area and are supporting its growth by issuing guidelines and rulings in this regard. In particular, AAOIFI has issued a very comprehensive standard titled 'Corporate Social Responsibility (CSR), Conduct and Disclosure for Islamic Financial Institutions' in 2009. The standard aims to provide both mandatory and recommended standards to implement CSR in all aspects of an Islamic financial institution's activities and provide guidance on the disclosure of CSR information to the Islamic financial institution's stakeholders. AAOIFI is also mindful that there have been a lot of developments in the sector since the issuance of this standard, and as a result the AAOIFI Governance and Ethics Board is currently working on developing and issued a standard on sustainable financing, which is expected to be issued in 2022.

While the SDGs are important to achieve the long-term sustainability of society and mankind at large, it is equally important to ensure that there is a fair and balanced treatment among the nations. The developed nations, which to date happen to be responsible for the highest emissions globally (G20 countries in particular), should play an active role in reducing their emissions and positively contribute to the environment rather than placing additional pressure on the developing countries (where the means for income may be limited) to lower their emissions. For example: G20 nations are responsible for 80% of global emissions and if they reduce it by 55%, the targets put forward by the COP26 and Paris Agreement can be achieved. Similarly, the capitalist divide between the rich and the poor, where 20% of the people control 80% of global wealth, is the widest in developed economies. There is a need for a better model of wealth distribution. In particular, there should be the adoption of a system that promotes socioeconomic justice and the well-being of all through integrated moral values; elimination of poverty; social justice and equality, as well as risk-sharing.

As per the organization's policy, the views expressed here are that of the author and do not necessarily reflect the views of the organization.

AAOIFI
ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

[2] Avoiding investing in unethical or Shariah non-compliant stocks

[3] Investing in stocks that are socially responsible

Islamic sustainable finance and the IFSB initiatives

By Dr Bello Lawal Danbatta,
the secretary-general of the IFSB

Authored by

Background

The cardinal triad of sustainable finance: environmental, social and governance (ESG) aligns with the fundamental objectives of the Shariah upon which Islamic finance is premised. The inherent attributes of Shariah as a means toward preservation of order, prevention or removal of hardship and promotion of shared prosperity perhaps explains the importance accorded to sustainable finance in the Islamic financial services industry (IFSI). Islamic sustainable finance, as a fusion of both Islamic finance and sustainable finance, therefore would entail a process through which ESG objectives are given due consideration in both investment and financing decisions in a Shariah compliant manner for the purpose of economic sustainability and shared prosperity.

Prior to the outbreak of the COVID-19 pandemic, there were already global concerns including in the IFSI relating to climate change, green economy and socioeconomic inclusion, etc, which are all very relevant in the context of Islamic finance. Global warming stemming from human expansion of the greenhouse effect due to activities related to oil and gas usage, power plants based on fossil fuels, oil drilling, transport and vehicles, consumerism, farming, industrialization and overfishing[1] are all linked to global climate change. In fact, climate change is cited as one of the key manifestations of environmental degradation, which portends serious threats to both lives and livelihood in the form of extreme weather, rising sea level, natural disasters, famine, disease and even increased poverty.[2]

There has been notable successful issuance of green and other sustainability Sukuk prior to and after the outbreak of the pandemic. Nonetheless, the relative importance of Islamic sustainable finance for delivering the global environmental, socioeconomic and governance agenda has been brought further to the fore as the world enters into the recovery phase of the pandemic and investments are being made on critical sustainability projects and economic activities. To achieve a sustainable post-pandemic recovery would therefore require significant reforms in how the ESG considerations are taken into account in both Shariah compliant investment and financing decisions on related economic activities. This would also require widespread participation of the IFSI to transform and adapt in order to keep contributing to the global society and economy.

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1 Berry, "*Top 10 Causes of Global Warming*", Sustainability Magazine, 2021

2 Bank Negara Malaysia Discussion paper, "*Climate Change and Principle-based Taxonomy*", 2019

A considerable number of international organizations, global leaders as well as regulatory and supervisory authorities (RSAs) have been responding to this issue through various measures in order to reduce greenhouse gas emissions. Examples are: (i) Paris Agreement in which 197 countries were involved and pledged to a legally binding commitment toward climate change objectives, (ii) Declaration by the United Nation Human Rights Council on the 8th October 2021 stated that access to clean and healthy environment is considered as a fundamental human right and lately, (iii) UN Climate Change Conference (COP26) 31st October–13th November 2021 has agreed to: (a) secure global net-zero emission by mid-century and keep limiting global warming to above 1.5oC industrial levels 'alive' or within which, (b) adapt to protect communities and natural habitats, (c) mobilize finance, and (d) work together to deliver.

Principles and examples of Islamic sustainable finance

Indeed, the principle of ESG aligns with the Islamic principles and objectives set out in the concept of Maqasid Shariah which include: the safeguard of life, intellect, religion, wealth and dignity of mankind. Furthermore, as the term ESG, sustainable and responsible investment (SRI) and impact investing are gaining popularity, and there have been efforts in the IFSI to also key into this trend, for instance through the issuance of global green Sukuk, sustainability Sukuk, SRI Sukuk, etc. The presence of sustainable-driven Islamic financial instruments, along with the risks faced by the IFSI, would require the RSAs' attention to ensure and guide the IFSI in their respective jurisdictions in incorporating the new climate-related risks into their risk management framework for the purpose of maintaining the overall financial system's resilience and stability.

Green Sukuk have emerged in some IFSB member jurisdictions, notably Malaysia and Indonesia, in responding to achieving the goals of sustainable finance and resolving the climate change issues. In this case, green Sukuk channel investment which brings not only commercial value but also environmental benefits by avoiding environmentally-degrading activities. At least, Islamic principles of: (i) Wasatiyyah (equalibrium) to maintain the balance of Mizan (natural state of the world) such as avoidance of waste, extravagance and corruption and (ii) prohibition of Fasad (promotion of disorder) to prevent unethical transactions and dealings that have Riba (interest), Gharar (uncertainty) and Maysir (gambling) are among the main principles to promote and support the sustainable finance and environmentally friendly financing activities.[3]

Last but not the least is Islamic social finance which has also played a significant role prior to and during the pandemic, and will remain very crucial in the post-pandemic era. Notable Islamic social finance instruments such as Islamic charity (Shadaqah), alms giving (Zakat) and endowment (Waqf) have been extensively used to assist the needy and also promote wealth distribution and shared prosperity. During the current pandemic, many countries have adopted and intensively applied social and humanitarian policies and programs such as rental payment relief, pension funds, wage subsidies, capacity-building initiatives and mobilization of social funds to support certain sectors

[3] Liu and Lai journal article, "Ecologies of Green Finance: Green Sukuk and Development of Green Islamic Finance in Malaysia", 2021.

in the economy via Islamic social finance. They have not only reserved and secured the financial and purchasing power of the people but also balanced both commercial and social finance for the sake of public welfare.

To sustain the economy of the grassroots, the recent initiatives enumerated by the World Zakaf Forum (WZF)[4] to extend the roles of Islamic social instruments should be appreciated and noted as another role of Islamic finance during the difficult conditions due to the pandemic. These include:

a. Strengthening collaboration with the respective governments to mitigate the spread of the pandemic.
b. Establishing a contingency plan to assist the most vulnerable and underprivileged group of people due to possible multidimensional crises.
c. Consolidating Zakat resources to assist the medics, paramedics and humanitarian volunteers in the front line with the endeavor to overcome the negative impacts of the pandemic.
d. Exchanging information and experience in handling the pandemic among WZF member countries.
e. Providing critical assistance to those working in the informal sector of the economy which highly depends on daily income sources.
f. Strengthening global cooperation among WZF member countries for potential collaboration to conduct crowdfunding donations in order to help member countries.

Furthermore, such Islamic social finance instruments (ie Zakat, Sadaqah, Waqf) could be coordinated together and integrated with the fiscal policy of the governments in the form of safety nets and pro-poor expenditure. Governments could look at issuing Sukuk that is linked with temporary cash Waqf to mobilize social and benevolent funds at below market rates for financing various safety net measures. Cash and corporate Waqf funds could also have a useful role when a government begins unwinding its holdings of corporate assets in the recovery phase.

IFSB initiatives on Islamic sustainable finance

The mandate of the IFSB is to promote the stability and resilience of the IFSI through issuing and facilitating the implementation of global prudential standards and other initiatives that foster knowledge-sharing and cooperation. In relation to supporting sustainable finance, the IFSB acts as a body for coordinating and giving guidance on good practices in the regulation and supervision of Islamic financial services, which would also serve to promote sound growth and support the resilience and stability of the global IFSI.

The IFSB, in December 2020, issued 'IFSB-25: Disclosures to Promote Transparency and Market Discipline for Takaful/Retakaful Undertakings'. Also, in December 2018, the IFSB issued 'IFSB-22: Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services [Banking Segment]'. In these standards, a dedicated section is provided on the ESG disclosure requirements in order to promote market discipline and transparency in the IFSI. The IFSB also issued in December 2019 'TN-3: Technical Note on Financial Inclusion and Islamic Finance'. In this document, the IFSB provides a detailed technical guide on the priorities and considerations that are pertinent for regulatory and supervisory oversight for financial inclusion through the IFSI of member jurisdictions.

In addition to a dedicated research paper titled 'The Role of Social-Impact Sukuk in the Recovery-Phase of COVID-19' to be issued in December 2021, the IFSB has also included in its strategic work plan for 2021 a dedicated paper on ESG. Furthermore, in its flagship Islamic Financial Services Industry Stability Report, the IFSB has consistently addressed developments relating to green and sustainability financing in the IFSI especially in the Islamic capital markets segment of the report. Specifically, in the recently issued Islamic Financial Services Industry Stability Report 2021, a chapter is dedicated to the role of Islamic social finance in a post-COVID-19 recovery phase. Notable examples and best practices across jurisdictions were highlighted.

> The mandate of the IFSB is to promote the stability and resilience of the IFSI

To ensure the sustainability of the IFSI during and post-pandemic, the IFSB has assessed the impacts of the pandemic on the IFSI (Islamic banking, Takaful and Islamic capital market) and held various events (conferences, webinars, forums, etc) to elaborate the issues and ways ahead with regulators, market players and Islamic scholars on ESG issues. These platforms provided by the IFSB offer opportunities to various stakeholders to identify extant ESG investment gaps and financing initiatives, best practices, exchange of ideas and information, regional and international collaboration, etc.

For instance, the IFSB recently held its 15th Summit in November 2021 in Jeddah, Saudi Arabia where nine central bank governors, 24 other distinguished high-level speakers representing key stakeholders in the IFSI and 200 other participants from the RSAs, international organizations, the private sector, academia and the media attended. ESG issues featured prominently across the seven panel discussion sessions and keynote addresses delivered during the global event.

As the IFSB will not relent in its efforts toward providing guidance and support to its member jurisdictions in order to promote the stability and growth of the IFSI through Islamic sustainable finance, the IFSB will be conducting its 13th Public Lecture in Abu Dhabi that is co-organized and hosted by the Central Bank of the UAE on the 8th December 2021 with the first session lecture to be on sustainability.

The IFSB also issues public statements and updates its compendium of policy responses to COVID-19 in its member jurisdictions on related matters. All related IFSB materials are available for free download via: www.ifsb.org.

[4] World Zakat Forum (WZF) Press Release (2020)

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

By Ijlal A Alvi,
CEO of International Islamic Financial Market

Authored by

السوق المالية الإسلامية الدولية
International Islamic Financial Market

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

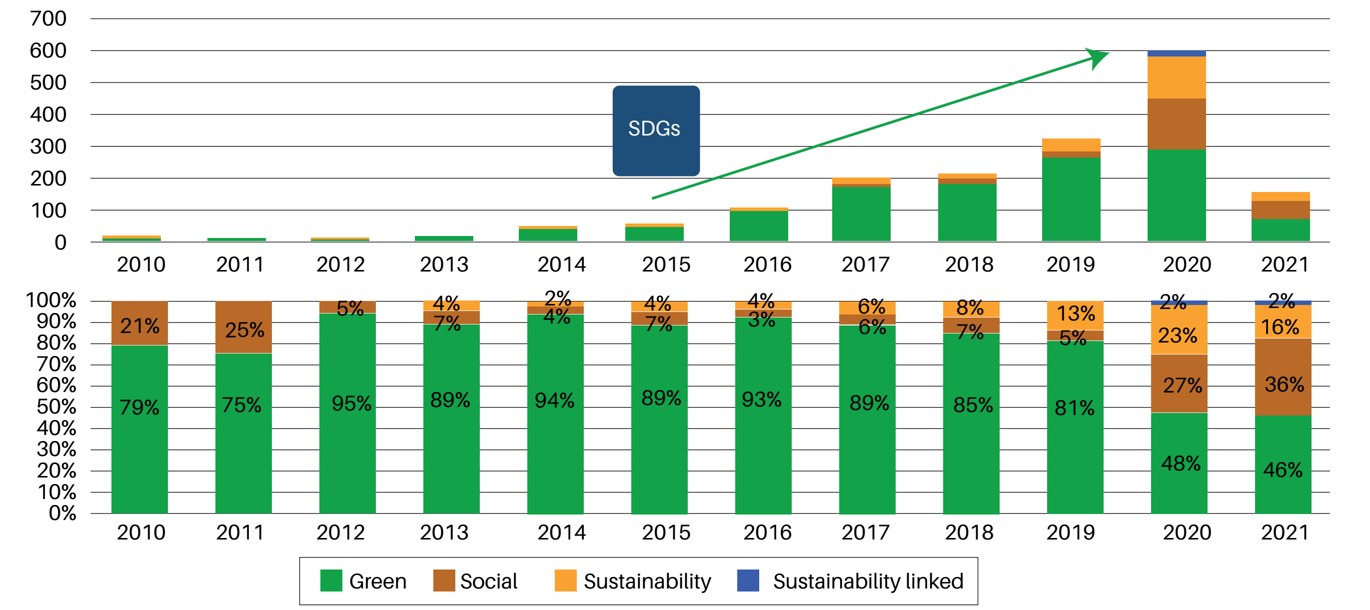
The goals of the recently concluded COP26 [2021 United Nations Climate Change Conference] meeting are to secure global net zero by mid-century, to protect and restore ecosystems, to build infrastructure and agriculture that are resilient, developed countries to make good on their promise to deliver US$100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

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

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

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

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



Source: Environmental Finance, 11th March 2021

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

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

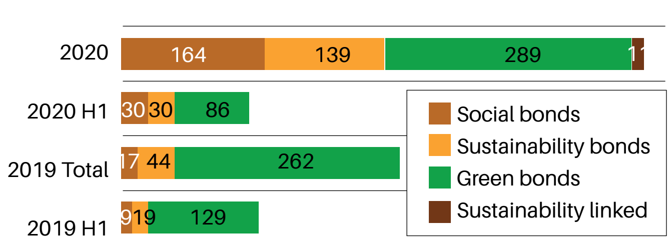
Carbon castoffs

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

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

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

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



Source: Environmental Finance, 30th January 2021

ESG key risks

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

ESG or financial stability risks

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

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

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

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

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

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

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

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

ESG implementation and its impact on supply chain

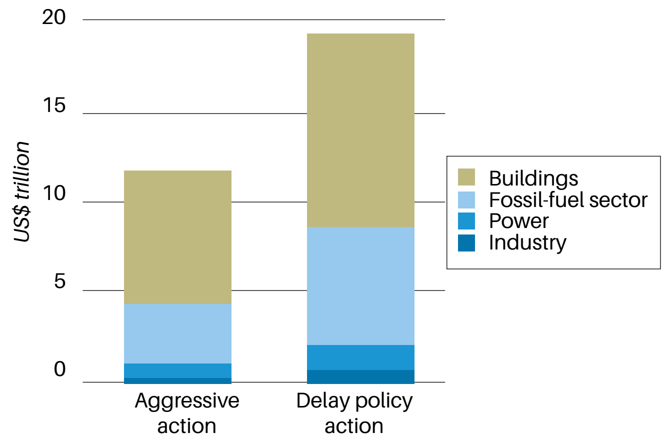
As per a Standard Chartered Bank report titled 'Carbon Dated – The net-zero supply chain revolution', governments are striving to deliver net zero by 2025 to avoid an environmental catastrophe, but without the direct engagement of businesses the efforts may fail. Multinational companies (MNCs) in turn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

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

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

- For 67% of MNCs, reducing supplier emissions is the first step in their net zero strategy, underlining the importance of supply chains in carbon transition.

Chart 3: Value of stranded assets



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

Source: International Renewable Energy Agency

- About 78% of MNCs say they will start removing slow-to-transition suppliers by 2025 (including 15% who have already started this process).
- MNCs expect to cut around 35% of their current suppliers as they respond to net-zero pressures.

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

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

Conclusion

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

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

Integrating sustainable development goals into Islamic finance

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بسم الله الرحمن الرحيم

Prophet Muhammad said: "The most preferred to Allah of good deeds are regular and consistent ones, no matter how small they are."

" أحب العمل إلى الله أدومه وإن قلّ "

This statement succinctly summarizes the Islamic approach to development: steady and consistent progress rather than quick and abrupt growth. "Haste makes waste," as the saying goes.

Sustainable economic progress requires sustaining resources and therefore economizing on them. We live in a finite world, and resources are eventually depletable. So, how to economize on resources?

We cannot economize by simply reducing the utilization of these resources. Instead, we should be using them to build and uncover new and environmentally better resources that outlive the existing ones. And then using the new resources to build and explore yet additional and better ones to outlive them, and so on. In other words, sustainable development requires continuous efforts to build and discover resources for the future. Although no single resource can live forever, this strategy helps to consistently create sustainable resources.

And what is the most important resource on Earth? It is humans. Human capital is the most valuable asset in the economy. The best way, therefore, to sustain resources is to invest in human beings. This is why health and education are the most valuable, long-term, investments.

Humans are the most creative and innovative creatures on Earth, and that is why they are the most productive and able to discover better resources. One important reason why we are facing environmental crises is that we are taught that the primary objective of man is consumption, not long-term sustained production.

If you pick a microeconomics textbook, you will find that the objective of the 'economic man' is to maximize the utility of consumption. This is very different from the objective of sustaining resources. Only under very narrow and hypothetical conditions, the two perspectives might lead to the same outcome. But in a rich and complex world like the one in which we live, the two perspectives diverge much more often than they converge. When the objective of economic activity is to sustain resources, production takes priority over consumption, because we want to build productive resources for the future.

It is essential, therefore, to integrate sustainable development into mainstream economics. Believe it or not, today there are mainstream textbooks that question the size or extent of climate change and undermine the threat it poses to our existence. If the youth learn this in school, our battle against climate change will be a losing one. To win the battle, we must win over the new generation who in a few years will be leaders in their societies and will, therefore, be able to make a lasting impact. Economic textbooks should make sustaining resources the primary objective of the economic man rather than selfish, short-term, consumption.

And this brings us to Islamic finance. To finance sustainable development, financing mechanisms must be sustainable as well. Take, for example, the prohibition of Riba, a major principle of Islamic finance.

The essence of Islamic finance is that finance must be integrated with the real economy. We cannot make money out of money — we must participate in trade or production to earn profits. Interest-based lending decouples financing from the real economy, leading to the self-multiplication of debt. As debt grows faster than wealth, the burden of debt services puts huge pressure on economic resources to catch up with the unbounded growth of debt. But this is a losing game because self-multiplication will necessarily outgrow the economy, no matter how hard people work and no matter how fast they extract economic resources. This inevitably leads to crashes and depressions, resulting in yet another round of waste of resources. The prohibition of Riba, therefore, is critical for sustaining economic resources.

Islamic finance integrates universal moral values with economic activities. This integration is essential to achieve sustainable development and to overcome the climate crisis the world is facing today.

To see this, we should note that the climate crisis has two dimensions: time dimension and space dimension.

The time dimension extends over generations. The narrow perspective of giving substantial priority to the present over the future encourages us to forget about the future and enjoy the current moment. When each generation follows the same strategy, it is almost certain that humanity will not survive the climate crisis.

This is where moral values come into play. If we care enough about future generations, then we must act now to save humanity. To care about future generations means to care about humanity, and to care about humanity means to care about oneself.

The whole concept of "sustainable development" is based on the ability to see the future clear enough to plan and to sustain resources, not only for this generation but for the coming generations as well. Moral values help to balance the present versus the future. The lack of this balance is a major factor behind the environmental threats that humanity faces today.

The space dimension of sustainability is reflected in the collective action it requires. Curbing the climate crisis is a form of a 'prisoner's dilemma' game, where cooperation is necessary to achieve optimal outcomes. However, there is always the incentive for the few to deviate from the group to win short-term gains at the expense of the community. But if everyone follows the same strategy, everyone loses. Moral values are necessary to control selfish motives and to balance self-interest vs. group interest.

So, we can see why moral values are essential for optimal and sustainable economic performance.

We have to remember that the Earth was created for all mankind of all races and cultures. A threat to the environment is a threat to humanity as a whole. Saving humanity is a decent Islamic value. The Holy Quran says: "And whoever saves a life is as though he had saved all mankind."

ومن أحياها فكأنما أحيا الناس جميعاً

معهد البنك الإسلامي للتنمية
Islamic Development Bank Institute

By Oussama Kaissi
CEO
The Islamic Corporation for the Insurance of Investments and Export Credit (ICIEC)

Authored by

Two of the unintended consequences of the COVID-19 pandemic have been the acceleration toward digitization in financial services and a redoubling of initiatives toward sustainable investment.

Sustainable finance is the practice of integrating environmental, social and governance (ESG) metrics into financial services to bring about sustainable and impactful development outcomes.

These include meeting the UN Sustainable Development Goals (SDGs) Agenda by 2030 to eradicate poverty, protect the environment and improve the lives of everyone; inculcating socially responsible investment; fostering social and impact investment and its independent measurement; and mitigating and adapting to the adverse effects of climate change to transition to a low-carbon economy and net-zero emissions as per the Paris Climate Agreement to build climate-resilient societies, cities and economies.

The Islamic Corporation for the Insurance of Investments and Export Credit (ICIEC), the insurance arm of the IsDB Group, is unique in that it is the only multilateral export credit and investment insurance corporation in the world that provides Shariah compliant insurance, reinsurance and guarantee solutions.

Sustainable finance and ESG are entrenched in the ethos of Islamic financial institutions and multilateral development banks (MDBs). We adhere to the Shariah principles, not to exhaust nature but to preserve it; and deliver development and social impact without leaving people behind. The proscription of interest and usury is a defining sustainability factor, and an ESG framework is a built-in characteristic of Islamic finance and insurance.

Sustainable finance is the practice of integrating environmental, social and governance (ESG) metrics into financial services to bring about sustainable and impactful development outcomes

Our mandate is to promote cross-border trade and foreign direct investment (FDI) in our member countries (MCs) by providing risk mitigation and credit enhancement solutions to exporters selling to buyers across the world and investors from around the globe investing in our MCs.

These include Non-Honoring of Sovereign Financial Obligations (NHSFOs); Bank Master Policy Murabahah Facilities; Political Risk Insurance for Cross-Border Loans, Equity Investments and Projects; Sukuk Insurance Policy and Reinsurance and Co-insurance facilities.

Supporting intra-OIC trade is a priority for the ICIEC. Since its inception, the ICIEC has supported a total of US$30.2 billion in intra-OIC exports. The ICIEC catalyzes impact by supporting transactions and projects that contribute to the SDGs. ICIEC business solutions are closely related to six goals. Our commitment is based on a Development Effectiveness Framework derived from a conceptual road map called 'Theory of Change', which links the corporation's services to intended outcomes in the export, sustainable investment and financial sectors. It is further underpinned by a Monitoring and Evaluation System.

The SDGs have been a central tenet of the ICIEC's operations since their introduction in 2015. Trade and investment facilitation is an effective vehicle by which to achieve the SDGs. We are committed to supporting sustainable development; we actively target real impact and change in all our insurance policies and projects; we support and act as a catalyst for private sector capital mobilization to be directed toward achieving the SDGs.

As the 2021 UN Climate Change Conference (or COP26) convenes in Glasgow, four metrics stand out: the science is indisputable, the issues are complex, the challenges monumental and the time for action is fast running out. Climate change is one part of the sustainability universe, including biodiversity, food and water insecurity, healthcare, financial inclusion, gender and other inequalities and human rights issues

As the 2021 UN Climate Change Conference (or COP26) convenes in Glasgow, four metrics stand out: the science is indisputable, the issues are complex, the challenges monumental and the time for action is fast running out. Climate change is one part of the sustainability universe, including biodiversity, food and water insecurity, healthcare, financial inclusion, gender and other inequalities and human rights issues.

This requires all stakeholders to buy into the ESG and sustainable investment agenda in pandemic-related building back better and economic recovery and long-term financial, social and economic development.

While there is a definitive synergy and convergence between Islamic finance and the broader sustainable investing movement, the two are not necessarily wholly inclusive. There is potentially much overlapping, but the unique specificities of Islamic finance must not be lost in translation or the exuberance in achieving ESG and SDGs at any cost.

There is vast scope for intelligent and meaningful partnerships, cooperation and co-financing. The ESG challenges in terms of cost, technology and reach cannot be met by one country, bloc, institution or pool of funds. The ICIEC has established partnerships with over 131 national export credit agencies, reinsurers, banks and other multilateral institutions.

A burgeoning private sector and investment in infrastructure can lead to recovery from the pandemic for economic transformation, job creation and inclusive growth. The pandemic exposed the woeful lack of sufficient infrastructure in countries the world over. Infrastructure was brought to a near standstill. The ICIEC responded swiftly by forging strategic partnerships, ensuring the continuance of critical trade flows and creating innovative de-risking solutions to help mitigate fallout in MCs.

According to Fitch Ratings, there is currently a pipeline of US$12 trillion-worth of global projects, with rail and renewables the top investment sectors. Of this, US$7.49 trillion is required by Asia, the MENA region and Africa.

Political risk insurance and credit enhancement have a track record of effectively de-risking and thus catalyzing private investment into emerging markets through capital-efficient instruments. Channeling investment into sustainable projects presents a sizeable growth opportunity for insurance firms, especially infrastructure and development projects in various sectors. Insurers can design products to reduce risks in infrastructure projects and increase their attraction to investors.

The ICIEC has led from the front. We jointly launched with the IsDB the US$2 billion COVID-19 Guarantee Facility in support of the private sector, particularly COVID-19-hit industries, and attracting cross-border investments. In 2019, we jointly established the Co-Guarantee Platform for Africa (or CGPA) with other multilateral institutions to increase the volume of insurance and guarantee solutions available to project sponsors and their bankers.

MDBs are a significant finance and insurance source for developing countries, even though more can be done. The investment needed to green the global economy is enormous and exceeds the scale of official finance. The answer is a mix of government and MDB finance, private capital and philanthropy (including the Islamic instruments of Waqf, Zakat, Sadaqah) to fill the gap. When well-designed and implemented in a balanced regulatory environment to avoid unnecessary fiscal and other risks, public–private partnerships, for instance, can bring greater efficiency and sustainability to the provision of public services, thus freeing up scarce public resources for other purposes.

The ICIEC, since its inception in 1994, has built up an impressive record in facilitating sustainable investment in projects and infrastructure in MCs through its well-received risk mitigation solutions.

Cumulatively, over 27 years, the ICIEC has insured US$77.9 billion in trade and investment, which includes US$62.3 billion in supporting exports and imports and US$15.6 billion in support of FDI. Our activities were directed to specific sectors, including US$29.3 billion to clean energy, US$23.8 biilion to manufacturing, US$5 billion to infrastructure, US$2 billion to healthcare and US$1.4 billion to agriculture.

The ICIEC, together with the IsDB, was the fastest among peer institutions to respond to the pandemic. During the peak of the pandemic in 2020, underpinned by our 'Aa3' insurance financial strength rating by Moody's Investors Service, the ICIEC's business insured reached US$9.8 billion, of which US$5.4 billion was directed to sustainable energy, US$2.1 billion to manufacturing, US$861 million to services, US$586 million to infrastructure and US$37 million to healthcare.

The ICIEC's pandemic-mitigation strategy is underpinned by:

i) US$643 million in insurance coverage toward the implementation of the IsDB Group's US$2.4 billion COVID-19 mitigation Strategic Preparedness and Response Program (or SPRP), guided by the three R's (Respond, Restore, Restart).

ii) Supporting MCs' recoveries, including US$262 million for the healthcare sector, US$331 million toward supporting imports of essential commodities and US$50 million for supporting the recovery of SMEs from the pandemic fallout.

iii) Partnering with the Islamic Solidarity Fund for Development (ISFD), the IsDB Group's poverty alleviation unit, to launch the ICIEC–ISFD COVID-19 Emergency Response Initiative to preserve the flow of essential imports to MCs, such as medicines, medical equipment, food supplies and other essential commodities. The ISFD allocated a grant to the ICIEC that could support some US$400 million to procure urgent product needs.

The ICIEC's sustainable financing impact and delivery over the years speak for themselves through the manifold transactions and case studies. To highlight a few:

1. Senegal benefited from our insurance to mobilize resources from private lenders given the scarcity of concessional lending. This provided comfort to investors and allowed them to be more flexible in extending the facility maturities. Senegal managed to secure private financing for the rehabilitation of a significant water collection system in Dakar. The financial structure enabled Senegal to borrow in local currency. Without the ICIEC's support, these investments would have taken longer to financial close and probably at a much higher cost.

2. The ICIEC supported the Ivory Coast in developing its healthcare infrastructure by covering EUR142 million (US$163.95 million) for a Deutsche Bank financing of a major healthcare project. Two new hospitals with a collective capacity of 400 beds will be built in the underserved towns of Adzope and Aboisso. The hospitals will employ 600 local people and foster the development of a micro economy in the surrounding areas. The development impact of this project provides the people with access to quality healthcare and advancing progress toward SDGs 3 and 9.

3. The ICIEC supported Egypt in its COVID-19 response by providing US$135 million in an NHSFO policy for Sumitomo Mitsui Banking Corporation, covering its participation in a US$1.5 billion syndicated facility for the Egyptian government. The transaction serves SDG 8 by contributing to Egypt's pandemic response efforts through maintaining economic activity.

Despite the challenging environment, the ICIEC maintains its resilience in mitigating these risks, ensuring the continued flow of international trade and sustainable investment between OIC MCs and the world. As countries slowly recover from the impacts of the pandemic, we will be there to support them as they rebuild a healthier, inclusive and resilient OIC community with sustainability as a priority.

We expect the impact of the pandemic to continue for a few years, even if it starts receding in earnest. We will continue to find ways to support our MCs, clients and partners throughout recovery.

In doing so, the ICIEC works to see its solutions bring companies closer to progress their sustainable financial goals and bring MCs closer to achieving their development agendas in the process.

ICIEC THE ISLAMIC CORPORATION FOR THE INSURANCE OF INVESTMENT AND EXPORT CREDIT

IsDB البنك الإسلامي للتنمية Islamic Development Bank

Beyond net zero: People, nature and climate

By Nick Villiers,
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Authored by

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INSTITUTE FOR SUSTAINABILITY LEADERSHIP

Embracing a 'beyond net zero' strategy means we have an opportunity to protect not only climate but people and the natural world. The collapse of our ecosystems, climate change and growing social inequity are interconnected challenges and that is why a safe future will involve us working now to protect and restabilize the global climate while conserving and regenerating nature so resources can be shared sustainably and fairly.

A 'beyond net zero' strategy requires the finance industry to look beyond net zero emissions, taking an active and assertive role in supporting, enabling and accelerating the transition to a more regenerative economy — one that puts nature and society centre stage. While leading financial institutions will follow their clients in unlocking and accelerating action, without a widespread and proactive approach, both the sector and its customers will suffer.

Net zero: From commitments to action

The Intergovernmental Panel on Climate Change (IPCC)'s **Sixth Assessment Report** warned that some changes to the climate are now inevitable and irreversible, stating that even the most ambitious scenario sees us peaking at 1.6°C mid-century.

CISL welcomes the recent pledge at COP26 made by more than 450 finance firms, jointly managing US$130 trillion, to align their financing activities to achieve net-zero emissions by 2050. These commitments will need to be backed up by individual net-zero commitments and transition plans. Viable delivery mechanisms, including blended finance, and guarantees, will be required to ensure finance reaches emerging markets where it is most needed.

While global frameworks and pledges to tackle climate change are in place and ambition is increasing, there remains a stark lack of progress. Significant work is now required on implementation, including building transition pathways, measurement tools and development of new financial products, as well as widening the focus to areas such as **net zero insurance underwriting** and support for **small and medium-sized enterprises globally.**

Critical to a successful transition and to deliver against their commitments, the financial sector must also engage its clients, alongside its staff and industry peers. Financial institutions must recognize that some clients will require support and incentives to embed sustainability through their organizations. **Building new forms of relationships with clients** is necessary to create a transition pathway that co-creates sustainable products and services. Without broader collaboration across finance, net zero will be harder to achieve.

To drive the necessary change, staff at all levels of financial institutions need to build their understanding of what the transition to a sustainable economy means for their clients, as well as their own business.

Arguably even those who have made commitments or are currently demonstrating leading practice are in a **zone of transition** — no one is near institutionalization. The financial sector is trying to understand the current position and exposures before they start to map transition journeys for sectors and geographies. Critically, such action will require firms to move beyond viewing sustainability as an overlay or silo but embed it into financial decisions. Nor can they rely on small teams of sustainability experts but need to grow capacity across their business operations.

CISL works to address this need through a number of channels, including helping boards to understand the changing context and delivering a **range of education programs** for financial practitioners, including customized programs for senior staff in financial institutions. CISL's Banking Environment Initiative also recently published a guide, **Let's Discuss Climate**, to help client-facing bankers engage with their corporate clients around transition plans.

Adaptation and resilience have not yet received the required attention from large parts of sustainable finance, but can no longer be ignored

Beyond net zero: Adaptation and resilience

The IPCC report showed that net zero is an important milestone, but cannot be the final destination. We will be living in a warmer world, even with the most ambitious actions, meaning that investing in adaptation and resilience must be an urgent focus for the finance industry. In particular, that requires a focus on financing the adaptation of emerging markets, and learning lessons from action already taken in those markets.

At COP26, an agreement was made to double adaptation finance - this acknowledgment of the lack of progress on delivering the US$100 billion needs to be underpinned with swift implementation to enable vulnerable countries still to plan and deliver their adaptation and mitigation programs in earnest.

The recent floods in Germany and the wildfires in the US, Canada and Australia echo devastating climate impacts that have already been felt across some developing nations for decades. As far back as the 1990s, South Pacific islands at risk from climate-related sea-level rise attended UN climate talks to share their knowledge and ask for action to protect their very existence. We need to address such existential threats that people and nature have long been facing and learn from them as we see a rise in their frequency and the increase in temperatures. Insurance has a long track record of understanding physical risks, and is using that modeling experience to better understand the impact of climate change across the world, as exemplified by ClimateWise's **Physical Risk Framework**. This understanding must be harnessed and adopted by policymakers as well as the wider finance and business communities to drive investment in adaptation and resilience measures.

Beyond net zero: People and nature

Achieving net zero can no longer be considered in isolation. The climate crisis is a catastrophic symptom of a much deeper deterioration in society's relationship with the planet's systems and resources, and also the relationships within society's own structures that are compounding inequality and injustice. The activities of the poorest countries and their communities have contributed the least to the present climate crisis and it is imperative the aid needed to support their aims of reaching net zero is made available. Everyone's health, homes and livelihoods depend on a balanced and flourishing planet.

For finance, that means taking a broader view of transition plans — looking at the real sources of risk and opportunity that become clear when we factor in the social and environmental damage being caused by some economic activities and then aligning financial flows with real long-term sustainable value.

This includes supporting the **mobilization of capital** toward low-income countries, to meet the trillions that emerging economies and developing countries need to decarbonize and build climate resilience. It also includes building an understanding of how finance can support a nature-positive set of changes.

Over 50% of the world's economy depends on fresh water, clean air or productive soils. Disruption of environment and society can impact negatively on the valuation of companies, products and services. CISL's handbook on identifying **nature-related financial risks** contains a framework for identifying those nature-related risks to finance. We are currently working on a number of case studies to show how this works in practice, yet more work in this area by finance is urgently needed. By examining climate disruption impacts on people and nature, firms can act to negate disruption to their own underlying business.

By addressing three elements together — people, nature, climate — we will give ourselves the best chance of avoiding any catastrophic unintended consequences of the transition to a new economy. Despite all the significant efforts to reduce carbon, we must embrace a truly regenerative economy.

Better data and transparency for resilience

To enable us to move beyond net zero, we also need improved data and transparency to understand environmental and social impact of financing decisions, to drive more robust investment choices.

Finance needs to continue collaborating to build core principles, frameworks, data points and standards to better manage the climate, people and nature transition. CISL's **Sustainable Investment Framework** enables users to measure the impact of an

investment portfolio, with six metrics: three on climate and three on the environment. This framework is designed for use across all funds (not just environmental, social and governance funds) to understand the impact of an investment in the round. It is based on a transparent methodology and data, essential to build confidence and avoid greenwashing.

An understanding of the wider impact of financing activity is needed to build better decisions in all forms of finance

However, we also recognize that current levels of disclosure still fall considerably short of what is required to truly understand the impact of an investment. We welcome the range of initiatives to improve disclosure and bring forward industry-wide standards that will enhance comparability and simplify the reporting process for business.

Understanding the impact

Finance has a vital role in delivering a low-carbon economy in ways that create jobs and preserve nature. The finance agenda was pivotal from the start to the end of COP26 - the pledge from 450 finance firms to align their financing activities to achieve net zero by 2050 is indicative of both the scale and ambition needed, as well as understanding from the sector on its role to achieve this goal.

As we start to think about stakeholder capitalism, just transition and the impacts of our activity on nature and society, there are lessons to be learned from different forms of finance. Some approaches to finance, such as Islamic finance, understand that every financing decision has an impact on the world, and that considerations of that impact are required to ensure fairness and transparency. The 'notion of stewardship', or 'Khalifa', can be seen in financial responsibility when prioritizing respect for employees, customers, fulfilling obligations to shareholders and caring for the environment, and feels aligned with approaches such as stakeholder capitalism.

An understanding of the wider impact of financing activity is needed to build better decisions in all forms of finance.

We are standing at a crossroads, where we need to choose between a narrow and outdated methodology or embrace a more sophisticated decision-making and integrated pathway. If we do so, a tremendous opportunity for society and finance is there for the taking.

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By Sunita Rajakumar, the chairman of Climate Governance Malaysia, the second country chapter of the Climate Governance Initiative, founded in May 2019. The Climate Governance Initiative currently has more than 20 chapters around the world.

Authored by

Climate Governance Malaysia

"Climate change is a complex and inherently systemic issue making it an extremely difficult risk and opportunity to manage." — World Economic Forum's Principles of Climate Governance

The massive build-up of ambition, expectations and momentum prior to the two-week Conference of the Parties to the United Nations Framework Convention on Climate Change in Glasgow (COP26) proved too weighty for the frail shoulders of mere politicians and leaders. More than 100,000 protesters took to the streets of Glasgow alone, significantly more than anticipated, while an estimated 500 representatives were present from the fossil fuel industry alone, significantly more than any single country.

The present outlook is a grave warning that global leaders simply do not have the capacity or political will or, for other reasons, are not able to set aside their differences and priorities to be able to effectively attain consensus about the action which is urgently needed in this existential crisis, as informed by science.

This could signify various responses:

- Governments which understand the enormity of the crisis and consequences will invest their time and resources in adaptation measures, to ensure a just transition within their spheres of influence.
- Civil society will endeavor to fill this vacuum and take the lead.
- Business strategies will continue to bifurcate sharply between those who understand the extent of the transition and those who do not and are essentially betting against society succeeding.

The unprecedented momentum of the past two years has been based on science and seen both prudential regulators (central banks, monetary authorities) and capital market regulators (securities commissions, stock exchanges) as well as allocators of capital (institutional investors, banks, insurers) demand for enhanced reporting and disclosure so they can make better informed decisions, as capital needs to be diverted away from businesses, industries, regions and countries which still have not internalized the enormity of this transition and are not prepared for a smooth transition.

The ultimate consideration is very clear: there can be no successful business on a dead planet ['companies do not succeed in isolation']. There is increasing evidence, especially from meta studies, that enterprises which have strong credentials in environment, social and governance (ESG) factors are delivering better risk-adjusted returns and financial performance. Non-ESG focused businesses will increasingly lose access to capital markets as allocators of capital signal that business and financial stability is synonymous with environmental stability.

Some of the key challenges facing many countries are:

- Lack of national and local climate-related data to make informed decisions, with such data needing to be accurate, timely and relevant.
- The absence of forward-looking scenarios which are relevant for their industry and region.
- Adequate policy signaling from legislators in decarbonizing the economy and the transition strategy, specifically necessary adaptation measures.

Science

Humans have relied on environmental and climatic stability for societies and civilizations to prosper and mature, yet the greatest existential crisis which human civilization is now facing involves the destruction of the natural conditions necessary for our own survival.

The effects of the triple crisis of climate, destruction of biodiversity and pollution are clearly established as arising from human activities. Changes in water cycles, rainfall patterns, sea level rise, the ocean and extreme weather events are further amplified by a rapid increase in urbanization and the destruction of the natural environment. Malaysia and Southeast Asia will be disproportionately adversely affected by rising temperatures.

Further, the Paris Agreement of December 2015 was not just about reducing emissions across all sectors, but about remaining within planetary boundaries, including the need to keep carbon sinks in nature intact and preserve nitrogen, water and phosphorus cycles. The majority of earth's massive biosystems have reached or are very close to tipping points beyond which reversion will be impossible or could take centuries, including the Atlantic Ocean's key circulation system with immense consequences for Earth's climate if/when it collapses.

Scientists have been warning about the consequences of the climate emergency for many decades — 'the world listened but did not hear' — and guided that global emissions need to be halved by 2030, just over eight years away, and be net zero by 2050.

Landmark commitments to decarbonizing include OECD countries by 2050 while China, Russia and Indonesia have committed to net zero by 2060 and India by 2070. It is important that these commitments are based on the reduction of absolute emissions, versus emission intensity, accompanied by a declaration of when emissions will peak, while considering the different combinations of transition of physical risks.

To illustrate the sheer scale of reduction which is necessary, in 2020, with almost the entire world under lockdown, during the COVID-19 pandemic, the International Energy Agency estimated that emissions only reduced by 6%.

The UN's Intergovernmental Panel on Climate Change's 6th Assessment Report issued in August 2021 is much more comprehensive, with over 234 authors having assessed more scientific evidence than ever before. It was described by the secretary-general as a "Code Red for Humanity" and compacted the expected range of warming to be between 2°C and 4.5°C.

[In the five previous assessments, the IPCC estimated the range of warming would be between 1.5°C and 4.5°C. The 6th Assessment Report is an unprecedented warning that limiting warming to 1.5°C is no longer an option, based on current declared national targets, the majority of which are not yet backed by legislation or frameworks for implementation. The minimum threshold of warming of 2°C is already locked into the ecosystem.]

So, the implications are clear: climate has already warmed by 1.2°C in 2021 [during a La Nina phase] and there is a high likelihood of achieving 1.3°C of warming during an El Nino year in 2022, which will cause massive upheaval around the world.

Therefore, with warming of 1.5°C well within range, it is increasingly clear that a decarbonization strategy alone is insufficient; in a crisis where no business or industry sector will be untouched, there is an urgent need to consider the needed resources, scenarios and strategies to ensure adequate adaptation measures for the impacts of climate change which would likely be prohibitively costly, damaging and deadly.

With warming of 1.5°C well within range, it is increasingly clear that a decarbonization strategy alone is insufficient

Direction of travel

Emissions can be traced to sources, indicating those industry sectors and businesses which are significant emitters.

As carbon is unequivocally recognized as an environmental pollutant which is destroying the natural conditions necessary for our own survival, this leads to a real and present danger that corporate earnings are misstated where it fails to capture the price of carbon. Further, nations which have declared climate ambitions and targets are reluctant to be accused of outsourcing their emissions.

Thus, there are increased concerns of drastic action in the near future, such as the inevitable policy responses from governments that have a vast arsenal of policies they could implement at short notice, including regulations and taxes.

Virtually every transition scenario is built on the pillars of electrification of multiple activities [such as transportation, heating, buildings, industrial processes], increased source of green fuels [such as hydrogen, renewable energy] and preservation of carbon sinks and biodiversity [halt to deforestation, restoring degraded ecosystems].

Asia, which accounts for 36% of global GDP, has made great progress in economic development and poverty reduction, but it is also responsible for around 80% of the world's coal consumption and up to 60% of current CO_2 emissions.

Thus, a critical global fault line is the lack of financing of clean energy investments in developing countries. Fatih Birol, the executive director of the International Energy Agency, observed that while rich countries were cutting their emissions, some developing countries would continue to increase theirs unless they could gain more in shifting to a low-carbon economy.

"More than 90% of emissions in the next two decades will come from emerging economies, but they are less than 20% of global clean energy investments," he said. "If we can't accelerate the clean energy transition in these countries, I believe this will be the most critical fault line in global efforts to reach climate goals."

There are recent laudable efforts in the region to enable the early decommissioning of coal power plants but a persuasive argument has been advanced, based on the principles of equity, that the party responsible for any damage must be accountable for the reparation, also described as 'common but differentiated responsibilities'.

The argument is that those countries which have contributed historically to the bulk of accumulated emissions have an opportunity to demonstrate leadership in limiting emissions, restoring ecosystem stability and extending assistance [whether soft loans, grants or knowledge transfer] to those countries which will be adversely and disproportionately affected, through no act of their own.

This is a persuasion to reduce emissions but meanwhile, significant work is needed within each jurisdiction to ensure adaptation measures are well underway.

Existing plans to limit global warming rely too much on "increasingly unrealistic assumptions" that societies will be able to remove huge amounts of carbon from the atmosphere while simultaneously maintaining incessant economic growth over the next 50 years, according to a May 2021 **study** in Nature Communications. These strategies appear to be speeding the planet deeper into the climate crisis, the authors said.

Another option is economic degrowth — strategies to shrink the economies of rich, developed countries while maintaining the wellbeing of the people and environments they are based on — which appears to be less risky, and possibly, a better way to simultaneously meet both the goals of the Paris climate agreement and a growing population on earth.

Some conversations are still focused on raising awareness and encouraging a willingness to pay [also described as a 'green premium'], which might not be an accurate way of describing the consumer's purchasing decision. It stands to reason that with an existential crisis, there are many opportunities to generate significant value, especially where staggering amounts of capital are looking for sustainable investment opportunities which, in turn, will need appropriate risk allocation models. Businesses which are able to provide products and solutions which are simply better value for money, more attractive and efficient, while being sustainable and good for the planet, will clearly have an edge and break away from competitors.

Many countries have already experienced the devastating consequences of climate change: floods, droughts, heat waves and storms. We will not be able to self-isolate from these events. While we urgently need to focus on the quality and integrity of these promises made by nations and alliances, and ensure that commitments actually support the real economy transition, it is clear that business leaders are the key drivers of this transition.

Business leaders

Thought leaders in business are responding decisively to help address the clear and present dangers of the climate emergency, demonstrating they can be a force for good, advocating for and supporting long-term value-accreting zero-regret investment decisions to future-proof their business and communities, as well as increasing our collective climate resilience.

Thought leaders in business are responding decisively to help address the clear and present dangers of the climate emergency, demonstrating they can be a force for good

First-order implications which need addressing are physical and transition risks, including an understanding of what the extent of exposure is and an assessment of resilience to adverse climate events [such as fire, floods].

As mitigation efforts alone are no longer sufficient, leaders need to deepen their thinking and efforts on second-order implications including the availability of foreign labor, institutional stability and other significant social impacts such as mass climate migration, huge social disorders, which can escalate very dramatically and very quickly.

However, while such leaders are evolving their transition strategy to be a competitive advantage, there are laggards among the boards: one of the key findings from a recent Deloitte Asia Pacific survey was that 72% of audit committees had not completed a comprehensive climate change assessment.

In Malaysia, the central bank [Bank Negara Malaysia], which joined the global Network for Greening the Financial System in 2018, is very clear: the climate crisis poses a systemic risk to the financial system; it is simultaneously foreseeable and yet unpredictable. The prudential regulator is relying on licensed entities to be high-impact contact points with customers in raising awareness on sustainability ['force for positive change'], starting with the recently-issued Principle-based Taxonomy, which will also increase capacity as institutions grapple with implementing these principles internally.

The upcoming International Sustainability Standards Board standards in June 2022 will be a game-changer, having galvanized multi-stakeholder inputs in less than a year. The prototype disclosure requirements issued by the Technical Readiness Working Group during COP26 requires a level of granularity which we are certainly unaccustomed to, including detailed transition plans; how investments in research and development relating to mitigation, adaptation and identifying opportunities are being advanced internally; how assumptions underlying the accounts are aligned to Paris; which scenarios were used for the assessment; inputs into the scenarios; and policy assumptions.

Directors also need to be fully alert to misalignment of interests and attention between the board and management. As climate risks are longer-term and often extend beyond the considerations of the typical business planning cycle, this can lead to a phenomenon former governor of the Bank of England Mark Carney described as the "Tragedy of the Horizon".

It is abundantly clear that the costs of inaction are significantly more than the costs of action but, despite the increased ambition recently demonstrated in the nationally determined contributions, which signatories to the Paris Agreement are required to submit, and industry-wide commitments [most noticeably Glasgow Financial Alliance for Net Zero or GFANZ with an eye-watering US$130 trillion of assets backing it], all of the stated intentions need to be translated into legislation or policies; almost none of the assets are net zero today or fossil fuel-free while new fossil infrastructure is still being supported and financed, most famously the auction of a colossal 81 million acres to be leased by the US government for oil and gas production in the Gulf of Mexico, just four days after COP26 in Glasgow.

To be clear: a decarbonization strategy is a subset of the transition strategy. When we are not pricing in the cost of pollutants or environmental destruction which critically impairs our ability to be resilient, are we misstating earnings of corporations worldwide? And if so, who are the stewards of the business who would be responsible for that?

Many investors are naturally using this difficult conversation as a proxy to the quality of management: starting with understanding of the issues [climate literacy] and measuring internal carbon, waste and water footprints as well as energy efficiencies, closely followed by benchmarking to best practices, reporting and disclosure in accordance with the Taskforce for Climate-related Financial Disclosure and finally, setting science-based targets for carbon emissions and/or a declaration of operating within planetary boundaries.

Climate governance

The best practices of corporate governance require the majority of the board of directors, including its chairman, to be independent non-executive directors. These non-executive directors need to be sufficiently climate-literate to guide the direction of travel of the business they are accountable for as well as grapple with the forward-looking concepts of double materiality — where issues material to environmental and social objectives may develop financial consequences over time — and dynamic materiality — "what appears financially immaterial today can quickly prove to be business-critical tomorrow".

In January 2019, the World Economic Forum issued the Principles of Climate Governance which have proven to be a valuable framework for boards to adopt in developing climate resilience and recognizing the opportunities which are arising. Issued in the format of a set of principles with guiding questions for directors to consider, they walk the board through key considerations which recognize the important role directors are to play in embedding climate literacy across board committees and throughout the organization.

These principles are "intended to enhance the discussions on climate competence of directors to the extent that climate risk considerations become embedded in normal board processes. This should enable better-informed investment decision-making, more systemic thinking and an integrated approach to crafting and implementing [a] business strategy that is informed by consideration of climate impacts in both the short and long term."

Principle 1 — Climate accountability on boards
The board is ultimately accountable to shareholders for the long-term stewardship of the company. Accordingly, the board should be accountable for the company's long- term resilience with respect to potential shifts in the business landscape that may result from climate change. Failure to do so may constitute a breach of directors' duties.

Principle 2 — Command of the (climate) subject
The board should ensure that its composition is sufficiently diverse in knowledge, skills, experience and background to effectively debate and take decisions informed by an awareness and understanding of climate-related threats and opportunities.

Principle 3 — Board structure
As the stewards for long-term performance and resilience, the board should determine the most effective way to integrate climate considerations into its structure and committees.

Principle 4 — Material risk and opportunity assessment
The board should ensure that management assesses the short-, medium- and long-term materiality of climate-related risks and opportunities for the company on an ongoing basis. The board should further ensure that the organization's actions and responses to climate are proportionate to the materiality of climate to the company.

Principle 5 — Strategic and organizational integration
The board should ensure that the climate systemically informs strategic investment planning and decision-making processes and is embedded into the management of risk and opportunities across the organization.

Principle 6 — Incentivization
The board should ensure that executive incentives are aligned to promote the long-term prosperity of the company. The board may want to consider including climate-related targets and indicators in their executive incentive schemes, where appropriate. In markets where it is commonplace to extend variable incentives to non-executive directors, a similar approach can be considered.

Principle 7 — Reporting and disclosure
The board should ensure that material climate-related risks, opportunities and strategic decisions are consistently and transparently disclosed to all stakeholders — particularly to investors and, where required, regulators. Such disclosures should be made in financial filings, such as annual reports and accounts, and be subject to the same disclosure governance as financial reporting.

Principle 8 — Exchange
The board should maintain regular exchanges and dialogues with peers, policymakers, investors and other stakeholders to encourage the sharing of methodologies and to stay informed about the latest climate-relevant risks, regulatory requirements, etc.

As long-term stewards of the enterprise, directors are tasked with identifying material risks and effectively managing them, as well as those opportunities which will arise as a result of the climate emergency

Conclusion

Capital markets are pulling climate risks forward in their assessments of value. Allocators of capital are demanding for increased reporting and disclosure to enable capital to be allocated to those businesses, management teams, industries, regions and countries which appear most capable of making a smooth transition to a greener economy, while diverting capital away from those businesses which still do not appear to comprehend the enormity of this existential risk.

As long-term stewards of the enterprise, directors are tasked with identifying material risks and effectively managing them, as well as those opportunities which will arise as a result of the climate emergency. It will be very difficult for any director to claim they were not fully aware of the material financial risks arising from this critical transition.

Thus, directors need to balance competing board priorities against a backdrop of limited time and capacity to address all strategic topics and the constant pressure to meet expectations of all stakeholders.

When responsible and conscientious directors and businesses accurately anticipate the direction of travel, we can be a force for good.

CLIMATE GOVERNANCE MALAYSIA

Structuring Sukuk

*By **Dr Scott Levy,***
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and
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Authored by

The synergies between sustainable and ethical finance on the one hand and broadly Islamic finance on the other are clear and well established. Given that both of these topics have received and continue to receive a great deal of attention in the online and offline financial press, one has to ask: why have these synergies not resulted in the kind of growth in financial markets that one might expect?

Part of the answer to this question lies in governments' activity or perhaps we should say inactivity. Governments have an important, if not essential, role to play in national and international financial markets in signaling the strategic direction of financial markets, in creating the conditions (through, for example, regulation) that shape the development of financial markets and in providing incentives (such as tax breaks) for specific activities.

Notwithstanding the importance of these government actions (and we need to see more of them), they are not capable of directly increasing, in this instance, the extent of financial market activity that links sustainable and ethical investment with a step-change improvement in extending the depth of the markets including improved market liquidity for Sukuk issuers.

In order to make practical the kind of benefits and advantages from bringing conventional finance and Islamic finance together, we need action in financial markets from a wide and increasing range of financial market participants. Governments may set the context but the financial markets and the private sector are the only ones which can make this strategy a reality. Indeed, while we wait for governments (globally) to catch up on their responsibilities, there is much that can be done by the private sector to advance practice in this area.

In this article, therefore, we are going to set out 14 reasons (not in any order of priority or importance) why there is a need for more market participants which combine the efficiencies (both technological and operational) of dedicated Sukuk issuance platforms like Al Waseelah and, equally importantly, structuring specialists and marketplace operators which are aligned to the goal of democratization of Sukuk issuance such as Bedford Row Capital, Wethaq, Fasset and a small but growing list of others, which are ideally placed to bring the advantages of combining conventional and Islamic finance to market.

- Mainstream banks are just not interested in this market — even now! Issuers, such as Al Waseelah, specialize in the SME market (in the GBP50–250 million (US$68.83–344.15 million) range) and have a proven route to market. Financial institutions are capital-rich, looking for high-quality projects (both conventional and Islamic) to invest in: to resolve this issue, a combined effort is needed of structurers and issuance platforms working together to cater to these market opportunities.

- The SME marketplace needs capital to flow (to function, to aid recovery, to promote sustainability and just transitions). There is significant scope for Islamic finance to grow in these spaces. The combination of issuer and structuring specialist makes this real.

- Knowledge of conventional financial markets plus the development of experience in the field of Islamic finance facilitates a no-nonsense, smart, quick and impact-focused route to market (often with dedicated and specialist fintech solutions for which there are a growing number).

- The combination of issuer and structuring specialist provides access to international markets (and thus supports domestic growth).

- Specialist knowledge gained through immersion in this market facilitates a demystifying of Islamic finance through a process we call delabeling, thereby making Islamic finance products readily understandable and available to a wider investment base — promoting democratization.

- Specialist knowledge of both western financial markets and Islamic finance enables both issuer and structuring specialist to focus on what matters to investors (impact, outcomes, etc). This is particularly valuable in attracting investment in Islamic financial products from 'traditional' western markets: investors like to invest in products they understand!

- Bringing Islamic financial products to (particularly) western markets is still relatively novel. Exceptionally thorough and effective due diligence on the part of the structuring specialist can (and does) assist the issuer with the complexities (and changing dynamics) of regulatory compliance in international markets.

- Effective structuring of bonds also permits linking the achievement of sustainability targets, for example, to dividend payments. Failure to meet targets results in higher dividends (the coupon goes up). The thorough and voracious nature of these market-driven processes can (and does) engender greater confidence in Islamic products on the part of investors.

- There is significant capital and liquidity in Islamic banks to expand the financing of new businesses (or refinance established businesses) across the entire Islamic finance world but it needs a route to market. Specialist issuers and structuring specialists exist to provide this route to market (so essential to economic prosperity and just transitions).

- So-called traditional western finance tends to struggle with the 'S' (social) in environmental, social and governance (ESG). Conversely, Islamic finance is very strong on the 'S': to the extent that there is an emphasis, for example, in social impacts in Sukuk. To maximize the potential impact of Islamic finance on financial markets, there is an urgent need to link the expertise of structuring specialists with that of Shariah scholars to ensure that the 'S' in ESG is promoted effectively.

- In the absence of legislation or regulation (or perhaps we should say in the confusion of legislation and regulation that exists nationally and internationally), effective, robust and trustworthy structuring of Sukuk is of enhanced significance — particularly in attracting investors. Cooperation between issuers and structuring specialists (rather than simply lawyers) provides such an established route to market.

- For Islamic finance to grow and thrive, it needs to draw investors not just from the Islamic world but from broader international financial market participants. The experience, expertise and track record of Bedford Row Capital provides the assurances that investors from non-Islamic backgrounds require to make the necessary steps.

- There is demand for new product supply lines — one which emphasizes green, socially-conscious and sustainable investments wrapped in the robust principles of good governance: all highly desirable qualities in western markets.

- Finally, the focus of issuers such as Al Waseelah on SMEs and the services of a non-bank structuring specialist whose core business is sub-benchmark issuances or emerging economy issuers means that, together, the services offered are flexible, innovative and outcome-focused.

The potential for Islamic finance to grow and to make significant impacts globally is vast. This can only be achieved, however, if effective, robust and trustworthy routes to market are opened up and operationalized. This is the ultimate goal of all market participants and it is not exclusively for traditional Islamic financial institutions. New entrants like Orestes Asset Management will bring a new actively managed fund which will combine in a retail-friendly manner ethical finance and Shariah compliant stock selection in a retail-friendly product.

These activities, however, are taking place in an increasingly internationalized context in which international bodies are pressing the commercial world to become sustainable (in investments and in business practices) and national as well as supranational (eg the EU) bodies are introducing mandatory regulation into financial markets focused on carbon reduction and sustainability. Islamic finance is ideally placed to take advantage of these developments but, at present, it remains outside these international developments. Al Waseelah, for example, is one of only two Islamic finance companies to be registered with the UN Principles for Responsible Investment (UNPRI) and to report on its activities under the UNPRI reporting framework. Although relatively new and although many, if not all, investors and companies in the west are still getting to grips with its consequences, the Sustainable Finance Disclosure Regulations already have significant implications for Islamic financial products — and knowledgeable issuers and structuring specialists have an essential role to play in acclimatizing Islamic financial market participants to these developments. Knowledge of and compliance with developments in international financial markets are essential components of today's financial world to which the combination of issuer and structuring specialist is equally dedicated in their efforts to tap into the global liquidity which should be available to the entire Islamic finance marketplace.

BEDFORD ROW CAPITAL

Al Waseelah

How ESG enhances Islamic asset management in the 'year of the taxonomy'

By Blake Goud,
CEO, RFI Foundation

Authored by

Responsible finance encompasses everything from socially responsible investing (SRI), environmental, social and governance (ESG) and Islamic finance. Despite the growth of all segments of responsible finance, the evolution of our knowledge about how the different sectors interact in practice remains limited. In part, this is because although many objectives are shared, definitions are at varying stages of development.

What we have learned through intensive research is that it is not enough to just find the highest ESG-scoring investments and overlay it with a screen for Shariah compliance. The interaction between Shariah screening and ESG is more complicated. We find ways that promote better outcomes from combining the two than using them independently.

At the core to understanding responsible finance is understanding that the integration of ESG information into investment practices is not merely a compliance exercise. There is no set threshold for what constitutes compliant or non-compliance on the ESG spectrum. There is an institutionalization push underway in responsible investment to make actions by investors integrating ESG into their investment decisions more credible, but it is still unlikely to create clear thresholds.

The drive for national taxonomies and global standards like those proposed to be created by the International Sustainability Standards Board under the IFRS Foundation will help to provide some certainty about what we mean by 'ESG'. It mirrors the efforts taken over the past 20–30 years in Islamic finance to define a 'common ground' approach to Islamic finance as described by the standards issued by AAOIFI and IFSB.

The institutionalization gap between Islamic finance and ESG has stymied rigorous comparisons about the value of each and how they might work together in practice. One of the first efforts was undertaken when RFI was established in 2015 to show that the objectives shared between Islamic finance and responsible finance had more similarities than differences. We lined up the exclusionary screens of ethical and responsible investment against Islamic investment screens providing a side-by-side[1] lineup of the exclusionary screens common to the two.

[1] Thomson Reuters and RFI Foundation, 2015. The Thomson Reuters – RFI Responsible Finance Report 2015. Manama: Thomson Reuters, https://www.zawya.com/mena/en/ifg-publications/260815053724N/

We found similarities in some market practice relating to common exclusions against weapons, nuclear power and tobacco. Other sectoral screens were found in SRI, responsible finance or Islamic finance but were not found in the market practice of the whole responsible finance sector. For example, SRI screens that investors use that are focused on excluding genetically modified organisms which do not overlap with Shariah screens.

For many years, this has been the filter through which responsible finance and Islamic finance are viewed through — a shared set of negative screens with a few that differ between the two. One of the steps to clarify whether this 'exclusionary' approach was the element of the commonality and the financial value added or subtracted in responsible finance came in 2017 with research by SEDCO Capital. Rather than qualitatively lining up the negative screens of SRI and Islamic finance and seeing what was the same and what was different, it looked into the financial results of these ethical screens.[2]

SEDCO's analytical focus zeroed in on one often overlooked element of Islamic finance that goes beyond the issue of negative screening to avoid investing in prohibited businesses: the financial ratio screens. These screens are incorporated into Islamic finance primarily as a proxy for avoiding companies that are likely to have significant interest income or expense, although the most common exclusions that result are for companies with excessive debt.

If there is less of a gap in ESG practices between leaders and laggards, it becomes harder to find any systematic financial benefit from improving ESG practices

The result of SEDCO's analysis focusing on this question of excessive debt was that the financial ratio screens in Islamic investing come out as more of a 'positive' screen than a 'negative' screen in both objectives and financial returns, and these results are linked. The positive objective that the financial ratio screens bring to the analysis is that it narrows the available investment universe so that they are more 'prudent'.

By adding positive screens, the slightly negative returns of the SRI screens (just the sectoral exclusions) are more than offset by the positive impact of more prudent screens, particularly during periods of financial stress like the global financial crisis. This leads to a question about whether other features of responsible finance — ESG — can have a similar impact on returns, making Shariah compliant ESG investing more appealing than conventionally screened ESG funds.

To explore this question, the RFI Foundation undertook a rigorous examination of the data together with the International Centre for Education in Islamic Finance or INCEIF, expanding the time period to both validate some of the results from SEDCO Capital, and extending the analysis to reflect a more comprehensive look at ESG. We find that ESG benefits companies in emerging markets, while Shariah screens provide more value in developed markets. The impact of combining the two screens is both more complex and more informative.

The financial impact of better ESG performance is much stronger in emerging markets than in developed markets. This in part reflects the nature of most ESG data as being more focused on the policies of companies and not always effective at measuring impacts, when viewed in tandem with a more limited ESG benefit in developed markets.

This could indicate that ESG scores as they are currently collected for emerging market issuers are better at gauging how well companies aspire toward best-in-class ESG policies. They could also act as a proxy for these companies being better governed. We find less of a difference between Shariah compliant and non-compliant company performance regardless of ESG scores in emerging markets.

As we mentioned, in most developed markets, better ESG-scoring companies underperformed lower ESG-scoring companies, but at each level of ESG score quartile, Shariah compliant companies outperformed similar scoring companies. This result is consistent with the 'policy'-focused approach to ESG scores.

Many ESG issues are legislated in developed markets with more rigorous enforcement than in emerging markets, which may result in a narrower gap between leaders and laggards in a particular sector and country. If there is less of a gap in ESG practices between leaders and laggards, it becomes harder to find any systematic financial benefit from improving ESG practices.

One explanation would be that best-in-class ESG screens are already factored into current prices, so buying higher ESG-scoring companies will be pursuing already fully valued (or overvalued) companies. Although this matches up with what some critics of ESG suggest, it does not fully explain the persistence of this finding across a long time frame with data going back to 2001, well before ESG became commonplace. A more compelling explanation is that, although we analyzed sources of risks in several different ways, there remain ESG-related risks that are not reflected fully in ESG scores.

For example, if an ESG score omitted some environmental or social risks, or this information was lost in the process of aggregating ESG data into a composite score, the higher returns we identify could be compensation for bearing additional ESG risk not picked up by the aggregated score. If this is the case, it offers significant opportunity for the use of the Shariah screens in responsible investment that extends some of the results uncovered by SEDCO.

Our findings suggest that the 'prudent' features of Islamic investing could help investors benefit from investing and engaging with lower ESG-scoring companies. In contrast, investors who simply overlay a best-in-class ESG screen with a Shariah screen may be sacrificing potential returns in exchange for lowering their ESG risk exposures (measured by the score). For investors willing to take on additional ESG risks, they can use Shariah screens to provide a 'margin of safety' while they work with investees to lower their overall ESG risk profile.

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[2] Gueckel, Christian. "How can responsible investors benefit from Islamic criteria?" SEDCO Capital White Paper, 17 February 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2918849

This raises a fundamental question about how to look at these results in terms of what responsible investment strategies will look like in the future. As the world's standards on ESG data are harmonized, there will be more consistency and comparability of ESG information (although its quality may improve only with a lag and after greater assurances are introduced).

As countries pursue taxonomies to define what is 'green' or 'sustainable' within their economies and financial markets, the way they set out these definitions will also affect how investors evaluate ESG data. To dig into one possible scenario, although there is no data yet to test the hypothesis in our research, countries which adopt a 'bright-line' taxonomy may find that the expected return for unsustainable companies rises while expected returns fall for green companies.

There is value to be had in looking at empirical data to understand how to link ESG and Shariah screens and engagement together

This could occur because 'green' companies find it easy to raise funding and maintain a stable investor base. They are included in indices that track 'green' companies that passive investors use to find the best-in-class ESG companies. The access to finance based on backward-looking ESG information or sustainability data about their products does not necessarily indicate higher returns for investors. We found this to be true in developed markets even in the absence of rigorous taxonomies.

By contrast, lower ESG-scoring companies that are labeled as 'unsustainable' tempt investors with higher returns in part because they are underinvested by ESG best-in-class investors. On average, these higher returns may persist, but the companies will be less resilient in part because of their less dependable access to finance.

Investors could see this as an opportunity to pursue higher returns by investing in and engaging with lower-scoring companies, with a Shariah screening overlay to provide a margin of safety for investors, while they engage to uplift the companies into the 'green' universe, lowering risk and broadening their access to a wider investor base.

However, in bright-line taxonomies, there is a sharper cliff between green and unsustainable companies. This may put more focus on improving companies near to the dividing line and reducing the value of improving lower ESG-scoring companies. Lower ESG-scoring companies that will not likely become qualified as 'green' are unlikely to get the uplift in investor appetite if they cannot cross the 'think green line'.

In contrast, in places that use what Mark Carney dubbed the 'fifty shades of green' taxonomy approaches (such as countries covered by the ASEAN Taxonomy including Malaysia and Singapore), the value of improving lower-scoring companies even if they do not end up becoming green may translate into higher returns for investors. What our research shows is that in these cases, there may be higher returns available through Shariah compliant screening of lower ESG-scoring companies to improve returns during the process of engagement to improve ESG characteristics.

Recognizing these nuances in ESG screening rules and taxonomies can help responsible investors to improve their process by considering Shariah screening. By taking a more active approach to pursue potentially riskier companies with lower ESG scores, Islamic investors can take advantage of the prudent characteristics of the Shariah screening process and engage with companies. The Shariah screens will help to increase the margin of safety against adverse realized ESG risks while the engagement can reduce their prevalence and significance.

As ESG data standards improve comparability across different types of data and narrow differing requirements across different markets, aggregate scores between companies may provide more forward-looking information about potential risks and returns. Until then, there is value to be had in looking at empirical data to understand how to link ESG and Shariah screens and engagement together, and to find new opportunities beyond the ones discussed above.

RFI FOUNDATION

Authored by

BURSA MALAYSIA

How have you articulated and implemented a sustainability strategy at Bursa Malaysia? Who are the key stakeholders and what factors are critical for success for such an exercise?

The aim of assimilating sustainability into our organization as well as the marketplace was in line with the aspiration to establish Bursa Malaysia as the preferred marketplace for sustainable and responsible investment.

Following a thorough analysis of the materiality assessment exercise and consultation with key internal and external stakeholders, Bursa Malaysia had formulated the Sustainability Roadmap 2021–2023 in 2020. The roadmap is underpinned by five priority areas and 25 key strategies, which aims to integrate sustainability into our core operations and the wider ecosystem.

Stakeholder feedback was essential in formulating a robust and effective strategy. It aids in the identification of strategies that address our stakeholders' needs and concerns. Recognizing their significance, we conducted an annual materiality survey to collect feedback from our stakeholders on issues they consider to be important.

Stakeholders are categorized into nine key groups, namely Public Listed Companies (PLCs) or potential PLCs, Investors, Intermediaries, Regulators and Government Agencies, Employees, Shareholder and Analysts, Industry Associations, Professional Bodies and Industry Experts, Vendors and Suppliers, and Community Groups.

We believe the success of implementation of our sustainability strategy necessitated a holistic approach. Therefore, we have ensured that each strategy in the Roadmap is supported by an implementation plan with clear division of responsibilities across our functional units, enabling sufficient focus and allocation of resources.

Aside from the Sustainability Roadmap, we have a Sustainability Policy, which outlines our sustainability commitments and provide guidance on how to operate our business responsibly. The commitments are characterized by the following three pillars which help emphasize our behavior and conduct across our operations:

- Economic/Market
- Environment; and
- Social.

What key themes and objectives form the cornerstones of Bursa Malaysia's sustainability strategy?

Bursa Malaysia's 2021–2023 Sustainability Roadmap is built around three core pillars namely Marketplace, Internal and Community with five priority areas, as outlined below:

i) **Marketplace**
   a) Priority Area 1: Strengthening our core by building capacities of market participants to support a vibrant and sustainable capital market.
   b) Priority Area 2: Driving our growth. We aim to enhance a sustainable finance ecosystem through new investment products and high standards of sustainability practices and disclosures.

ii) **Internal**
   a) Priority Area 3: Protecting our Environment by reducing our environmental footprint and managing climate-related risks as we transition toward a low carbon future.
   b) Priority Area 4: Empowering our workforce. We aim to cultivate an empowered workforce to develop more sustainable approaches.

iii) **Community**
   a) Priority Area 5: Advancing our communities by creating a positive impact for society and demonstrate commitment to support social issues that are aligned with our community focus areas.

As an Exchange, we want to facilitate a sustainable capital market and assist the nation's transition toward a low-carbon future. This is aligned with our vision to be ASEAN's leading, sustainable and globally connected marketplace.

In addition to the five priority areas, we also developed a Thought Leadership Strategy to further galvanize our influencer role in the sustainability space.

The Thought Leadership Strategy is supported by a wide range of high-level content available on our BURSASUSTAIN platform. It includes a dedicated 'CEO's Thoughts' column where our CEO shares his views on various sustainability topics every month, and a video series 'CEO2CEO' in which our CEO engages in peer-to-peer conversation with other corporate CEOs about their approach and thoughts on sustainability.

Another important component of our Sustainability Strategy is our partnership with ecosystem players, the recent and strategic partnership being with the UN Global Compact Network Malaysia and Brunei, with whom we have developed the Corporate Sustainability Practitioner (CSP) Competency Framework.

The CSP Competency Framework is designed to help guide sustainability practitioners and support their work in transitioning their organization toward sustainable business models. Through this competency framework, corporate sustainability practitioners in Malaysia will be able to gain credentials and learn how to be the change agents for responsible and profitable business. Further, the CSP Competency Framework is also accompanied by a digital self-assessment tool to support practitioners to upskill and reskill on corporate sustainability.

With initiatives such as Bank Negara Malaysia (BNM)'s important Values-Based Intermediation (VBI) well established and understood, does Malaysia enjoy an inherent competitive advantage in the area of Islamic sustainable investment? Is it simply a case of building on these existing initiatives?

Since the adoption of VBI by Malaysian Islamic banks in 2017 and more recently by Takaful operators, BNM has observed positive momentum for the Islamic banking industry, intermediating around US$38.6 billion (RM161 billion)-worth of VBI-related transactions as of December 2020.[1] According to the Finance Minister, Tengku Datuk Seri Zafrul Tengku Abdul Aziz, the implementation of VBI reflects the industry's efforts to produce a positive and sustainable impact.[2]

VBI aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate a positive and sustainable impact to the economy, environment, as well as the community, and is consistent with the shareholders' long-term interests such as sustainable returns. Additionally, it aims to achieve the economy, society and environmental goals, all within the Maqasid Shariah, with Shariah outcomes including justice, wealth protection and wealth circulation, among others.

VBI is primarily based on intermediation in Islamic banking, while sustainable and responsible investment (SRI) is concerned with intermediation in capital markets. While values under VBI are derived from the Maqasid Shariah, the values under SRI, on the other hand, are derived from pure economic, social and environmental frameworks, and may be Shariah compliant.

VBI realigns Islamic banking toward 'substance over form' based on the Maqasid Shariah, whereas SRI realigns capital market activities also toward 'substance over form' but based on local and global sustainable strategy initiatives, such as the UN Sustainable Development Goals.

VBI and SRI share great similarities as both look beyond structures, contracts and agreements, and shift the focus toward the creation of impact. VBI and SRI could potentially leverage each other to create a comprehensive ecosystem that could positively impact the economy, society and the environment.

VBI is a game changer for Islamic finance as it pushes forward into proactive action toward sustainability and sets forth its ethical features, which are derived from the Maqasid Shariah with a strong resonance with the principles of Islamic finance, as well as an overlap with sustainable investment and environmental, social and governance (ESG).

Technological tools that enable substantial data recording, tracking and analysis have the ability to showcase VBI's positive influence in Islamic capital markets and will assist in its mainstream adoption.

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[1] MalayMail (2021) Malaysia ranks first in Islamic finance development indicator 2021

[2] The Edge Markets (2021) IFDI 2021 recognition shows strength of Islamic finance in Malaysia

What role do you see Bursa Malaysia playing as a standard bearer for Islamic sustainable investment in Malaysia and the region? How important is this role in terms of encouraging issuers and investors to embrace a green and sustainable agenda?

Bursa Malaysia is home to the largest number of public listed companies in ASEAN, and one of the most vibrant and diverse marketplaces facilitating trade in both conventional and Islamic securities and derivatives.

Our crude palm oil futures serves as a global price benchmark for the commodity, while innovations such as its Bursa Suq Al-Sila' commodity Murabahah trading platform and Bursa Malaysia-i end-to-end Shariah compliant securities trading and investing platform are world's firsts in the Islamic capital market. These innovations offer unique value creation opportunities for its stakeholders and create strategic linkages to exchanges in key destinations.

Bursa Malaysia is delighted to be at the forefront of thought leadership in Islamic capital markets, with the largest portfolio of Islamic goods and services in ASEAN. Our expertise in providing Shariah compliant market-based solutions enables us to promote a better understanding of the value-based Shariah investment principles.

For instance, Bursa Malaysia-i, which offers faith-based investors a unique proposition and platform for Shariah compliant investing, positions the Exchange as a global marketplace for Shariah listing and investments.

As at the end of October 2021:

(i) 748 out of 948 listed companies on the Exchange, or 79%, are Shariah compliant;
(ii) Shariah market capitalization makes up 68% of the total market capitalization of RM1.8 trillion (US$424.42 billion), and
(iii) The average daily trading value of Shariah compliant securities makes up 79% of the overall average daily trading value of RM3.8 billion (US$895.99 million).

We also observe that our Shariah indices consistently outperformed their conventional counterparts over the last 10 years. For example, the FTSE Bursa Malaysia Hijrah Shariah Index, comprising the 30 largest Shariah compliant companies on the FTSE Bursa Malaysia EMAS Index, has surpassed the FTSE Bursa Malaysia KLCI and FTSE4Good Bursa Malaysia Index, growing about 24% between 2010 and October 2021. These facts serve to suggest that Shariah compliant investments are an attractive source of value for investors.

As sustainability and ESG considerations become more mainstream in the capital market and investment conversations around the globe, there is a growing number of investors that place greater emphasis on sustainable solutions.

As a leader in the Islamic finance landscape, the Malaysian Islamic capital market has taken the lead in promoting sustainability as well as the ESG proposition based on its shared values with Islamic finance.

We see ample scope to capitalize on the growing demand for asset diversification, SRI and ESG to expand the global reach of our innovative Shariah compliant product and service offerings. This

presents a strong growth opportunity for the Islamic capital market, due to the common principles between SRI, ESG and Shariah investing.

The convergence of SRI, ESG and Shariah plays a significant role in facilitating and delivering our unique proposition to further build our strength and competitive edge in the Islamic finance space. It has the potential to boost the expansion of sustainable and ESG investments across multiple Islamic finance asset classes, as well as the financial industry at large.

Additionally, the similarities between the ESG and the principles of Shariah open a wider choice for investors looking for opportunities in a broader socially responsible investment space. As a result, choosing investment activities anchored on Shariah and characterized by long-term socially responsible perspectives build greater stability and ensures the socioeconomic wellbeing of our nation. This will considerably broaden the appeal for Shariah investing.

ESG investing, much like Shariah investing, promotes responsible behavior and appeals to investors seeking products that advocate ethical investing, due to the selection criteria for the underlying investments.

At Bursa Malaysia, we play a crucial role in facilitating an enabling environment to unlock sustainable investments and improve access to SRI products and services. We are committed to advancing the sustainable finance agenda and adopted a multifaceted approach to create long-lasting positive impacts on the planet and society.

Bursa Malaysia is also driving the sustainability agenda, by encouraging the adoption and integration of SRI principles in the marketplace. PLCs are required to make sustainability-related disclosures in their annual reports as required by the Main Market and ACE Market Listing Requirements, and Bursa Malaysia supports their efforts to do so through our education and promotional programs.

Overall, sustainability within the Islamic proposition brings added advantages to the economy and society through the promotion of sustainable businesses and investment activities that entail positive results with stable prospects and the welfare of societies.

Sustainable and ESG investing is evolving quickly, particularly in terms of standards and taxonomies. As a capital market regulator, how do you factor in this dynamism and how do you help formalize the regulatory environment for market participants?

In the past few years, we have observed significant advancements across the international sustainability reporting ecosystem. Some of the most influential international sustainability reporting standard-setters have either issued, or are in the midst of making, revisions to their respective standards and/or frameworks (eg GRI, SASB, TCFD) — so this space is indeed highly dynamic.

The existence of distinct standards/frameworks is deemed problematic by a large number of market participants as each has its own set of requirements. The inevitable overlapping similarities as well as differences have led to much confusion and fragmentation — especially for preparers who are faced with the prospect of having to report using multiple standards that are both complex and costly.

Separately, there are increasing calls from key capital market stakeholders (eg institutional investors) to affect some degree of comparability or standardization of sustainability disclosures to facilitate benchmarking as well as decision-making.

Responding to the stakeholders' call, Bursa Malaysia is currently undertaking a major review of our Sustainability Reporting Framework to explore potential ways to enhance the availability, comparability as well as quality of certain sustainability-related disclosures. For instance, we intend to mandate the adoption or disclosure of certain sustainability-related themes and indicators.

What we mandate is also 'common' across the different international standards/frameworks in order to lessen our PLCs' overall reporting load, while simultaneously serving as a springboard for them to work toward full adherence of the said frameworks.

On the other hand, the enhancements would also cater to the evolving informational needs of our key capital market stakeholders. This is how we can give sustainability disclosures and practice more structure and 'formalize' them.

As for taxonomies, we view these favorably as they generally provide clarity, consistency and also transparency on what can be classified as being green or sustainable. Taxonomies encourage standardization and facilitates decision-making, and is a key enabler for scaling up and mainstreaming green or sustainable investments that mitigates potential market fragmentation. Bursa Malaysia actively contributes to the nation's taxonomy efforts and is currently involved in the development of the Securities Commission's SRI Taxonomy.

Are we (in Malaysia) in a position to be able to offer a range of financial services that satisfy both ESG and Shariah compliant investors?

The globally benchmarked F4GBM Index continues to play an important role in recognizing companies that demonstrate strong ESG practices and disclosures. It recognizes PLCs that have taken steps to improve their ESG practices and disclosures. Since its launch in 2014, the Exchange continuously engages with its stakeholders to see if there is interest or a need to incorporate more SRI elements in the ESG index that can better suit our local investment landscape.

In 2021, the number of F4GBM Index constituents rose to 76 (from 69 in 2019), with 54 out of the 75 (72%) constituents being Shariah compliant, prompting Bursa Malaysia to expand its ESG and Shariah Index portfolio by launching the FTSE4Good Bursa Malaysia Shariah Index (F4GBMS) in July 2021.

This new index comprises constituents that are Shariah compliant, based on the Securities Commission Malaysia's Shariah Advisory Council's screening methodology, and presently contains 54 PLCs.

In terms of index performance, the two ESG indices have outperformed our benchmark FBMKLCI. For the period of the 31st December 2014 to the 31st August 2021, the F4GBM Index outperformed FBMKLCI by 1.6%, while the F4GBMS outperformed FBMKLCI by 4%.

Recognizing the synergistic potential of Shariah compliance and sustainability, the Exchange has been leveraging its insights and pioneering Islamic programs to drive sustainability alongside its market-leading ESG initiatives and embed sustainability among listed issuers as well as within the Exchange itself. This has enabled the Exchange to effectively promote ESG and Shariah investing as complementary and has put us in a unique competitive position as demanded by global funds and investors, as SRI, ethical and Shariah investing continues to grow year on year.

Our end-to-end Shariah compliant securities trading and investing platform, Bursa Malaysia-i, showed a compound annual growth rate of a 33% increase since its launch in September 2016 to the end of October 2021. This is further testament to the growing demand for Shariah compliant financial solutions, driven by the shift toward value-based investing and heightened interest in Islamic capital market products and services by non-Muslim investors and SRI investors from around the world.

Moving forward, Bursa Malaysia aims to scale up its Shariah compliant offerings through product and service innovation to create greater alignment between Shariah investing and SRI, and broaden the product range across the Islamic wealth management solutions value chain. This is also expected to spur new market segments and attract greater domestic and international participation to accelerate the growth of Shariah compliant SRI. Bursa Malaysia will continue to drive thought leadership and advocacy to promote greater alignment between Shariah and SRI.

Ultimately, our goal is to build a vibrant ecosystem of SRI- and ESG-themed investment products that fulfill investors' needs and expectations. With this in mind, we will continually endeavor to provide a range of products and services catered to SRI. We also plan to expand our efforts to identify emerging sustainability-driven opportunities in our range of products and services to steer the capital market toward sustainable solutions and assets in the coming years.

BURSA MALAYSIA

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

Authored by LuxembourgforFinance
Agency for the Development of the Financial Centre

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

Islamic and sustainable finance — a close connection

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

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

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

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

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

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

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

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

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

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

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

A solid European capital market infrastructure for Islamic investors

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

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

Bringing Islamic finance to the globe

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

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

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

LuxembourgforFinance
Agency for the Development of the Financial Centre

Authored by

CIMB

CIMB Group (the Group) is a leading ASEAN universal bank and one of the region's foremost corporate advisors. It is also a world leader in Islamic finance. The Group is headquartered in Kuala Lumpur, Malaysia and offers consumer banking, commercial banking, investment banking, Islamic banking and asset management products and services.

As a leading ASEAN bank, our greater purpose is to advance customers and society toward a sustainable future. In line with this, we integrate economic, environmental and social (EES) considerations into all aspects of our business.

Our strategy is two-pronged. We commit to investing resources and influencing networks to reduce negative EES impacts. We also aspire to create a net positive impact through our business activities.

Sustainability is one of the key elements of our strategic theme to become a purpose-driven organization. As we strive to be a top quartile bank in ASEAN under our Forward23+ strategy, we target to achieve the 75th percentile of the Dow Jones Sustainability Index ranking by 2024.

Based on our 2020 performance, we are now at 79th percentile of these rankings, achieving this target three years ahead of time.

We are the first banking group in Malaysia and the first in Southeast Asia to commit to phasing out coal from its portfolio by 2040, with no new coal/coal-fired power plant-related financing by 2021 onwards.

Our recent commitments are:

- Net zero by 2050, no deforestation, no peat and no exploitation, and
- RM30 billion (US$7.09 billion) in sustainable finance, RM150 million (US$35.46 million) in corporate social responsibility by 2025 and 100,000 annual volunteering hours.

As a regular issuer in the bond and Sukuk market, we strive to ensure our instruments and frameworks continue to reflect the latest sustainability commitments of the Group, and market standards as well as expectations. In this regard, we have decided to update the SDG Bond Framework in 2021 and effect the following changes:

- Insertion of a Sukuk component to allow for future issuances of Shariah compliant notes
- Consolidation of the SDG Bond and Sukuk Framework under the Group, ie CIMB and its subsidiaries including but not limited to CIMB Bank could use the SDG Bond and Sukuk Framework as the basis for future sustainability bonds and/or Sukuk to be issued on and after the 18th October 2021, and
- Inclusion of new forms of eligible assets that could qualify for the use of proceeds of the future sustainability bonds and/or Sukuk by the Group.

CIMB Islamic have been at the forefront of Islamic and Sustainable financing and would like to highlight just two of our recent transactions as follows.

Indonesia's US$3 billion Sukuk issuance features landmark green tranche

The Indonesian government in June 2021 issued a landmark Sukuk issuance worth a total of US$3 billion, featuring a green Sukuk tranche that is touted as the first-ever 30-year and longest-tenored green Sukuk issuance globally.

The global Islamic trust certificates were issued in three tranches: a five-year US$1.25 billion facility; a 10-year paper worth US$1 billion; and a 30-year green Sukuk facility worth US$750 million.

The landmark green Sukuk tranche is the government's fourth global green Sukuk issuance under its Green Bond and Sukuk Framework since the debut paper in 2018, but is the first with a 30-year tenor — globally the longest tenor for an issuance of its kind.

"The global Sukuk issuance is aligned with the Republic of Indonesia's strategy to strengthen its position as a leader in the global Islamic financial markets, with the green Sukuk being a testimony of its dedication and long-term commitment to green and sustainable financing," CIMB Bank, the lead arranger and bookrunner of the transaction, said.

The offering garnered robust demand, receiving a final orderbook of US$10.3 billion, reflecting an oversubscription of 3.43 times

The offering garnered robust demand, receiving a final orderbook of US$10.3 billion, reflecting an oversubscription of 3.43 times that resulted in the final pricing going below the fair value across all three tranches.

According to CIMB Bank, the issuance also achieved the lowest-ever five-year, 10-year and 30-year yield spread over the US Treasury and profit rate achieved by the Indonesian government for an international Sukuk paper.

Indonesia's Sukuk

US$3 billion

9th June 2021

Issuer	Perusahaan Penerbit SBSN Indonesia III
Obligor	Republic of Indonesia
Issue size	Tranche 1: US$1.25 billion Tranche 2: US$1 billion Tranche 3: US$750 million
Structure	Tranche 1 and 2: Sukuk Wakalah Tranche 3: Green Sukuk Wakalah
Maturity date	Tranche 1: 9th June 2026 Tranche 2: 9th June 2031 Tranche 3: 9th June 2051
Yield/periodic distribution rate	Tranche 1: 1.5% pa Tranche 2: 2.55% pa Tranche 3: 3.55% pa
Listing	Singapore Exchange; NASDAQ Dubai
Governing law	English law; Indonesian law for asset-related documents
Joint lead managers and bookrunners	CIMB Bank; Citibank; Dubai Islamic Bank; HSBC; Standard Chartered
Joint green structuring advisors	HSBC; Standard Chartered
Co-managers	BRI Danareksa Sekuritas; Trimegah Sekuritas Indonesia

SME Bank's Sukuk: Meeting demand for ethical products

Malaysia has added another feather to its Islamic sustainable finance cap as government-backed SME Bank made its sustainability Sukuk debut to overwhelming response, cementing the country's global lead in the area.

Receiving more than triple its target of RM500 million (US$118.22 million), SME Bank's sustainability Sukuk Wakalah program, which recorded a final order of RM1.78 billion (US$420.85 million), underscores the latent demand for ethical investments in Malaysia, which accounts for the most corporate socially responsible investing (SRI) Sukuk in the world at 16 offerings as at the start of 2021. The issuance consists of an Islamic medium-term note program worth up to RM3 billion (US$709.31 million) and an Islamic commercial paper program of up to RM1 billion (US$236.44 million), with a combined limit of up to RM3 billion in nominal value.

With the issuance of the sustainability Sukuk, the bank will now be able to offer more innovative financing solutions for SMEs

Without detailing the breakdown of investors, SME Bank Group President and CEO Aria Putera Ismail noted that the local offering was also subscribed by foreign asset managers and had a diverse mix of investors including financial institutions, fund management companies, insurers and government-linked companies. The paper, the first non-government guaranteed Sukuk for SME Bank, was priced at a 3.1% profit rate. Aria attributed the oversubscription to "awareness movements within and outside the country that continue to support a balanced and sustainable development". Malaysian Rating Corporation awarded the issuance programs 'AAA' ratings and also a gold standard for the Sustainability Sukuk Framework.

"With the issuance of the sustainability Sukuk, the bank will now be able to offer more innovative financing solutions for SMEs and continue to play our countercyclical role to ensure their success and becoming the nation's engine of growth that not only contributes positively to the GDP, creating employment but ultimately, a positive spillover to society and the environment," Aria commented.

SME Bank's Sukuk

SIZE: RM500 million (US$118.22 million)

SME BANK GROUP

24th July 2021

Issuer	SME Bank
Type	Sustainable Sukuk
Profit rate	3.1%
Use of proceeds	To finance and/or refinance new or existing asset businesses and projects that promote sustainability
Sole principal advisor and lead arranger	RHB Investment Bank
Joint lead managers	AmInvestment Bank; CIMB Investment Bank; Maybank Investment Bank; RHB Investment Bank
Rating	'AAA' by Malaysian Rating Corporation

Bank, which falls under the Ministry of Entrepreneur Development and Cooperatives, is embarking on a multiphase environment, social and governance (ESG) strategy, with the first stage focusing on building awareness among SMEs through financing facilities. In the second phase, the bank will engage SMEs to educate businesses on utilizing the right financial instruments to meet their ESG needs as well as to apply and integrate ESG elements in their operations.

The offering comes amid greater commitment from the Malaysian financial community to align their financing activities with ESG principles. Maybank recently publicly committed RM50 billion (US$11.84 billion) in sustainable financing and confirmed it will be scaling up its green and sustainability Sukuk/bonds program.

Malaysia anchors Islamic finance leadership with upsized debut sovereign sustainability Sukuk

The Malaysian government upsized its debut sovereign sustainability Sukuk — also the world's first — from its initial target size of US$1 billion to US$1.3 billion following strong demand confirmed by an oversubscription of 6.4 times.

The US dollar sustainability Sukuk facility is comprised of US$800 million 10-year trust certificates carrying a 2.07% profit rate and US$500 million 30-year trust certificates with a 3.08% profit rate — the lowest-ever yield for a US dollar Sukuk issuance by Malaysia.

The warm reception to the issuance is, according to the government, a "vote of confidence in the country's policies and strong economic fundamentals". The investor pool was made up of fund managers, banks, insurance companies, central banks and governments and other investors from Asia, Europe, the Middle East and Africa and the US.

Supporting the green Sukuk is the government's Sustainable Development Goals (SDGs) Sukuk Framework, which aligns issuances with the Green Bond and Sustainability Bond Principles and Standards of the International Capital Market Association and the ASEAN Capital Markets Forum.

The Ministry of Finance will manage the proceeds, which will be used to fund social and environmental projects in support of the government's efforts to combat climate change and build a more resilient and inclusive economy.

In particular, the essential service categories of healthcare, education, affordable infrastructure, employment generation through SMEs, clean transportation, renewable energy and green buildings and the sustainable management of natural resources will take center stage.

Also, a unique highlight of the Islamic paper is that its underlying assets are sustainable: vouchers for travel entitlement on Malaysia's Light Rail Transit, Mass Rapid Transit and KL Monorail networks. "As the first sovereign issuance with such assets in a Sukuk structure, this issuance sets a new benchmark and showcases Malaysia's global leadership in Islamic finance, reinforcing the country's position as the world's largest Sukuk market," the Ministry of Finance said.

The Sukuk facility, rated 'A3' by Moody's Investors Service, was issued by the government's SPV, Malaysia Wakala Sukuk, and approved by the Shariah boards of its joint bookrunners and lead managers which included CIMB Islamic Bank.

The success of Malaysia's sustainability Sukuk mirrors that of its Sukuk Prihatin initiative in 2020, the proceeds of which were used to combat the impact of COVID-19.

CIMB

The overlap between ESG and Islamic investment, and the opportunities

Authored by

Prestige Funds

This article looks at the similarities between environmental, social and governance (ESG) investing and Islamic investment, and secondly how specific ESG-oriented projects can satisfy many of the principles that underpin Islamic investing. It will also examine the growing area of private debt and how Shariah compliant investment vehicles can be created to satisfy prohibitions on interest-based transactions.

We also use a case study of a new approach to the financing of small biogas projects within the UK rural economy, using an Islamic fund structure.

Common values

Islamic finance and ESG investing hold many values in common, including for the investor to be a good steward to the environment and society. Social justice and inclusion are important factors for both. The level of overlap is hard to estimate and will differ from institution to institution. But Islamic-based investments will tend to line up with 80% of the UN Sustainable Development Goals as a general rule of thumb. [1]

Both investment approaches require a level of screening to be applied to the underlying investments. For active portfolio management, eg equities, this demands an additional layer of due diligence be applied to all investments in a portfolio.

At the more convenient end of the scale is the screening-out of companies in specific sectors, eg arms, alcohol, fossil fuels, etc. Both approaches maintain a high level of scrutiny which fund managers must also be aware of when developing products.

There is obviously an overlap between activities banned under Shariah investing (Haram) and those screened from ESG portfolios. This is most consistent in areas where the investor is seeking to achieve wider social benefits or avoid damage to the environment. Passive screening by both approaches immediately eliminates many companies from a possible portfolio, for example, companies specifically involved in environment-harming activity or with very poor records of social governance.

Islamic finance structures are already well-established and draw on centuries of legal corpus, whereas ESG investment criteria represent a fast-evolving landscape with newer levels of regulatory oversight and reporting being applied.
The two can be complementary, however: environmental issues are consistent with the fundamental principles of Shariah. But like the wider ESG investing community, Islamic investors are pursuing a more active ownership agenda than previously.

We are already seeing progress in this area, for instance in the green Sukuk market. Organizations like the Clean Energy Business Council (MENA) and Climate Bonds Initiative have been working on the groundwork for Sukuk that are issued specifically to support the green energy transition. Green Sukuk are being designed to invest in renewable energy and other environmental assets and address the Shariah concern for protecting the environment and being a good steward of the planet.

[1] 'Malaysia to bring Islamic finance and ESG together', Euromoney, 10/2021

Eligible assets for green Sukuk, as outlined by the Climate Bonds Standards certification, include solar parks, wind energy, renewable transmission and infrastructure, and significantly, biogas plants, of which there are more below.

The first green Sukuk facility was launched more than four years ago and led a strong program of issuance to finance environmentally-friendly energy projects around the world. These products combine the best of both worlds, the structure of a Sukuk facility with clearly defined goals of the proceeds.

This market is already relying on green bond standards to provide that additional layer of responsible investing, and it is here that we have seen the start of that synergy between Islamic and ESG investment.

The evolution of private debt

Private debt has grown impressively over the period since the 'Great Financial Crisis' in 2008. Some of the key drivers behind it include the retreat of commercial banks from active lending in the SME sector, and the low yields from government bonds. The yield picture for government debt remains very depressed, and with global inflation picking up quickly, investors are searching for consistent yields from other quarters.

The private debt sector was valued at around US$575 billion in 2016 and expanded to close to US$900 billion by the end of 2020. According to research data group Preqin, it is projected to grow 11.4% annually to US$1.46 trillion by the end of 2025. It is becoming a much more diverse and mature part of the overall asset management sector.

The private lending market has created a body of specialist fund managers who have been active in the SME market in various countries, developing the knowledge base, in-house expertise and network of contacts required to source deals and manage large loan books. This has led to a premium being placed on their expertise by larger fund managers, banks and investors.

Importantly, the market also provides investors with access to the economics of a very significant slice of the global economy — private SMEs. These are companies defined as having fewer than 250 employees, and a turnover of less than EUR50 million (US$57.96 million). In the UK alone, they account for 99.9% of the business population, over 60% of the jobs, and over half of the total turnover. [2]

ESG investing is becoming a factor in the work of direct lending funds as well. While the strategy manages business loans rather than equity investments, this necessitates that top-down screening criteria are applied first of all (eg fund managers can still screen out SMEs with activities in specific sectors).

Close analysis of an SME is part and parcel of the secured lending process and an important factor in the ongoing risk management of private debt portfolios. When applying an additional ESG screen or indeed Shariah criteria, these additional requirements can be readily factored into the process by a sophisticated private debt fund manager.

Impact investing is gaining ground

Impact investing is, however, becoming an area of more interest to investors. This includes lending strategies that are specifically focused on businesses and/or infrastructure projects with strong environmental and/or social characteristics. This can be applied to the private debt market, with the creation of funds that target lending at very specific areas of the economy.

The financing required for the creation of global clean energy infrastructure is going to be enormous. While some of this will be satisfied by governments, much of it will have to come from private capital sources.

With energy prices trending ever higher at the moment, well-financed projects that help to generate or distribute green energy, and reduce carbon emissions, will be at a premium. Private financing of such projects ticks the box for many ESG investors, as the capital is targeted specifically at projects involved in the shift to a zero-carbon emissions economy.

This is a long-term goal for many investors. It brings with it additional social benefits that can be more immediate, for example, the creation of new jobs in the green energy sector, and the provision of cheaper,

Chart 1: Ten-year German government bonds' 'real' yield falls to record low in August 2021

Source: Bloomberg

[2] Business population estimates for the UK and regions, UK Dept for Business, Energy & Industrial Strategy, 2020

cleaner energy to households and communities. This is important for those investors looking for social benefits beyond climate/environmental gains.

Taking for example the financing of biogas installations in the UK, such projects bring jobs to rural communities, create a source of clean gas and electricity and also help to process farm waste into fertilizer. The social benefits are considerable.

According to the UK Anaerobic Digestion & Bioresources Association (ADBA), biogas could deliver 30% of the UK's current carbon budget shortfall, and lead to the creation of 60,000 green energy industry jobs in the next 10 years. It has the potential to generate over GBP5 billion (US$6.82 billion)-worth of private sector investment and support the UK agricultural industry.

"There are over 140 million tonnes of readily available organic wastes still being left undigested in the UK every year," said Charlotte Morton, the chief executive of ADBA. "Left untreated, they release methane — a potent greenhouse gas — directly into the atmosphere, which contributes to climate change and causes human health issues. Recycling these through anaerobic digestion instead means that these emissions are captured and the organic wastes turned into valuable bioresources, such as a storable, flexible green gas (biogas), a rich-in-nutrient bio-fertilizer (digestate), bioCO2 as well as other valuable bio-products." [3]

An associate technology to biogas is carbon capture, which helps to ensure that no excess carbon is released into the atmosphere from the breakdown of waste. The efficient management of gases from farming processes is becoming an important, indeed necessary, part of the on-farm energy tech equation and requires finance.

It is also worth mentioning here the changing landscape in terms of commercial banking in the UK. Many businesses historically turned to high street banks for funding, but this has changed considerably in the UK since the financial crisis. Banks are closing their high street branches and retreating from SME lending, concentrating on easier-to-process areas like mortgages and credit card lending.

This has created problems for agricultural businesses that require funding for energy infrastructure projects like biogas plants. These have the scope to provide farms and rural communities with cheaper electricity, but to get there needs considerable project financing. Private debt funds are helping to fill that vacuum and have provided these projects with considerable financial support and on-site consulting services, helping them to continue to operate profitably during the coronavirus pandemic disruption.

Shariah banking and impact investing

Much impact investing can include long lead times, but environmental projects that can assist with the battle against climate change can meet the Islamic principles of Zakat, financing transactions which have a strong real economy component. Islamic finance models recognize this element of real economy investment.

Shariah investing is partly defined by a prohibition on Riba (interest-based transactions), but Islamic banking represents over 60% of the global Islamic finance market [4] and is a potential source of very useful capital when it comes to financing the green energy revolution.

The Murabahah and Ijarah contracts provide a strong foundation for more advanced debt-based contracts within financing. In 2017, 10% of Islamic fund assets were invested in Sukuk-based strategies, compared with 42% in equity funds. [5] When combined with the appetite in the Islamic world for making impact investments to help save the climate, this represents a massive force for good.

Shariah screens are applied to ensure that sources of income originate from Halal sources or are purified if the source of income is considered to be non-compliant. They differ from ESG screens in that they require assessment of capital structure and also require certification from Shariah boards/scholars. They can be effectively applied alongside ESG screens.

Private lending in the SME context necessarily requires a secured lending process, especially where an energy project is being financed (eg a large biogas/anaerobic digestion installation, which can require upwards of GBP10 million (US$13.63 million) in financing). This generates an interest-bearing income scheme which, in the Shariah context, requires a scholar-approved purification scheme.

Prestige Funds has created a dedicated Islamic fund that is focused specifically on the biogas opportunity in the UK. This requires a portfolio of biogas projects that can be approved by a Fatwa issued by an Islamic scholar in Saudi Arabia. It has required an already existing fund be reconstructed from the ground up and carefully analyzed to ensure that it meets the requirements of Shariah investors.

Part of the process is the dedicated screening of the waste sources used within the project. This requires ongoing screening of new opportunities by the fund manager as well as monitoring of the operations of the existing plants the fund is financing. In the case of Prestige, we employ a large team of experts in biogas in the UK who carry out regular due diligence and monitoring of the projects we support.

Projects to be included in the fund are screened to ensure they can be incorporated into a Shariah strategy. The movement of money between the fund and the firm which carries out the lending and due diligence activity is subject to a Murabahah transaction. The exchanges between the various parties to a transaction are governed by a clearly defined 12-step process that is the subject of its own Fatwa.

It has been important from the start that the scholars we have been dealing with are fully informed of the entire process, including how the anaerobic digestion plants work to provide energy and digestate which can be used on farms. Our lending partners had to ensure that there would be no lending to companies and farms that are active in the pig farming business.

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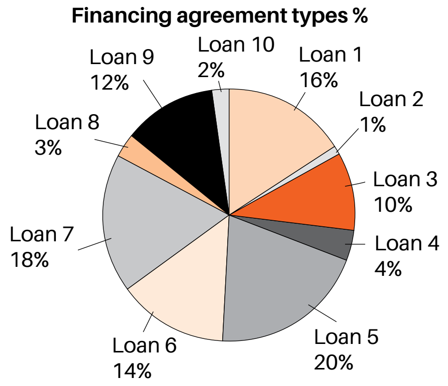
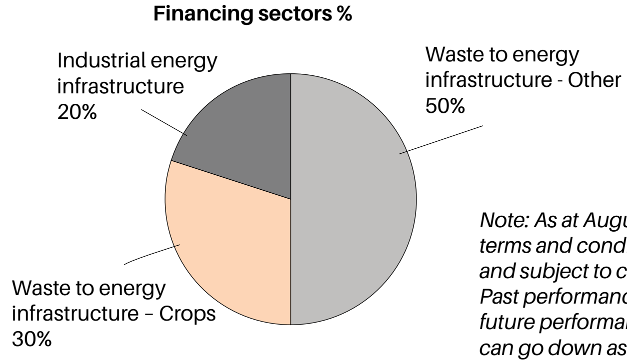
[3] Open letter to COP26 President Alok Sharma, 09/2021

[4] 'Islamic Finance Industry Assets Surpass $2 trillion Mark', Gulf Times, 2018

[5] Statista: Share of Global Islamic Fund Assets by Asset Class, 2017

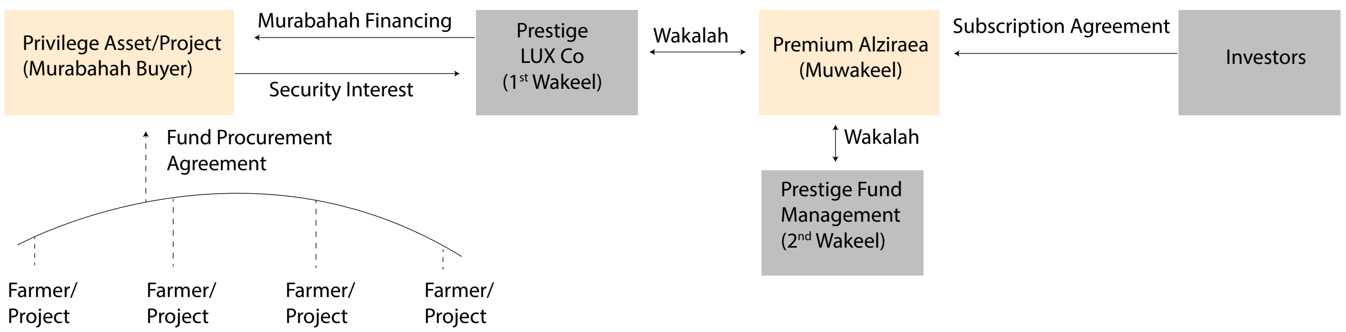
Chart 2: Investment process — portfolio snapshot





Note: As at August 2021. All figures, terms and conditions are approximate and subject to change without notice. Past performance is no guide to future performance and investments can go down as well as up.
Source: Prestige Capital Management

Chart 3: Shariah compliant operational flow — Premium Alziraea



Source: Intesa Sanpaolo Pb (Suisse) Morval/Reyl

Key observations

We have been managing funds in the private debt market since 2008 and have been witness to the evolution of a strong ESG component within our activity, ie lending to biogas and other on-farm clean energy projects. These have demonstrated that they can play an important strategic role in the battle to bring the UK's carbon emissions to net zero.

From our distribution relationships within the Islamic world, it became clear to us that there was a demand for an Islamic product which could sit alongside our other funds and satisfy the requirements of Shariah law. It has required an additional layer of reporting and supervision, but that is work that we anticipate will also be required now by ESG reporting demands.

We also wanted to ensure that the reporting/supervision costs of an Islamic product would not result in a higher fee profile for that fund.

Many fund managers are already facing a higher level of reporting and fielding more questions about ESG from investors; we have been able to leverage existing investment in the technology we use to oversee the credit risk on our portfolios and to also ensure ESG and Islamic oversight requirements are seamlessly incorporated. The complexity of an operation that oversees thousands of corporate loans is up to that task.

We are already seeing a considerable overlap between the demands of ESG investors and those following an Islamic mandate. In many cases, the values and goals that underpin these approaches are very similar.

What is also interesting is the development of an ESG-specific strain within Islamic finance structures. Despite the commonality between ESG and Islamic finance, there is also an appetite on the part of Islamic investors for products that also embed strong climate-related themes within them, while also being Shariah compliant.[6]

We are seeing activity within the Islamic finance market this year which supports this thesis, eg recent sustainable debt sales like the US$2.5 billion sustainability Sukuk launched by IsDB in March 2021.

Islamic finance has a strong social inclusion component which we are also now seeing in ESG investing. Projects should be seen to be putting money to work to achieve the greater good. This goes beyond pure environmental characteristics to include social impact. This is one of the main pillars of ESG investing and has been at the core of Islamic finance for centuries.

Ultimately, we will see more synergies between these two worlds in the near future. There is already discussion within the Islamic banking world about value-based intermediation[7] and the need by investors to act within the spirit of these objectives. There is a similar discussion within ESG investment: moving forward from simply screening and actually also focusing on positive outcomes will benefit both the planet and society.

Prestige Funds

[6] 'ESG to spur demand for green Sukuk as sustainable assets top US$40 trillion', Arab News, 10/2021

[7] 'Malaysia brings Islamic finance and ESG together', Euromoney 10/2021

The rise of green and sustainable Sukuk and the road ahead

By Bashar Al-Natoor,
the global head of Islamic finance, Fitch Ratings.

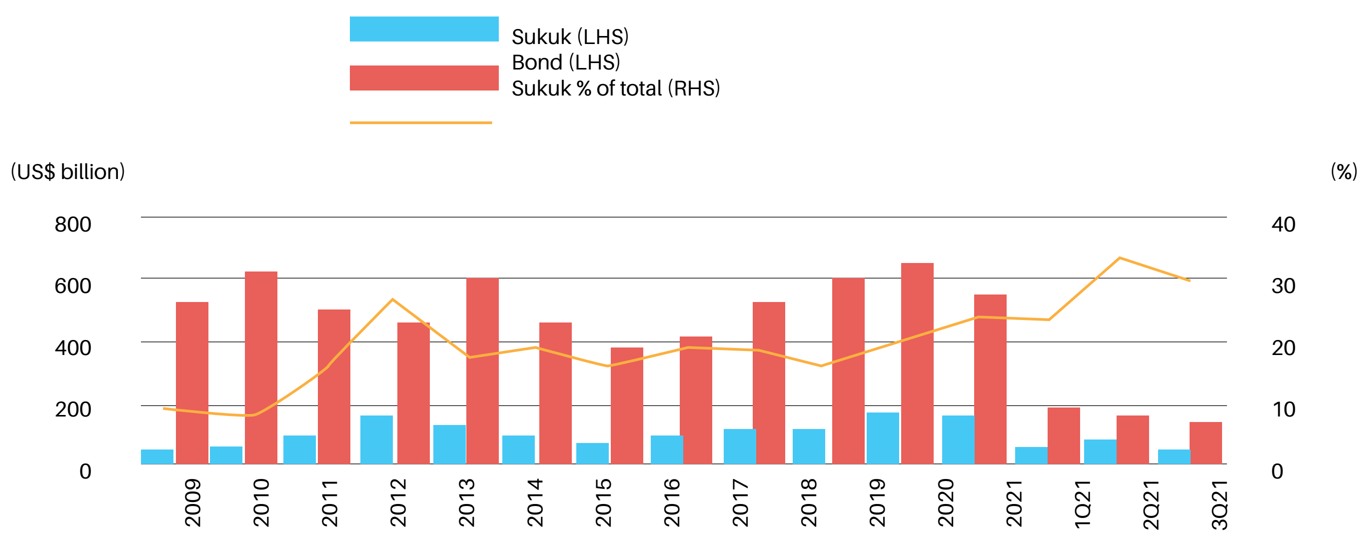
Authored by

FitchRatings

The link between the world of ethical finance and Islamic finance is strong. In fact, the origins of the modern Islamic finance industry, which started off in the 1970s, are very similar to the ethical finance principles of not being solely focused on bottom-line profits and instead focusing on doing what is good for society and avoiding practices that are considered harmful. Investments must avoid providing income from alcohol, tobacco, gambling, pornography, prostitution and illegal arms trading, among others.

It is in this spirit that the global Islamic finance industry has been venturing into the world of environmental, social and governance (ESG)-linked products with innovative and diverse issuances like green, sustainable and transition Sukuk over the last few years.

Chart 1: Sukuk and conventional bond issuance in key Islamic finance jurisdictions



Sources: Fitch Ratings, Bloomberg

Government support has also been witnessed among a number of key Islamic countries. While Islamic finance is a growing subsegment, more can be done to better align it with the ESG world. Tools from Islamic economics such as Zakat, Sadaqah and Waqf could also be utilized to promote financial inclusion, sustainability and positive impact.

The global Sukuk landscape

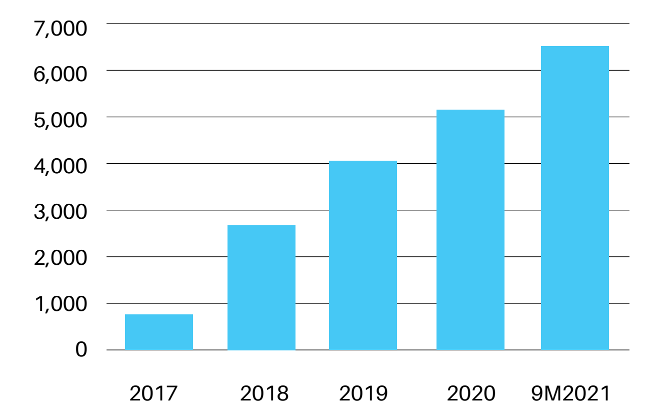
Islamic finance is systemically important in many jurisdictions and growing in the wider regions of the Middle East, Asia and Africa. Sukuk remain an important funding tool, with the share of Sukuk issuance in the total funding mix for key Islamic finance jurisdictions reaching 30% in the third quarter of 2021 (Q321) (2020: 23.6%). Global outstanding Sukuk volumes reached US$775.4 billion in Q321.

Key drivers of green and sustainability Sukuk

More than US$19 billion-worth of green and sustainable (GS) Sukuk have been issued since the market's inception in 2017. GS Sukuk issuance is driven by sovereigns and multilateral development banks in key Islamic finance jurisdictions. This is because various OIC countries are signatories to the 2015 Paris Agreement on climate change, and have adopted the UN Sustainable Development Goals (SDGs) and set net-zero emission targets. These issuers require sizable funding to meet targets and to finance COVID-19 relief measures, part of which could be funded through GS Sukuk. Corporates have also issued GS Sukuk to diversify their funding.

Issuers have also been opportunistic in leveraging the spike in global investor appetite for green, sustainable and social bonds, of which more than US$790 billion were issued in the first nine months of 2021,

Chart 2: Green and sustainability Sukuk issuance by year (US$ million)



Sources: Fitch Ratings, Bloomberg

a 145% increase from 2019. Many GS Sukuk were oversubscribed multiple times over in the past three years, with sizable interest from US, Asian and European investors. We expect that more first-time issuers are likely to enter the GS Sukuk market in the short to medium term.

Sukuk, rather than conventional bonds, were the preferred format for GS instruments in key Islamic finance countries. This is indicated by Sukuk accounting for more than 60% of the outstanding GS securities in the top 10 Islamic finance countries in the first half of 2021. This is driven by issuers' need to attract the sizable Islamic investor base in these countries who can only invest in Shariah compliant securities. In the ASEAN region, green Sukuk represented 19% of green financing instruments in 2020, based on research from Climate Bonds Initiative.

Issuers' concern for ESG issues is also driven by regulatory requirements, along with rising pressures from customers and employees, according to the HSBC MENAT report titled 'Sustainable financing and investing survey 2021'. According to the report, around 63% of Middle East, North Africa and Turkey (MENAT) issuers expect their company to actively seek advice on green, social or sustainability issues in relation to capital market transactions in the next 12 months.

Investors' interest is being driven by their recognition that paying attention to ESG issues can improve returns and reduce risk, along with meeting regulatory demands. Consequently, investors are increasingly incorporating ESG considerations into their corporate and investment strategies. The HSBC report also said around 19% of MENAT investors have a firm-wide policy on responsible investing or ESG issues.

Key market developments

Countries such as Malaysia, Indonesia and the UAE are the most active out of the top 10 key Islamic finance markets.

In 2017, the world's first green Sukuk facility was issued in Malaysia by Tadau Energy. In 2021, Malaysia issued the world's first US dollar sustainability Sukuk issued by a sovereign. The country issued the Sustainable and Responsible Investment (SRI) Sukuk Framework in 2014, and SRI Sukuk issuers in the country are granted cost and tax incentives under the SRI Sukuk and Bond Grant Scheme, which was expanded in 2021. Supported by it, the country houses the largest number of active GS Sukuk at 156 issues in September 2021, out of a total of 172 GS Sukuk globally.

In 2017, Bank Negara Malaysia launched the Value-based Intermediation initiative, a Shariah equivalent of sustainable and impact financing, with many Malaysian Islamic banks committing to integrating its principles into their own core practices. In 2018, HSBC Amanah, the Malaysian Islamic banking arm of HSBC Holdings, issued the world's first UN SDGs Sukuk, raising RM500 million (US$120.63 million).

Indonesia issued the first sovereign green Sukuk in the world in 2018, and is a regular issuer with issues in 2019, 2020 and 2021, raising a total of US$3.5 billion to date. Indonesia also launched its Green Bond and Green Sukuk Framework in 2018.

The UAE is also increasingly active in the SRI space. In 2019, Majid Al Futtaim issued the GCC region's first green Sukuk. In 2020, the first transition Sukuk facility was issued by Etihad Airways. The UAE launched its Sustainable Finance Framework in 2021. Dubai Financial Market, Dubai's stock exchange, had also updated its Shariah standards to cover green Sukuk.

In 2020, Saudi Arabia-based IsDB issued the world's first sustainability Sukuk to support responses to COVID-19 in its member countries, and followed it up with another issue in 2021. Saudi Arabia's Public Investment Fund and National Debt Management Center have also announced plans to issue green Sukuk.

In 2021, the world's first sustainability Tier 2 Sukuk facility was issued out of Turkey by Kuveyt Turk Katilim Bankasi. In 2021, Bangladesh's first green Sukuk facility was issued by Bangladesh Export Import Company or BEXIMCO, and the government issued a circular that allowed banks to invest in private sector-issued green Sukuk.

Key challenges for GS Sukuk

While GS Sukuk are experiencing notable growth in key Islamic jurisdictions, they are still nascent products equaling 2.4% of the total Sukuk market. To ignite growth for GS Sukuk and bonds, especially in the GCC region, government support, attractive incentives and infrastructure are required.

Key challenges impeding GS Sukuk's growth potential include the still-evolving market infrastructure, regulations and ecosystem for GS financing and projects in most OIC countries.

Issuance is also constrained by the lack of regulatory and/or tax incentives for GS Sukuk and bond issuers and investors in most OIC countries. While Sukuk issuance is often linked to an underlying pool of assets which can support GS securities, issuance is often still constrained by the lack of available and appropriately-sized GS assets which can enable Sukuk issuance, especially for non-sovereign issuers.

Lack of standardization of Sukuk is also a key challenge as the time spent drafting green Sukuk structures and frameworks that are acceptable to governments, investors and the Sukuk's Shariah boards can mean substantially longer time to market, leading to higher costs, at least until a standardized framework is established.

This is in addition to the lack of standardization around GS bonds as the market norms and standards for GS products are also still evolving, again reflecting the market's nascent status. It is essentially a self-regulated market although various voluntary guidelines exist, like the Green Bond Principles supported by the International Capital Market Association or the Climate Bonds Initiative.

According to the HSBC MENAT report, an ESG skills gap is also a challenge as investors in a number of OIC countries face a shortage of expertise and qualified staff which limits their ability to pursue ESG investing more broadly. The report also noted that environment and social performance disclosures by companies remain inadequate in a number of OIC countries, while some investors reported a lack of demand among their clients.

Conclusion

The GS Sukuk market has exhibited promising growth to date, with this trend likely to continue at least in the medium term. Islamic finance seems to be a logical area where GS Sukuk could flourish as Sukuk issuance is confined to a pool of assets, which by nature makes it easy to focus only on GS assets. Indeed, OIC countries have a clear potential to engage further with this growing market. Nevertheless, the segment faces significant challenges, and achieving a large, sustainable and established GS Sukuk market still seems to be a long way down the road.

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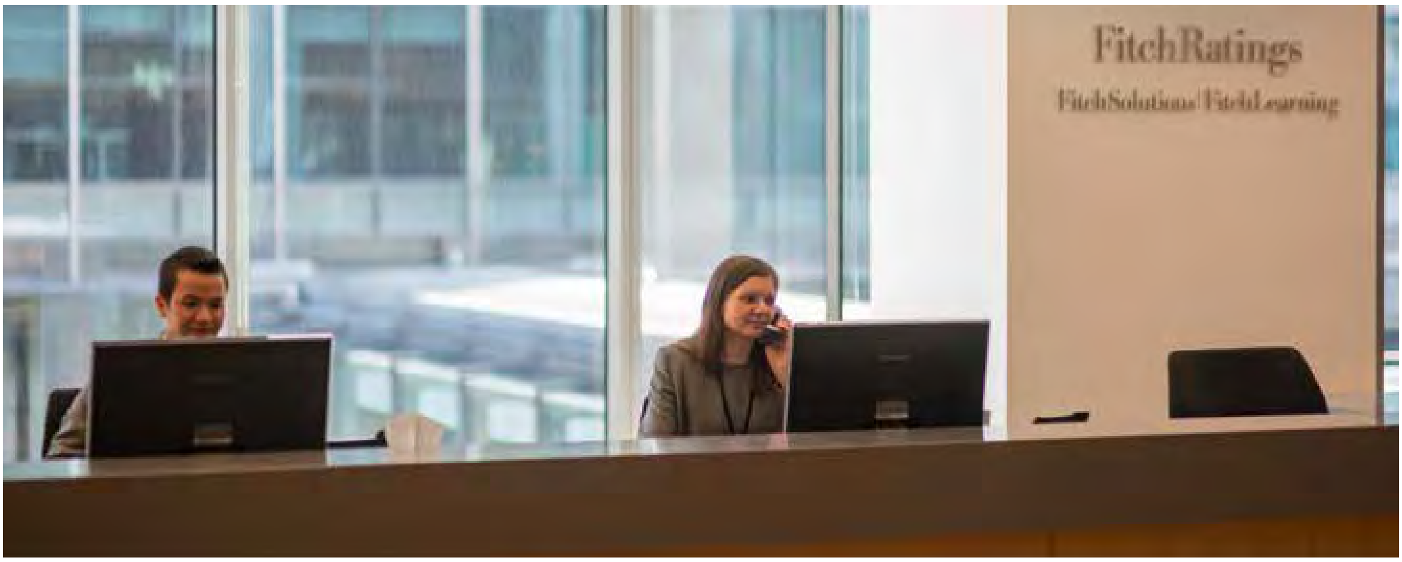
We cover more Islamic finance-based issuers than any other international credit ratings agency, as well as over 150 outstanding Islamic finance instruments worldwide. Fitch produces in-depth analysis, ratings and research with a dedicated Sukuk rating criteria, as well as ESG considerations for Islamic finance ratings. We also incorporate Takaful-specific considerations within our global insurance rating criteria.

Fitch has rated a number of sustainability-linked Sukuk including Etihad Airways PJSC's Unity 1 Sukuk Limited and Kuveyt Turk Katilim Bankasi A.S.'s Fixed Rate Resettable Sustainability Tier 2 Sukuk.

For more news and analysis, please visit Fitch's dedicated Islamic finance website at:

https://www.fitchratings.com/site/islamicfinance



Kuveyt Turk's Sukuk: Landmark sustainability issuance

Kuveyt Turk Katilim Bankasi, a leading Turkish Islamic bank majority-owned by Kuwait Finance House, has issued what is said to be the world's first regulatory capital Tier 2 environmental, social and governance (ESG) Sukuk paper, which will support its Sustainable Finance Framework.

The fixed-rate resettable sustainability trust certificates facility issued by KT21 T2 Company, the bank's SPV, was oversubscribed 12 times, receiving an orderbook of US$4 billion.

"The issuance also achieved the tightest pricing for any Tier 2 issuance out of Turkey since 2017, at 6.125%, reflecting strong fundamentals and positive market sentiments," a statement read. Proceeds from the landmark issuance will be used to finance or refinance eligible green and social projects by the bank.

"We are honored to be in the market with the first-ever sustainable Tier 2 Sukuk issuance globally. Our management philosophy is governed by sustainability which is also very much in line with principles of Islamic finance. We are very happy to be issuing a Sukuk intended to preserve nature, not exhaust it," noted Ufuk Uyan, CEO of Kuveyt Turk.

Rizwan Kanji, a partner at Akin Gump Strass Hauer & Feld, which acted as the legal advisor to the issuance, added: "This is a ground-breaking transaction which complies with multiple facets including ESG and sustainability, Basel III regulatory capital and principles of Islamic finance. We are delighted to have assisted Kuveyt Turk on yet another first-of-its-kind issuance."

Kuveyt Turk regularly issues Islamic lease certificates, but its last foray into the international Sukuk market was a US$500 million Sukuk Wakalah paper issued in 2016 that was oversubscribed four times.

Kuveyt Turk's Sukuk

US$350 million

KUVEYTTÜRK

16th September 2021

Trustee	KT21 T2 Company
Obligor	Kuveyt Turk Katilim Bankasi
Type	Fixed rate resettable sustainability Tier 2 certificates
Structure	Wakalah/Murabahah
Purpose of issuance	To finance and/or refinance eligible green and/or social projects
Tenor	10 years
Profit rate	6.13%
Maturity date	September 2031
Periodic distribution dates	Every 16th June and 16th December commencing on the 16th December 2021
Joint bookrunners	Bank ABC; Citi; Dubai Islamic Bank; Emirates NBD Capital; KFH Capital; HSBC
Legal advisor	Akin Gump Strauss Hauer & Feld
Listing	Irish Stock Exchange
Governing law	Turkish law
Rating	Final long-term rating of 'B'/'RR5' by Fitch Ratings

Etihad Airways's Sukuk: A gradual switch to green

The UAE's national airlines and Abu Dhabi-owned Eithad Airways has issued a US dollar-denominated Sukuk facility worth US$600 million, touted as the world's first 'transition' Sukuk and also the first sustainability-linked financing in the global aviation industry, structured under a transition finance framework.

Proceeds from the issuance will be used by Etihad to raise capital focused on gradually switching to greener, more environmentally sustainable operations. The carrier plans to use more fuel-efficient planes and eliminate single-use plastic, aiming to cut its 2019 carbon emissions level by 50% by 2035 and achieve net zero carbon emissions by 2050.

"This follows the first aviation financing linked to the United Nations Sustainable Development Goals raised in December 2019, further confirming Etihad's role as an industry leader in sustainable finance," the company said.

Sustainability and responsible climate action are the most significant challenges facing the aviation industry

Transition bonds or Sukuk are typically targeted at industries with high greenhouse gas emissions, including aviation, energy, shipping and steel and cement manufacturing. "Sustainability and responsible climate action are the most significant challenges facing the aviation industry," Adam Boukadida, CFO of Etihad Aviation Group, said, adding: "By issuing a sustainability-linked Sukuk, Etihad is voluntarily adding to its existing commitments under CORSIA, and also committing to reduce carbon emissions intensity by over 20% from the 2017 baseline."

Etihad will be conducting research and development into sustainable aviation fuel, and has committed to paying a penalty in the form of carbon offsets should it fail to meet its short-term target of reducing the carbon intensity of its passenger fleet.

HSBC, which acted as the joint global coordinator with Standard Chartered, was also the joint sustainability structuring agent on the deal, which comes only weeks after the bank had announced an ambitious strategy to help drive the transition to a net zero economy.

Etihad Airways's Sukuk

US$600 million

الاتحاد
ETIHAD
AVIATION GROUP

29th October 2020

Issuer	Etihad Airways
Mode of issue	Private
Tenor	Five years
Currency	US dollar
Joint global coordinators/ joint sustainability structuring agents	HSBC, Standard Chartered
Joint lead managers and bookrunners	Abu Dhabi Islamic Bank, Dubai Islamic Bank, Emirates NBD Capital, First Abu Dhabi Bank, HSBC, Standard Chartered
Joint lead manager	Abu Dhabi Commercial Bank
Financial advisor	Mashreq Bank
Rating	Rated 'A' by Fitch Ratings (published 9th November 2020)

"Many industries, including airlines, need to undertake complex and gradual transformations to reduce their carbon emissions, and the financial sector has a responsibility to help them," Ali Taufeeq, the director of HSBC's Middle East Debt Capital Markets division, said.

Etihad Airways last issued Sukuk in 2016 — a US$1.5 billion facility maturing on the 30th November 2021. The successful issuance of the transition Sukuk has secured US$300 million in early repayment for the company's outstanding facility.

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 NOMURA

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

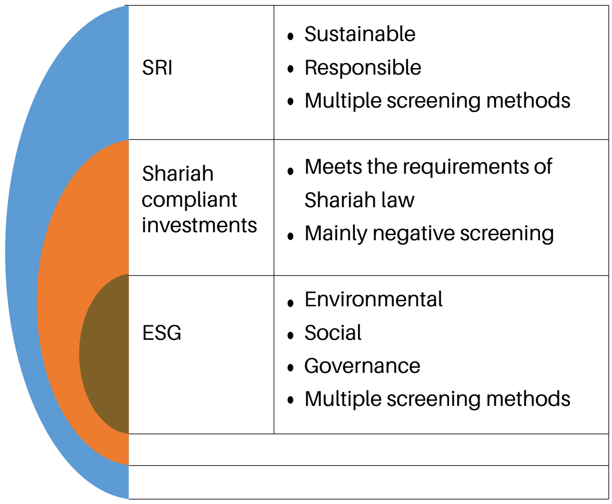
2 Financial Services Global Market Report 2021: COVID-19 Impact And Recovery To 2030

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.

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The path from COP26: The role of Islamic finance in transition financing

Authored by

DDCAP Group™

As the 26th United Nations Climate Change Conference of the Parties (COP26) drew to a close in mid-November of this year, UN Secretary General Antonio Guterres warned: "Our fragile planet is hanging by a thread. We are still knocking on the door of climate catastrophe." [i] While the Glasgow Climate Pact took important steps forward, he hastened there was still much to be achieved. His points included an end to fossil fuel subsidies, a phase-out of coal, a price on carbon, building the resilience of vulnerable communities against the impacts of climate change and delivering the long-promised climate finance commitment to support developing countries. Even with this list, he noted with a hint of optimism that while global leaders "did not achieve these goals at [COP26] … we have some building blocks for progress." [ii]

Among those building blocks are the commitments made by the financial services sector. COP26 saw the first-ever Finance Day held on Day 3, in prime position after the two-day World Leaders Summit. The engagement of the financial sector was at a level not seen previously, leading some even to refer to this as the Finance COP. Among the discussions on Finance Day, and the days that followed, was the growing need for transition finance. While not a new topic, the two weeks of COP26 advanced that discussion to focus not only on the necessity of financing the transition, but of financing a just transition. Financing a just transition is not solely about decarbonizing the economy, it is about innovating for a lower carbon future without creating severe economic impact, particularly to the developing world.

Therefore, the focus now has evolved to mobilizing funding to limit climate change and promote the shift to a lower carbon future in a way that is sustainable and positive for all communities. This presents a very unique opportunity for the Islamic capital markets (ICMs). Islamic finance is a proxy and an entry point to the 'Global South' which is disproportionally vulnerable to climate change and significantly impacted by decarbonization. The global finance community, and in particular the ICMs, now have the opportunity, and perhaps even the responsibility, to help accelerate the transition to a less carbon-intensive economy and become stewards of the said change.

The case for transition financing

Before COP26, estimates suggested that an annual US$6.9 trillion in infrastructure investment and between US$1.6 trillion and US$3.8 trillion for the energy transition were required to meet the Paris Agreement targets. With new goals surrounding the Glasgow Climate Pact, these amounts will have only increased. As there are not sufficient public funds to meet these needs, private capital is vital and this presents a considerable prospect for engagement by the ICMs.

Environmental, social and governance (ESG)-focused capital market activities are often synonymous with portfolio divestment from heavy emitting sectors such as oil and gas, cement, steel, shipping, aviation and mining. However, many of these currently high-emission sectors are sectors the real economy will still need decades from now and viable low- or no-carbon alternatives do not yet exist at the scale required, if at all. Some sectors face significant hurdles to achieve decarbonization whether they be economic, technological or rooted in other considerations. Other sectors may not be able to completely decarbonize but still must be included in the global economic transition. Furthermore, divestment by ESG-principled investors effectively abandons control to those who may not share the same concerns and who may not exert their influence in the furtherance of a sustainable agenda. Equally, by refusing to provide financing to these areas, the capital markets leave them without the necessary resources to transition. Divestment does not result in lower emissions.

This is particularly true for the emerging markets. Currently, there is a substantial gap in emerging market transition finance because emerging market investing is inherently carbon-intensive, as many of these economies are still heavily dependent on coal. In fact, investing in emerging markets can increase portfolio emissions by 10%. Carbon targets and other divestment policies, while well intentioned, often serve to drive capital away from areas which need it most.

Therefore, on the path from COP26, the focus should shift to engagement with these industries globally to build outcome-led partnerships focusing on decarbonizing the real economy. If the finance is mobilized to support the transition, investing in new technologies and, where possible, retooling to accommodate renewables, the financial sector and in particular the ICMs can enable increased momentum to convert intent into action.

Developing a responsible transition Sukuk market

One structure by which to achieve a lower carbon economy is the growing area of transition bonds and Sukuk. Transition bonds and Sukuk, as opposed to green bonds and Sukuk, provide financing to high-emitting sectors and projects that would not be eligible for green certification but yet are still necessary to implement the changes required to meet the Paris Agreement targets. To date, there have been fewer than 20 transition bonds and even fewer transition Sukuk, but it seems momentum may be growing.

In 2020, the Islamic finance sector saw the first-ever transition Sukuk by Abu Dhabi's Etihad Airways, which raised US$600 million for investment in sustainable aviation and carbon reduction targets. In March 2021, the IsDB raised US$2.5 billion with its sustainability Sukuk, the proceeds of which will be allocated to eligible projects under the IsDB's Sustainable Finance Framework, which incorporates supporting the transition to a green economy as one of the three main pillars of its climate change policy.

The market has also seen increased commitment to transition funding in the MENA region. For example, in September 2021, APICORP announced it is considering the issuance of transition Sukuk as part of its green bond framework. Additionally, Saudi Arabia's Public Investment Fund (PIF) has stated that it would look to "gradually move toward turning down investments that lack their own sustainability plans".[iii] In the meantime, the PIF has been investing in the transition, boosting its stake in ACWA Power International which focuses on renewable energy sources and investing in electrical vehicle manufacturer Lucid. [iv]

Meanwhile in Malaysia, the instruments issued under the government of Malaysia's Sustainable Development Goals Sukuk Framework in April 2021 have allocated the use of proceeds to activities which are expected to facilitate the transition to a low-carbon economy. [v] These areas include: clean transportation, sustainable management of living natural resources, renewable energy and green buildings (among others).

Standing alongside investors and corporates, financial institutions are also supporting clients in this work. Standard Chartered's recently introduced Sustainable Trade Finance Proposition in the UAE helps industries transition and reduce carbon emissions by offering financing that recognizes their efforts to lessen their carbon footprints. HSBC has made a similar commitment and in early 2021 announced the formation of a dedicated Sustainable and Transition Finance team in the Middle East, North Africa and Turkey which will help institutions, corporates and individuals to transition to a more sustainable future.[vi]

There is growing interest and unlimited potential for the ICMs in this area. Stakeholder collaboration (including multilaterals, sovereigns and both regional and global financial institutions) across the ICMs will be needed to ensure the industry mobilizes the necessary capital as efficiently as possible to those companies with a legitimate dedication to the transition. Effective leadership from within the ICMs will be imperative to ensure effective standards are put in place, and compliance with those standards is monitored.

In its recent white paper, Climate Bonds Initiative (CBI) posited what might constitute a certification regime for 'transition bond' or 'transition Sukuk'. Under this new label, companies would be held to account based on "five hallmarks of a credibly transitioning company, ie a company whose transition is rapid and robust enough to align with … the Paris Agreement." [vii]

These key elements would be the focus and requirement of the certification assessment to achieve the 'transition' label. Specifically, the CBI's hallmarks include: (1) Paris-aligned targets; (2) Robust plans to reduce emissions; (3) Implementation action; (4) Internal monitoring; and (5) External reporting. The proposal, while complementing existing ESG frameworks and methodologies, goes beyond them to "avoid transition labelling". The CBI acknowledges that "different industries will have greater or lesser potential to reduce emissions/increase sequestration over time, meaning that the end goals and speed of transition will vary substantially by sector"; however, the requirement for all would be to reduce emissions to the greatest extent possible, as quickly as possible.

Whether the ICMs look to adopt this framework, or develop their own, the key governance elements must reflect a company's "willingness and ability to deliver on its decarbonization targets" as well as provide the necessary granularity "to ensure that those targets are ambitious and in line with climate goals". [viii] Governance and accountability will be key to ensuring a meaningful transition, requiring transparency not only of targets met, but targets missed. Projects must be analyzed not only from an investment perspective but also from an efficiency perspective, to avoid needlessly repeating structures that do not produce optimal results. Transition financing must address Scope 1, 2 and 3 emissions and short-, medium- and long-term targets must be set. The ICMs need to work together to agree methodologies and governance structures to be able to get to work to address these considerations and enable the transition. However, while Islamic financial institutions and investors wait for policy guidance on how the ICMs should best proceed, they should begin to take action now to build governance systems to embed sustainability considerations and build internal capacity to address these growing market demands.

Conclusion

In his closing media statement, COP26 President Alok Sharma gave the world a call to action that "the hard work starts now." After two years of preparation, and two weeks of negotiations, the global community has written down the commitments that will see it through to the next COP. Now, after catching its collective breath, the global financial community needs to work together to put that into reality. It is no longer about goals and aspirations; it is about actions.

However, actions require resources. The global financial community, and in particular the ICMs, must focus on mobilizing resources to meet these goals. The ICMs have a responsibility to meet this call to action, to continue to mobilize funding for green, blue and sustainability projects and begin to formalize their plans to dedicate resources to facilitating the transition required. The next two COPs are in the MENA region: 2022 in Egypt and 2023 in the UAE . In Glasgow, on the sidelines of COP26, Islamic finance stakeholders including the IsDB, Indonesia's Ministry of Finance and Her Majesty's Treasury in the UK announced their formation of a high-level working group to promote green and other sustainable Sukuk. The three-year initiative will ensure that the developing ICM contribution is highlighted at the annual COP summits in 2022 and 2023, promoting acceleration and elevation in the volume of green and sustainable Sukuk issued to help countries deliver against their climate-related targets. As the global community prepares for these events, the ICMs will be center stage and must grasp that key opportunity to differentiate the potential and the scale of contribution by Islamic finance and the ICMs.

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The changing ESG landscape and our part in it

By Ismitz Matthew De Alwis, the Executive Director/CEO of Kenanga Investors

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kenanga
Kenanga Investors

The term ESG [environmental, social and governance] is frequently mentioned these days, but what exactly does it mean? Perhaps a decade ago, it would seem almost performative to have ESG written as part of a company's corporate social responsibility statement. The fact that it is now one of the most trending topics in the industry shows that the world, at large, has truly shifted gears for the better. Now, it is a major part of many institutions' key performance indicators, and is something that customers or investors look out for before engaging with the said institution. It represents a more stakeholder-focused approach to business.

Shareholders have increasingly started viewing ESG-related issues as a window into the future, and a clear hierarchy has formed. As a result of this, leading corporations now view ESG issues as a business imperative. Companies that have included ESG principles/factors into their overall strategy and risk oversight discussion have presented a more positive image. The ability to detect and manage ESG-related concerns seems to have the capacity to create an engaging narrative surrounding a business and its practices.

The rise of Islamic finance in tandem

We also believe that Islamic finance can be an enabler in achieving sustainable development. We see promising sources of growth going forward in Islamic social finance. This includes instruments like Qard Hassan, Waqf and Zakat. In particular, we see Waqf, an Islamic endowment instrument, as an attractive asset class that integrates commercial obligations with sustainability and social objectives.

ESG investing and Shariah investing are commonly seen as two separate entities, yet they are, in fact, two sides of the same coin. Both ESG and Shariah investing seek to encourage responsible conduct with Shariah investing emphasizing being good stewards of society and the environment following Islamic principles while ESG aims for sustainable outcomes.

ESG practices and advancement are only feasible through education and training. However, it is also critical to have both integration and engagement when it comes to ESG. ESG integration will improve long-term returns through managing ESG risk and opportunities. I believe that ESG is just not one particular thing but it is broad, interconnected and informs the way we approach investment ideas and solutions. A holistic ESG plan should encompass clear directions for all business units.

Malaysia has been the hub for Shariah compliant investments in the region. According to the Securities Commission Malaysia (SC), Malaysia's Islamic capital market continues to hold a sizable part of the overall capital market, accounting for 65.85%. The market size in December 2020 was RM2.26 trillion (US$540.02 billion), up from RM2.04 trillion (US$487.46 bilion) at the end of 2019 [1].

Following the COVID-19 pandemic, there has been a rise in interest in ESG, notably in Asia, where several stock exchanges have begun to introduce sustainability reporting rules. The Singaporean government's development of the Singapore Green Plan, which seeks to provide a comprehensive framework for sustainable development, green economy and net-zero emissions, prompted the Monetary Authority of Singapore (MAS) to incorporate climate change and environmental sustainability into all of its frameworks. As a central bank and financial regulator, MAS seeks to collaborate with financial institutions in Singapore to increase the financial sectors' resilience to environmental threats [2]. In 2020, the Indonesia Financial Services Authority (Otoritas Jasa Keuangan) mandated ESG reporting for all listed firms in Indonesia while banks were obligated to do so beginning in 2019 [3].

Currently, in Malaysia, the region's evolution toward sustainability has progressed at varying rates among different organizations. Bursa Malaysia has set a good precedent by providing frameworks and rules since the beginning of its ESG journey in 2010, when it founded its sustainability committee [4]. The sustainability committee oversees the formulation, implementation and effective management of Bursa Malaysia's sustainability strategies. It ensures that Bursa Malaysia's strategic direction takes sustainability into account [5].

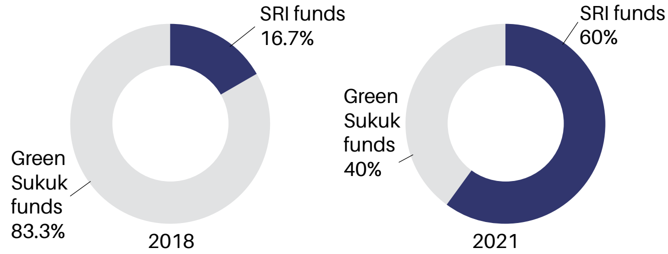
A recent global framework currently in the works is the joint Corporate Sustainability Practitioner (CSP) Competency Framework which was proposed this year, through the partnership of Bursa Malaysia, the UN Global Compact Network Malaysia and Brunei to support the credentialing of practitioners and professionals involved in Malaysia's corporate sustainability space [6]. Additionally, the SC released the Sustainable and Responsible Investment (SRI) Roadmap for Malaysia's capital markets in 2019. This roadmap is to create an SRI ecosystem, charting the role of the capital markets in driving sustainable development. All in all, regulators are looking toward building a holistic ecosystem that takes into account the perspectives of all stakeholders, whether investors, financial institutions or society at large [7].

It comes as no surprise that ESG and Shariah investment are intertwined with one another. The creation of the FTSE4Good Bursa Malaysia Shariah (F4GBMS) index demonstrates this. The F4GBMS index has been essential in identifying public listed companies that have improved their ESG policies and disclosures. It was created in Malaysia in 2014 in collaboration with FTSE Russell and represents firms that exhibit good ESG practices [8]. It is overseen by the FTSE4Good Committee, and firms are picked using FTSE's ESG approach, which is based on criteria outlined by the Global Reporting Initiative and the Carbon Disclosure Project [9]. The F4GBMS serves as a basis for fund managers to develop new investment products based on a portfolio with Shariah compliant equities governed by ESG principles. As of June 2021, the index's composition consisted of 54 constituents; this index will be revised twice a year, in June and December.

In Malaysia, there appears to be a gap between social enterprises and funding. This might be due to a lack of information and financing platforms. Greater transparency and knowledge about a sector are crucial since this information will educate funders, making it easier for them to decide who they can finance and why they should invest in them.

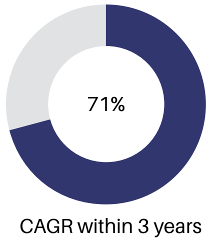
Impact investment is a growing topic of conversation in Malaysia, and it entails extending beyond funding non-profits and social enterprises.

Figure 1: Growth of SRI-related funds in Malaysia

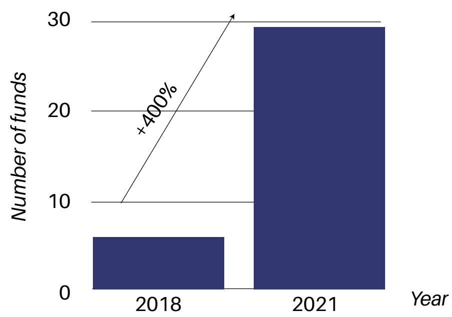


According to Securities Commission Malaysia (SC), there were only six SRI-related funds in Malaysia in 2008. The SC announced in October 2021 that there are currently 20 SRI-related funds in Malaysia.

There seems to be notable growth when it comes to SRI-related funds. The number of SRI-related funds increased four-fold between 2018-2021, growing by 71% on average per year.



Number of SRI-related funds in 2018 and 2021



Data sources:

1. *Responsible Investing: Looking for New Ways to Invest in Social Enterprises (8th August 2018, Bursa Sustain)*
2. *List of Sustainable and Responsible Investment ("SRI") Fund (as at 21st October 2021, Securities Commission Malaysia)*

Critical to this topic is SRI. SRI funds are funds that focus on the 'social' aspect of ESG in publicly traded companies. Figure 1 shows the growth of SRI-related funds and how they have developed in Malaysia. Encouragingly, the pace of growth has not been lacking and we foresee that rising interest will stimulate more product development within the market within the next few years.

Part of the change

The challenge we all face is clearly short-term thinking. Sustainable development promises better and more resilient economies and businesses, inclusive growth and equitable societies but only in the future, after a period of adjustment and potentially some pain.

Traditional thinking on the necessity of giving up growth for ethical or responsible investing is also being reconsidered. Many studies have highlighted that the investors of tomorrow will insist on a positive impact as well as positive returns, so ESG methodology is now part of the mainstream and is here to stay.

Kenanga Investors has always recognized the importance of a company that is driven by ESG principles and goals. We are of the opinion that by managing ESG risks and opportunities, ESG integration will boost long-term results. It is our responsibility, on behalf of asset owners, to generate a positive ESG impact through their investments. It is also the fiduciary duty of Kenanga Investors, as a signatory of the Malaysian Code of Institutional Investors, to engage in and promote ESG practices to all of our stakeholders. In addition to the collective benefits that we expect to derive from adopting ESG principles, it is a reality today that given the current wave ESG is riding on, we are at risk of losing competitiveness if we do not make significant strides in this direction.

As a firm, we intend to integrate ESG considerations into three major aspects; i) firm-wide, ii) product and iii) stock level. This perspective will allow us to develop overall targets and values, and focus on ESG-led portfolios and product structuring and ESG screenings throughout our investment processes, all the while maintaining an active stewardship stance through engagements with stakeholders and exacting our voting rights with investee companies.

The firm is also represented through my participation in and membership of several notable steering committees aimed at supporting Malaysia's transition toward an inclusive and climate-resilient economy such as the Sustainable Investment Platform, the FTSE Bursa Malaysia Index Advisory Committee and the Joint Committee on Climate Change (led by Bank Negara Malaysia and the SC).

As mentioned previously, Kenanga Investors is also a signatory of the Malaysian Code for Institutional Investors. As a signatory, we have developed practices to support the code and internalize the principles throughout the whole investment value chain. As investment managers, we have a say in the markets in which we invest in. We anticipate that frequent stewardship procedures within the investing community will raise awareness and, consequently, behavioral changes among community members.

Our recent appointment as the fund manager of Dana Wakaf Bencana, an emergency relief fund established for the purpose of channeling resources to those affected by climate change-related disasters as well as future pandemics, has seen us embarking on yet another milestone on the said roadmap. A collaboration between government-linked agencies and the private sector, the initiative is in line with the SC's Islamic Fund and Wealth Management Blueprint released in 2017 and the Waqf Featured-Fund Framework introduced on the 12th November 2020 which aim to facilitate the growth of the Islamic social finance segment. In April 2021, we also oversaw the launch of the Kenanga Waqf Al-Ihsan Fund, where half of the derived income will be distributed to sectors such as education, healthcare, economic empowerment and environmental preservation or development. Both funds are rooted in elements of Waqf, which encourages Muslims to channel revenue and various goods and services to the groups or communities in need. This bears credence to the idea that it is possible to do well while doing good. We foresee that these initiatives will generate a considerable amount of awareness and interest due to their altruistic nature especially in today's social climate which will lead to society empowerment and poverty alleviation.

We are aware that this is a long-term effort. As such, we have set our sights clear on the endgame and are confident in making good on our commitment to this agenda. We are also intending to encourage more policy discussions to effect enhancements in ESG integration within our investment strategies, voting policies and impact reporting to our stakeholders. In Malaysia, the government and regulators are pushing this as can be seen in the many initiatives, viewing the importance of a whole-nation approach in terms of developing short- to long-term key policies for sustainable development. This includes the impact of climate change on financial stability and the economy, as well as addressing social-related issues like poverty. Overall, on sustainability measures, the latest Budget 2022 announced by the finance minister included a transition toward low-carbon practices; environment and diversity; and community empowerment which augurs well for Malaysia in developing the local capital market sustainable roadmap and ecosystem.

We only have one Earth, and we feel that tackling the issues that have arisen as a result of decades-long neglect toward our environment is a once-in-a-lifetime chance. We look forward to being part of the change that will solve these concerns before the harm and its consequences are permanent. We must each accept the responsibility for change. It is time to 'create the future' that we want. We owe it to ourselves, and future generations, to ensure sustainable and beneficial outcomes for all.

This advertisement has not been reviewed by the Securities Commission Malaysia.

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Sustainable Islamic supply chain: Going the extra mile in supporting the Halal trade ecosystem

By Bilal Parvaiz
Executive Director, Islamic Business & Head Products, Standard Chartered Saadiq

Authored by

The Halal industry is witnessing an exponential growth with various projections stating the Halal economy as a multitrillion dollar opportunity.

As the Halal industry continues to globalize, it should harness the socially responsible funding mechanisms of Islamic finance and strive to produce goods and services which are Halal Tayyab. By capitalizing on the synergies between the two industries, there is an opportunity to foster a truly sustainable Halal economy — an economy in which the sum of its parts is not only Shariah compliant but also placed in a divine order.

The supply of Halal goods and services is dependent on a robust Halal ecosystem, with the primary criteria being Halal compliant. The credibility and trust around the Halal certification are of utmost importance; with Malaysia taking the lead in terms of the development of a world-class Halal ecosystem via Halal Development Corporation under the Ministry of International Trade and Industry. This achievement by Malaysia not only provides a greater sense of credibility but also offers a holistic ecosystem of facilitations supplementing the growth of the Halal industry and offers a degree of standardization, hence ensuring consumer trust and confidence.

Standard Chartered Saadiq, as a leading international Islamic network spanning across Asia, Africa and the Middle East, launched the Halal360 proposition in 2020. With an aim to connect Halal trade corridors and ensuring businesses across geographies are able to leverage our unparalleled Islamic network, the Islamic supply chain solutions are a key enabler of this strategic intent.

This unique proposition, based on a fully digital, straight-through processing model, brings about the following benefits:

- Supports suppliers across various geographies
- Provides a digital platform with straight-through processing
- Eliminates physical documentation and allows for integration to various enterprise resource planning platforms
- Complies with environmental, social and governance (ESG) criteria whereby the bank and buyer can work with suppliers on improving ESG practices, moving toward a net-zero target achievement, and;
- Provides preferential treatment for SME vendors, hence creating economic sustainability and uplifting participation.

The adoption of ESG and increased awareness equally apply on Halal businesses, which have a natural advantage by being more ethically

aligned and adopting practices around purification and cleanliness. The long-term sustainability of any business is not just dependent on the financial indicators but how well ESG practices are embedded into the corporate objectives and implemented into the standard operating model and the ecosystem. Building a sustainable and resilient supply chain is no longer optional. Instead, it is necessary and a vital part of creating a business model that enables a company and its ecosystem to thrive in the long term.

Case study

Malaysia Airports: A sustainable supplier finance solution

- Malaysia Airports Holdings (MAHB) is one of the largest airport operator groups in the world in terms of the number of passengers handled, managing 39 airports across Malaysia as well as an international airport in Turkey.
- Due to the COVID-19 pandemic and the ensuing lockdowns, MAHB was keen to set up a supplier finance program which enables its vendors to enjoy immediate liquidity at competitive pricing, ensuring economic sustainability for the suppliers during the pandemic.
- Standard Chartered Saadiq, as the sole mandated arranger of the program, has structured a Shariah compliant solution that meets MAHB's requirement of enabling access to finance for the SME suppliers. This aligns with MAHB's commitment to support its suppliers.
- Under the program, the SME suppliers enjoy preferential treatment over non-SME suppliers.

- **Digital** — The supply chain solution fully provides an end-to-end digital experience which is based on a straight-through-processing model with no physical documentation or manual processing involved.

- **Sustainability** — Preferential treatment to SME suppliers under the program is based on their **SME classification, advocating positive impac**t on smaller suppliers. Eligible SMEs are assessed based on International Finance Corporation criteria.

- **Shariah compliance** — The supplier finance demonstrates the depth of Standard Chartered's Islamic finance innovation and solution capabilities, delivering a seamless digital experience meeting MAHB requirements.

As a leader in trade finance, Standard Chartered continues to support its clients in their digitization and sustainability journey, as well as simplifying their trade processes, and delivering a seamless end-to-end financing experience.

This innovative sustainable supplier finance solution allows MAHB's vendors access to quick liquidity at preferential financing rates while helping MAHB optimize its cash flow.

The solution promotes best practices in sustainability across MAHB's ecosystem. It also reflects their commitment to support SME suppliers throughout challenging economic conditions while leveraging digital capabilities to deliver a straight-through process and a seamless client experience.

standard chartered saadiq islamic

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

[14] Ground-breaking sustainability Tier 2 sukuk 12-times oversubscribed - Environmental Finance (environmental-finance.com)
[15] Islamic Finance And ESG The Missing 'S' | S&P Global (spglobal.com)
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[17] Saudi Arabia's PIF hires banks to advise on ESG -IFR | Reuters
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[20] UN Secretary-General's Strategy for Financing the 2030 Agenda – United Nations Sustainable Development
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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.

Sustainable finance: New markets for Islamic finance

Authored by NORTON ROSE FULBRIGHT

The opportunity

The combination of global crises from climate change to the COVID-19 pandemic, combined with a new political urgency reflected at COP26 [2021 United Nations Climate Change Conference] in Glasgow and increased investor willingness to fund impact-based products, provides a unique opportunity for Islamic finance to reconsider its purpose and to tap into much larger global flows of money than can be provided by its traditional investor base. Islamic finance has always had sustainability embedded in its core ethical principles, although this is not yet recognized by many conventional investors. The conventional market's increasing focus on finding investments that promote sustainability provides an unprecedented opportunity for Islamic finance to enter the mainstream and attract investment from a wider pool of investors.

COP26 highlighted both the climate challenge facing the world and the vital role that finance must play if the poorest countries are to make the necessary adaptations to live with higher temperatures and to achieve sustainable development. The COVID-19 crisis also highlighted global inequalities and slowed the progress of achieving the UN Sustainable Development Goals (SDGs) adopted by the UN in September 2015 as part of the 2030 Agenda for Sustainable Development. These twin emergencies of climate change and COVID-19 have galvanized the financial markets so that environmental, social and governance (ESG) is no longer a niche market but a core investment focus for many financial institutions. On the 3rd November 2021, at COP26, UN Special Envoy Mark Carney announced the Glasgow Financial Alliance for Net Zero of 450 financial firms across 45 countries, which have stated their intention to align not only their own businesses but also their lending and investment criteria to achieving net zero, harnessing up to US$130 trillion of assets to plug the US$150 trillion funding gap needed to mitigate the worst effects of climate change. Financial institutions are also increasingly using the SDGs as the basis of their reporting. As of April 2021, 220 banks are signatories to the UN Principles of Responsible Banking, which require the signatories to produce SDG-aligned reporting. This is a helpful development because the UN has estimated that the pandemic-related downturn has pushed between 119 and 124 million more people into extreme poverty and many of them live in the 57 countries which are members of the OIC which collectively represent 1.82 billion people, and where Shariah compliant solutions would be welcome.

The market

The market potential can be easily assessed when examining the public capital markets and comparing green bonds with green Sukuk. The global Sukuk market has grown from an estimated US$85 billion of Sukuk issuances in 2016 to an estimated US$172 billion in 2020. Green Sukuk issuances also increased from US$500 million in 2017 to US$3.5 billion in 2019. The market was affected by the pandemic with only US$6.1 billion of Sukuk issuances from January–July 2020, but has recovered in 2021, with notable issuances such as the IsDB raising US$2.5 billion in March 2021 through its sustainability Sukuk and the Republic of Indonesia issuing US$750 million of green Sukuk.

However, this is tiny compared with the conventional green bond market. Between 2007 and 2020, green-linked bonds raised over US$1 trillion of capital. After the first green bond in 2007 (the EUR600 million (US$676.85 million) issuance by the European Investment Bank), the market began to grow, and the Paris Agreement at COP21 [2015 United Nations Climate Change Conference] was a key driver in the further expansion of the market, with an annual average growth in the green bond market of 60% since 2015. It is likely that COP26 will result in the green bond market growing even faster.

The World Bank reported that 17 green Sukuk had been issued as of July 2020. The first green Sukuk facility was issued in Malaysia by Tadau Energy in 2017 and the Republic of Indonesia issued the world's first sovereign green Sukuk in March 2018, raising US$1.25 billion. The majority of green Sukuk issued have used the Murabahah and Wakalah structures (eight issuances, all by issuers in Malaysia), with the second-most popular structure being Wakalah Istithmar which was used for four issuances — three by Indonesian issuers and one by a Malaysian issuer. Although the majority of issuances so far have been from Malaysia or Indonesia, there is huge potential for issuers based in other jurisdictions, such as the UAE, Saudi Arabia, Turkey or Pakistan, to also tap into this market. Energy targets have been announced by Middle Eastern governments, such as the UAE Energy Strategy 2050 and Saudi Vision 2030, which will require significant investment that the green bond and Sukuk market will be well placed to fund.

The last year has seen unprecedented demand from investors for sustainability-linked vehicles, and Bloomberg predicts that assets under management invested globally in sustainability funds and portfolios could reach US$53 trillion by 2025, accounting for more than one-third of a projected total of US$140.5 trillion. Green and sustainable Sukuk could appeal to core Islamic investors in the region as well as a wider pool of international ESG investors. Market conditions are therefore ideal for this investor demand to be harnessed by Islamic finance. The Islamic Finance Council UK estimates that an additional US$30–50 billion of capital could be raised by 2025 through green and sustainability Sukuk.

The regulatory framework

The green Sukuk issuances that have taken place have been underpinned by existing global standards such as the Green Bond Principles issued by the International Capital Markets Association (ICMA) and aligned with a local framework established by the issuer, addressing the intended use of proceeds, the process for project selection, managing the proceeds raised (including segregating the funds received) and ongoing reporting. Typically, an independent second opinion to verify the sustainability of the issuance from a third party, such as the Center for International Climate and Environmental Research-Oslo, is also required. These are all steps that Sukuk issuers are familiar with, from selecting suitable projects or assets (although note that from the Green Bond Principles perspective, it is the use of the proceeds which is key rather than the nature of the asset itself, unlike Islamic finance where the asset underlying the transaction structure is important in determining Shariah compliance) to segregating proceeds to obtaining a Fatwa from a Shariah scholar in order to confirm Shariah compliance.

The EU implemented the Sustainable Finance Disclosure Regulation (SFDR) in March 2021, which sets out specific rules for how and what sustainability-related information financial market participants need to disclose. This additional disclosure will be significant, but as additional milestones for SFDR are met throughout 2022 and 2023, this could create a benchmark for other financial institutions, and Islamic issuers wishing to attract investment from European investors may need to align themselves to the requirements of SFDR.

If issuers want to attract investment from the wider market, in addition to implementing green Sukuk frameworks, they will also need to engage with ESG ratings criteria. Companies that currently provide ESG ratings include Bloomberg ESG Data Services and Dow Jones Sustainability Index. ESG ratings are designed to measure and assess a company's exposure to ESG risks and evaluate its performance in managing those risks relative to its peers. There is currently no specific industry standard for establishing an ESG rating, with each provider applying its own set of criteria to the evaluation process. It is worth noting that the lack of standardization in the Islamic finance market, which has often been viewed as a weakness, may in this case help prepare issuers for the uncertainty and lack of standardization in ESG ratings.

The products

In the conventional market, there are different types of products: green bonds, social bonds and sustainable bonds, which are bond instruments where the proceeds will be exclusively applied to eligible environmental and/or social projects; and sustainability-linked bonds, which are bond instruments where the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives. Sukuk equivalents need to follow the ICMA principles for these products, in addition to any locally created frameworks such as the Republic of Indonesia's Green Bond and Green Sukuk Framework, the Sustainable & Responsible Investment Sukuk Framework issued by Malaysia's Securities Commission or the Sustainable Finance Framework introduced by the IsDB, as well as the usual Shariah principles that apply to all Sukuk issuances, creating a number of additional processes that potential issuers will need to satisfy when compared with a conventional bond issue. A pricing premium from the market or potential tax benefits are needed in order to incentivize issuers to go through these additional steps, but the increased focus from both investors and governments suggest these may be forthcoming in the near future.

The purpose of Islamic finance

A fundamental principle of Islamic finance is that investment should have a social and ethical benefit to wider society, and not focus purely on a financial return. The Maqasid Shariah, the objectives or purposes behind Islamic law (including Islamic finance), also include as

necessities the protection of life, lineage and intellect. There is therefore a natural alignment between the principles of Islamic finance and the SDGs, both in prohibitions and mandates. Prohibitions on activities that cause harm to society can be linked to SDG8 (Decent Work and Economic Growth), SDG12 (Responsible Consumption and Production) and SDG13 (Climate Action), and the benefits to society mandated for Islamic finance can be linked to many of the SDGS including SDG3 (Good Health and Well-Being), SDG4 (Quality Education), SDG6 (Clean Water and Sanitation), SDG7 (Affordable and Clean Energy) and SDG11 (Sustainable Cities and Communities).

There is already discussion in the global Islamic finance community about the benefit of shifting the focus of Islamic finance from the strictly legal requirements of Halal (permissible and lawful) to the broader ethical concept of Tayyib (pure and wholesome), which is more in line with the goals of the Maqasid Shariah. This is the moment for Islamic finance to use the SDGs to create a sustainability philosophy for Islamic finance that is easily understood and accepted by the wider markets and also answers concerns that Islamic finance is currently overly focused on formalistic compliance with Shariah principles. This will require a coordinated and consistent approach from national regulatory bodies and international bodies such as AAOIFI and possibly an increased awareness among Shariah scholars generally of the sustainability principles that are necessary in order for a Sukuk facility to appeal to the broadest range of investors, so that any negative impacts of the use of funds can be identified as part of the Shariah review and possible remediation steps identified.

There is nothing in the ICMA Green, Social, Sustainable Bond or Sustainability-Linked Bond Principles that is inconsistent with Islamic finance. There have already been green and social Sukuk issued by major Islamic issuers such as the governments of Indonesia and Malaysia and the IsDB, and the Saudi Electricity Company issued US$1.3 billion-worth of green Sukuk in September 2020 pursuant to its green Sukuk framework, with a second-party opinion on the sustainability credentials provided by Vigeo EIRIS.

Conclusion

Islamic finance, with its ethical underpinning in the Maqasid Shariah, has a significant head start on conventional finance in aligning itself to ethical standards such as the UN SDGs, although it has not yet capitalized on this advantage. Issuers such as the governments of Indonesia and Malaysia and the IsDB have produced green Sukuk frameworks and issued green Sukuk in the market with success, demonstrating that the technical requirements can be satisfied by other issuers wishing to engage the wider market. Perhaps the most important aspect of this engagement will be in communicating the congruence of the ethical dimension of Islamic finance with broader sustainable finance, which can be done through explicitly linking the ethical dimension of Islamic finance with widely recognized standards such as the UN SDGs, and engaging with other market standards such as ESG ratings by external organizations.

NORTON ROSE FULBRIGHT

Combining ESG and Islamic finance principles in an index framework

Authored by S&P Dow Jones Indices
A Division of S&P Global

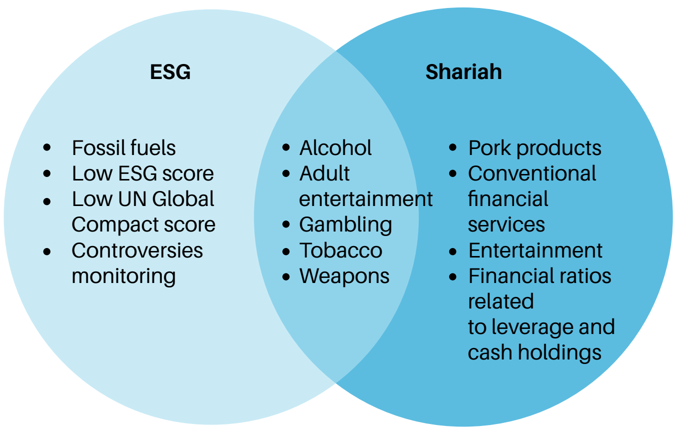
Islamic finance and environmental, social, and governance (ESG) investing are complementary in many ways and hold a number of shared principles. Though broader in nature, ESG strategies often exclude companies involved in such businesses as alcohol, tobacco and gambling that are considered Haram in the 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.

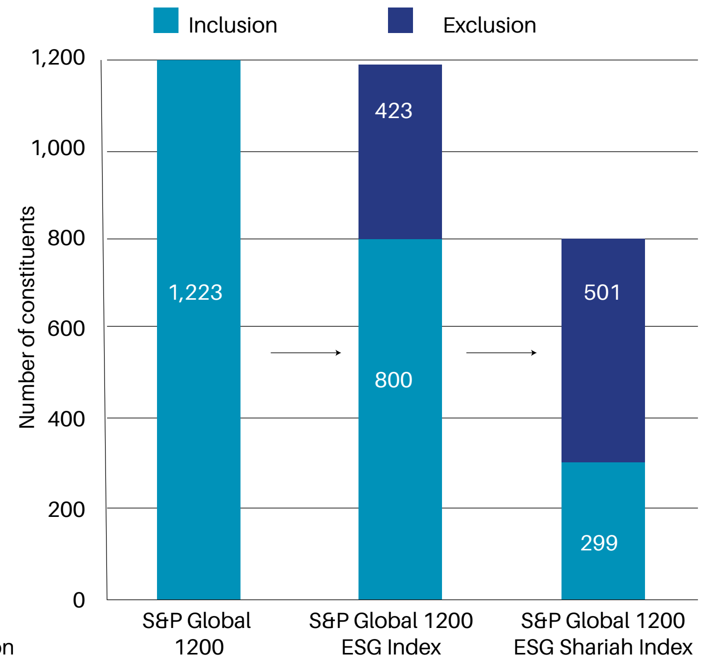
Step 3:
Rank companies by the S&P DJI ESG Score within each GICS Industry group.

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.

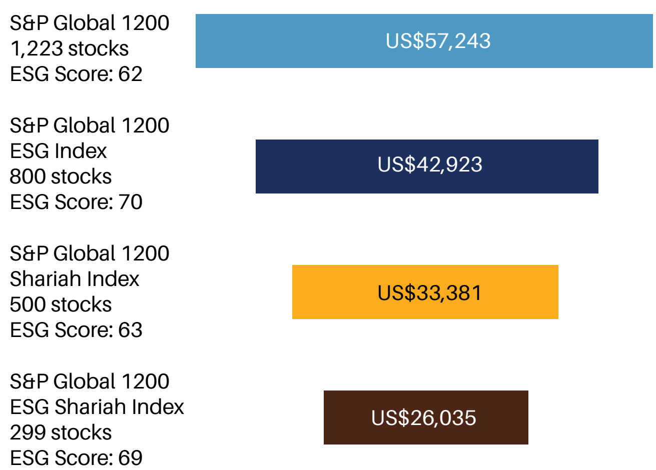
The S&P Global 1200 ESG Shariah Index — an overview

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

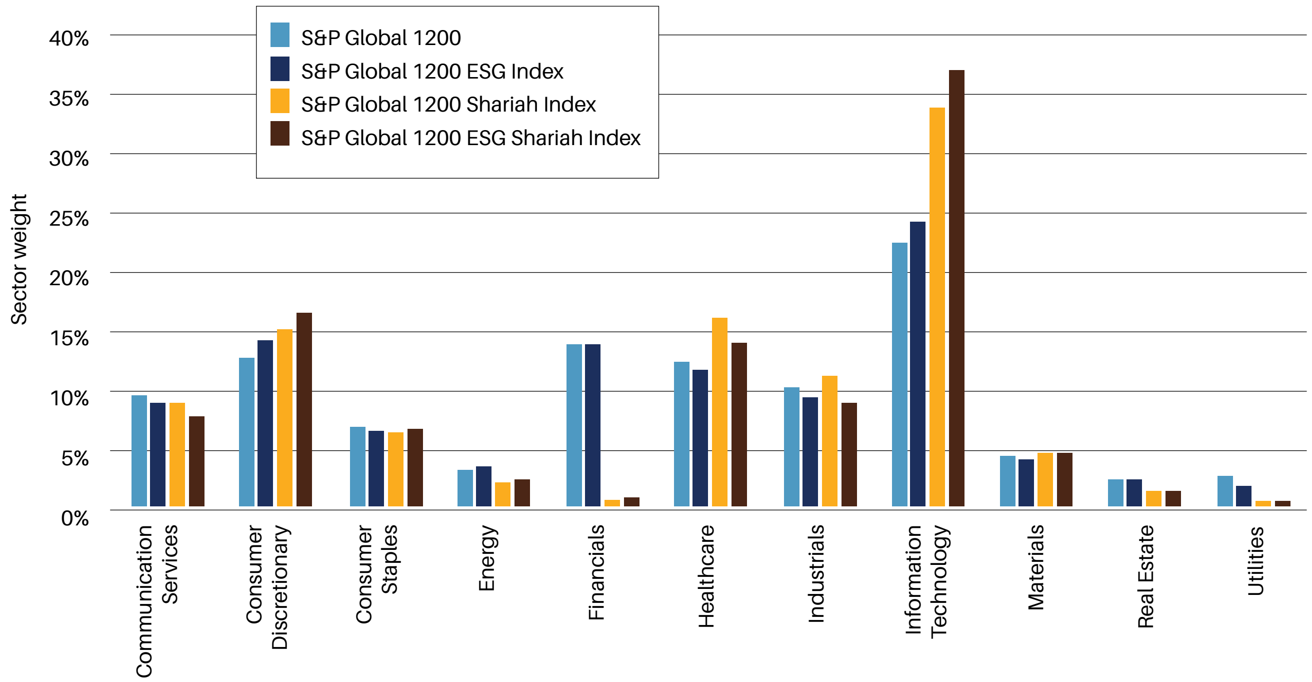
As illustrated in Figure 3, the application of ESG and Shariah screens results in a narrowing of the index universe, but also an increase in ESG performance. As of the 30th September 2021, the S&P Global 1200 ESG Shariah Index included 299 companies, representing about 45% of the market cap of the benchmark 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



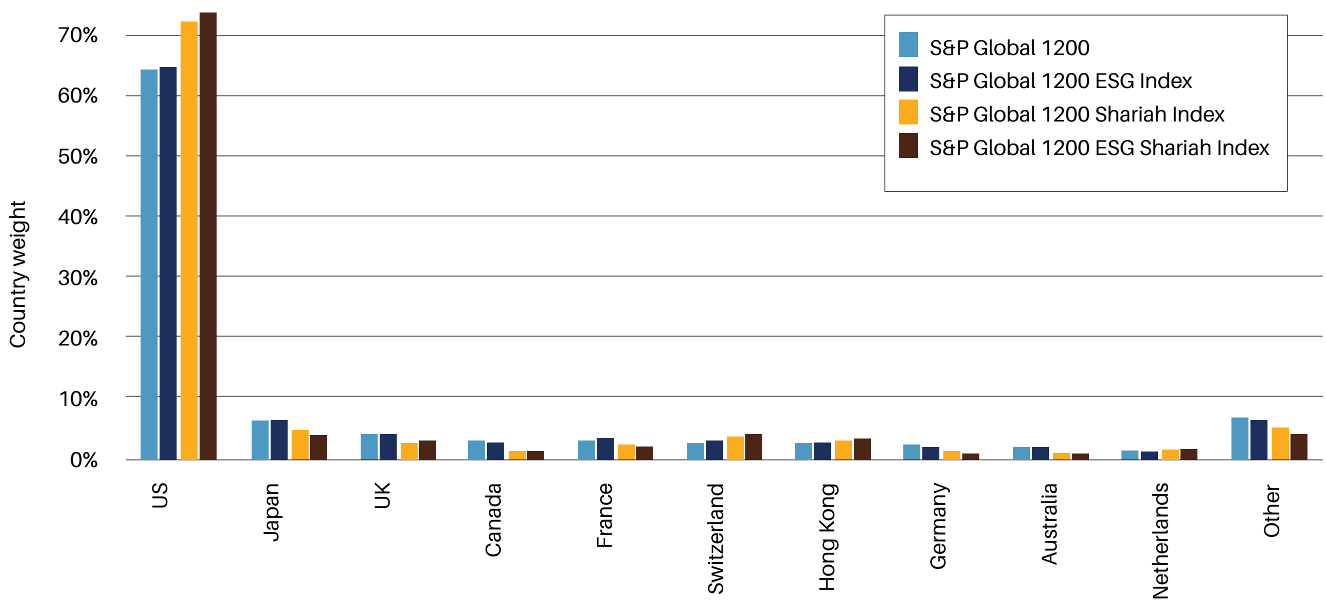
Source: S&P Dow Jones Indices. Data as of the 30th September 2021. Chart is provided for illustrative purposes.

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/.**

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.

Impact measurement, rating and exchange through IBF social cryptos

Authored by ibfnet

From the standpoint of investors, impact is an additional dimension in investment decision-making in addition to risk and expected returns. In the case of donors too, impact matters. A donor is typically connected emotionally and psychologically to the intended impact of his/her act of donation. Conventionally, impact is measured in the context of the the UN Sustainable Development Goals (SDGs). However, Islamic financing demands a broader framework of the goals (Maqasid) of Shariah (MaS). Available research demonstrates that there may be a significant degree of alignment between the two. Confluence is a platform introduced by IBF Net to bring together impact investors and donors and project owners with a revealed intention to make a positive impact on society.

Measuring impact

Any investment/donation can have a positive impact on society and the environment, but what distinguishes impact financing is the disclosed intention to make a positive social and environmental impact and then measuring the impact. Because intending and measuring impact is the distinguishing feature, the metric used is of critical importance. To help standardize measuring and reporting, the Global Impact Investing Network (GIIN), a non-profit organization dedicated to increasing the scale and effectiveness of impact investing, created the Impact Reporting and Investing Standards (IRIS), a catalogue of generally accepted performance metrics. IRIS is a catalogue of 621 generally accepted performance metrics. Impact investors use these metrics to measure social, environmental and financial results. IRIS is a free resource, and it provides a common language for the impact investing market. It makes it easier to compare both financial and nonfinancial investment performance. It also helps in accurately aggregating and analyzing results from a variety of impact investments.

Apart from GIIN, another serious attempt at developing environmental, social and governance (ESG)-based impact scores is by Refinitiv based on 450 metrics on ESG. ESG scores are currently being developed for companies in 76 countries based on official company disclosure on ESG metrics. While the two initiatives among several others involve fairly elaborate exercises at measuring the impact of projects and companies on the people as well as on the planet, the results may or may not be very relevant from an Islamic perspective.

Building an impact portfolio

Current practices and mechanisms relating to impact investments may be narrated as under the following steps (see Chart I):

1. The impact-conscious donor/investor donates to/invests in projects with potential impact.
2. Project invests in impactful projects (plantations/ambulance fleet/solar installations) and creates impact (carbon savings/ambulance miles/kilowatt hours).
3. Project monitors and measures impact and develops reports.
4. Project owner reports to donors/investors.

Table 1: Confluence of goals	
MaS: Protection and nurturing of:	**SDGs**
MaS1: Faith (Deen)	SDG16: Peace, Justice and Strong Institutions SDG17: Partnerships for the Goals
MaS2: Intellect (Aql)	SDG4: Quality Education SDG9: Industry, Innovation and Infrastructure
MaS3: Posterity (Nasl)	SDG11: Sustainable Cities and Communities SDG12: Responsible Consumption and Production SDG13: Climate Action SDG14: Life Below Water SDG15: Life on Land
MaS4: Property (Maal)	SDG8: Decent Work and Economic Growth SDG9: Industry, Innovation and Infrastructure SDG10: Reduced Inequalities
MaS5: Self (Nafs)	SDG1: No Poverty SDG2: Zero Hunger SDG3: Good Health and Well-being SDG4: Quality Education SDG5: Gender Equality SDG6: Clean Water and Sanitation SDG7: Affordable and Clean Energy

Source: IBF Net

The pain points from the donor's/investor's point of view are as follows:
1. There is usually a time lag between investments in or donations to impactful projects and the realization of the impact (eg plantation or ambulance fleet or solar installations).
2. Since the impact measurement tools are selected and employed by the project owner, there is a moral hazard problem in the form of possibility of bias and overstatement.
3. The investor-donor may have little control not only over the impact measurement tools and mechanisms, but also on the timing and quality of reports furnished by the project owner.
4. Usually, there is a certain degree of lumpiness with the donation/investment requirements (not finely divisible), ruling out the possibility for the impact investor-donor to create a well-diversified 'impact' portfolio.
5. There are rigidities relating to the desired impact creation; the impact-investor-donor is usually not in a position to alter the nature of the impact (say, change the desired nature of the impact from environment care to healthcare or to renewable energy)

Confluence: The Solutions Framework

Confluence is a platform introduced by IBF Net to bring together impact investors and donors and project owners with a revealed intention to make a positive impact on society. Phase I of Confluence measures the impact of project(s) from the standpoint of the MaS as well as the SDGs based on a broad set of metrics. Based on stakeholders' perception and available information with respect to the selected impact metrics, the platform generates performance ratings/scores for the projects. Phase II of Confluence allocates 'exchangeable' social cryptos to projects creating impact based on transparent objective criteria. It allows impact-deficit projects to enhance their ratings through the Impact Exchange by acquiring impact units in the form of social cryptos from impact-surplus projects.

Impact ratings

In a series of blogs, Dr Mohammed Obaidullah, the lead research economist with IsDB and the founder of IBF Net, writes extensively about the alignment or otherwise of the SDGs with the objectives of the MaS. A simple mapping of the MaS against the SDGs shows the high level of alignment or confluence between the two (see Table 1). The findings from such academic research are enhanced in the Confluence platform to develop a robust framework.

The Confluence platform identifies a set of metrics by adding to and revisiting available metrics to measure the SDGs (such as the IRIS and Refinitiv metrics) that objectively measure impact both from the point of view of the SDGs and the MaS based on research and text analytics. It then measures the performance of a given project using a relevant set of metrics; and then uses an algorithm to produce a rating score and/or a classification scheme. The rating for a given project reflects its relative performance against sector performance as a benchmark in terms of selected impact metrics. Where sector data is not adequate or unavailable, performance measure for the project is based on responses of stakeholders including the project owner. Ratings are placed on the blockchain and thus, are tamper-proof. These are shared with the market with continuity and enjoy complete transparency. The Impact Scoring Platform, besides being a stand-alone destination for investors/donors interested in obtaining an impact rating for projects, would also serve as a front-end application with crowdfunding platforms seeking to raise donations/equity resources. It can provide valuable data for Islamic donors and investors seeking to make a difference to the world while realizing their risk–return expectations.

Impact Exchange

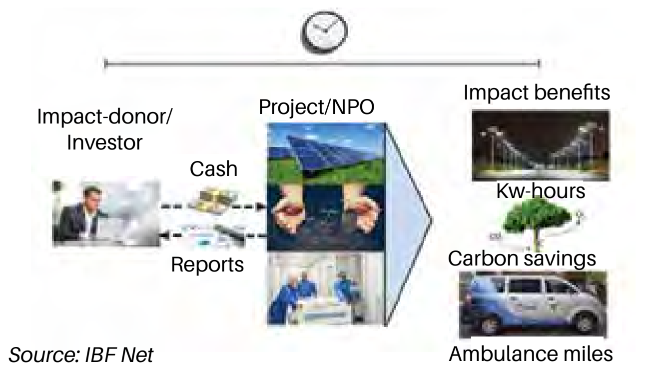
In Phase 2 of the project, given the availability of alternative tools for measurement of environmental and social impact (eg carbon savings), the Confluence platform identifies and adapts a suitable method for measurement and conversion of such impact into social cryptos. Projects can earn/liquidate such cryptos representing various types of impact at the platform that now serves as an Impact Exchange to alter their risk–return–impact profile for the market. This platform serves as a marketplace for exchange or mutual transfer of such cryptos, and enables donors/investors to build their own profile in terms of impact. How does Confluence take care of the pain points for the impact investor/donor as underlined earlier? The Impact Exchange mechanism may be described as the following:
1. Project is in the business of creating impact (existing plantation company or healthcare nonprofit organization operating a fleet of ambulances or solar installations)
2. Project provides verifiable data on impact to (or impact is directly measured by) third party (Platform: Impact Exchange)
3. Platform converts impact into cryptos using a metric (such as CO_2 savings or ambulance miles or kilowatt hours) and transparent accounting
4. Platform records impact on the blockchain in the form of cryptos (can no longer be tampered with or concealed)
5. Platform credits project with social cryptos in its social ledger
6. Donor(s)/investor(s) can now get the cryptos transferred to their accounts by making a payment of dollar-equivalent value to project, and

7. Such dollars are reinvested by project in the expansion of its impact-creating assets (new plants/ambulances/solar installations).

How pain points are addressed (see Chart II)

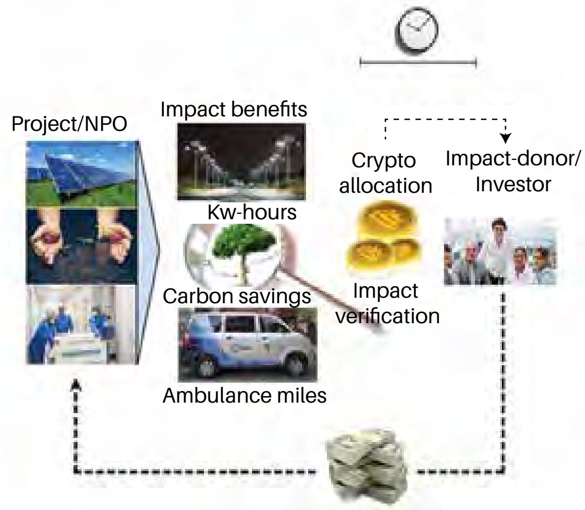
1. There is zero time-lag between donation/investment and impact, since impact creation precedes the donation/investment act
2. Impact measurement tools are employed by third party (platform) with no incentive to overstate/understate; project owner has little control over impact data generation (eg EID device on ambulance for tracking miles)
3. None of the stakeholders and players need to depend on reports provided by the project owner
4. Divisibility and granularity to impact assets is provided through social cryptos, and
5. Donor/investor can easily change the nature of his/her footprints across various sectors and design his/her preferred portfolio of impact-donations or impact-investments.

Chart I: Current practices and mechanisms relating to impact investments



Source: IBF Net

Chart II: How pain points are addressed



Source: IBF Net

Linking up with social cryptos

The two processes of impact rating and impact exchange are then integrated at the Confluence platform and provide a way for a firm/project to alter their impact rating. Projects that get a low rating after being subjected to the first process can acquire social cryptos to instantaneously improve their rating. Projects that transfer social cryptos from their account for cash will have no downward adjustment on their ratings, since they are bound by the condition to reinvest the same in similar projects (eg in new plantations or expansion of the ambulance fleet).

A major concern among Shariah scholars relating to cryptos is their possible abuse for speculation and gambling

Shariah perspectives on IBF cryptos

1. A major concern among Shariah scholars relating to cryptos is their possible abuse for speculation and gambling. Indeed, the concerns are not misplaced in the light of sharp volatility in the prices of cryptos in the private exchanges. Sold entirely based on expectations about steep after-market appreciation in prices, these tokens (mostly without any intrinsic value) have proven to be disastrous investments for the public. In order to examine a similar possibility in the case of IBF social cryptos, we consider two scenarios.
   a. One, where the social cryptos are transferred between the parties at a single rate with no change in prices ever possible. This is a non-commercial scenario in the context of donors with no intention to make profits from price appreciation. There is no buying and selling (of tokens) taking place — from a Shariah point of view — at negotiated prices between any of the parties, even while the transfer takes place through the Impact Exchange. Social cryptos issued against actual impact units measured in terms of agreed metrics carry a fixed and pre-agreed dollar-equivalent value. They will always be acquired and transferred at this value. There is no possibility of 'buying low and selling high' for any party, ruling out any profit whatsoever. The possibility of 'illegitimate' profits is just not there, since there are no profits to be made in the first place.
   b. Two, in this scenario, social cryptos are transferred between the parties at negotiated prices. In this case, the distinction between donor and investor disappears and the original donor is looking forward to making profits, even while it may plough back the same into the project leading to its expansion. It may be noted here that such profit-making would be similar to Waqf-making profits on their investments. Profits will be made only in the long term and not on the basis of short-term fluctuations in prices. Social cryptos are neither listed nor traded at any 'external' exchange, ruling out any significant volatility in conversion rates or a possibility of speculation or gambling. Social cryptos issued against actual impact units measured in terms of agreed metrics carry a fixed and pre-agreed dollar-equivalent value. Due to a clear benchmark for an 'intrinsic' value, they are always expected to be acquired and transferred around this value. There is no possibility of a purchase 'without any intention to take delivery' or a sale 'without ownership and possession of the object of sale or transfer'. The final conversion of cryptos to fiat money also takes place at fixed rates announced by the platform from time to time. Thus, the possibility of gambling on price volatility is completely ruled out here as well.

2. The social cryptos derive their dollar-equivalent value from a transparent accounting process based on the economic and technical life of the impact asset (tree/ambulance/solar installation) and its expected performance during its useful life. It is a notional value used for social accounting purposes only.

3. The use of social cryptos allows the parties to focus on 'impact' that is now measured in terms of impact metrics (carbon savings/ambulance miles/kilowatt hours). Hence, the donor/investor who cares about impact is encouraged to donate/invest more, as he/she clearly sees the impact even prior to making his/her donation/investment.

4. The use of social cryptos provides divisibility to impact assets (trees/ambulances/solar installations) and allows donation/investment in small amounts — of impact units (carbon savings/ambulance miles/kilowatt hours) — and thus, provides more ease and flexibility to the donor/investor. The donor/investor is no longer constrained by the lump-sum funding requirement that goes with financing a complete impact-making asset. Thus, there is a clear encouragement to impact creation through investment and/or benevolent and charitable acts in the line with the MaS.

Note that the Confluence project has been subjected to Shariah scrutiny by Amanah Advisors (UK) and observed to be Shariah compliant.

Use cases

I: IBF13 cryptos (carbon savings)

IBF Net and Yayasan Dana Wakaf Indonesia (Foundation for Islamic Endowment Funds Indonesia), popularly known as Green Waqf Indonesia, have entered into a landmark agreement under which IBF Net will create a digital portfolio out of green assets like trees planted by the latter on Waqf land in Indonesia and convert the carbon savings from these trees into green cryptos called IBF13 cryptos (number corresponds to the SDG). These cryptos reflecting real values to the economy will then be traded on the Impact Exchange created by IBF Net on the blockchain. The proceeds from the sale of the green cryptos will be channeled into fresh plantations.

The implementation of the agreement began with the plantation in Bogor, Indonesia where Green Waqf is planting about 10,000 tamanu trees on 100 hectares of Waqf land, with 50% of it under the management of the well-known Muhammadiyah organization, and the rest by various non-profit organizations. How much real value does a fully-grown tamanu tree brings to the economy? Tamanu trees reduce CO_2 in the air in two ways. First, every time biomass production goes through the photosynthetic process, plants absorb CO_2 as the main raw material along with water for this process. A mature tamanu tree with 100 kilograms of biomass production per year absorbs about 220 kilograms of CO_2 in the same year in addition to the general production of biomass similar to other trees for the growth of stems, twigs, leaves and so on.

The tamanu tree also produces fruits which contain high oil that can be used as a substitute for diesel from fossil fuels. There is a further reduction of CO_2 which occurs due to the replacement of fossil fuels by tamanu biofuel. Mature tamanu trees which can produce 50 liters of biodiesel per year will contribute to a reduction in CO_2 of 144 kilograms per year. The combination of both forms of reduction stands at around 300-plus kilograms of CO_2 per year, compared with just about 20–50 kilograms of CO_2 savings per year in the case of typical fully-grown trees. The financial equivalent of such benefits in the form of savings in social costs are estimable according to well-accepted methods. Based on years of research into various plantation alternatives, Green Waqf has identified tamanu as one that can provide maximum social benefits in addition to financial benefits in various forms through the sale of by-products for the Waqf. In the long run, the project targets around 14 million hectares of land in Indonesia for such plantations, which otherwise cannot be subjected to any kind of cultivation.

The issuance of the green cryptos is based on measurable social benefits from each tree that now has a unique digital identity. The cryptos allocated to a project on-chain, now available for sale on the Impact Exchange, may be purchased by existing or future projects with low 'impact scores' to improve the same. Projects can now rebalance their risk-return-impact profile.

The Confluence platform measures the impact of project(s) from the standpoint of the MaS as well as the SDGs based on a broad set of metrics

II: IBF03 cryptos (ambulance miles)

This innovation by IBF Net is motivated by Indonesian media reports about a severe shortage of ambulance services in the city of Jakarta. A surprising fact about DKI Jakarta as a province was that it has the smallest number of ambulances per hospital. Currently, Dompet Dhuafa Republika (DDR), a leading non-profit organization in Indonesia, operates a fleet of 17 ambulances to serve Jakarta and nearby locations. Under a proposed partnership, IBF Net offers to (i) tokenize the ambulance miles earned by DDR on its existing fleet of ambulances and (ii) tokenize every new ambulance that will be purchased in future to be part of the DDR fleet. This may lead to several possible outcomes.

The existing portfolio of ambulances of DDR can earn impact-credits in the form of 'ambulance miles' as they provide such services to the patients. These impact-credits can then be offloaded in favor of other organizations which make fresh donations against the impact-credits transferred to their accounts. These donations are ploughed back into the 'ambulance portfolio' to expand the ambulance services of DDR. The donating organizations can instantaneously improve their respective impact profiles through such an acquisition. They do not have to go through the rather lengthy (and perhaps less efficient and effective) process of actually setting up an ambulance service unit to create a footprint in the healthcare sector (SDG3). An organization without the specialized competencies required to efficiently operate an ambulance service can now create an impact in the healthcare sector.

IBF Net and DDR partner in the project with the following respective roles: DDR continues its healthcare/ambulance services provision as before, but undertakes to provide a 'digital identity' to each ambulance via fixing EID devices on each vehicle, closely monitoring the services in terms of ambulance miles and sharing this data with IBF Net at known intervals. It does what it is best at. IBF Net converts each ambulance mile earned by DDR into social cryptos and makes them available at its Impact Exchange.

A solution for the Islamic capital market

Islamic asset managers and investors currently incorporate Shariah-related concerns into the investment process using the tool of 'negative screening'. This is a type of investment strategy that excludes certain companies or sectors from investment consideration because their underlying business activities are not Shariah compliant or that have a negative impact on society and the environment. In the context of impact investment, however, there is a disclosed intention to make a positive impact from the MaS (and SDGs) standpoint and then measuring the impact. Because intending and measuring impact is the distinguishing feature, there is a need to develop appropriate metrics and measure impact from the standpoint of the MaS (and SDGs). The present solutions aim to fill in this important gap in the Islamic capital market environment.

The Confluence platform measures the impact of project(s) from the standpoint of the MaS as well as the SDGs based on a broad set of metrics. Based on stakeholders' perception and available information with respect to the selected impact metrics, the platform generates performance ratings/scores for the projects. Additionally, it also allocates 'exchangeable' social cryptos to projects creating impact based on transparent objective criteria. It allows impact-deficit projects to enhance their ratings through the Impact Exchange by acquiring impact units in the form of social cryptos from impact-surplus projects. By making available information to investors/donors on how a project may contribute to the SDGs as well as the goals of an Islamic economy in the form of the ratings/scores, this solution enhances informational efficiency of the financial system.

These solutions should further promote the adoption of Islamic finance principles in two major ways. They show the alignment between the noble goals of the Shariah and the UN SDGs, sending a clear signal about inclusiveness of Islamic finance and its relevance for the global community. Further, at the level of the Islamic investor, they mark a move from a minimalist strategy of Shariah compliance to a progression toward the noble Shariah goals of comprehensive human development.

Islamic social finance leading to Sadaqah Bangladesh account as a case study

By Ali Allawala,
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Background

There is a strong overlap between Islamic finance and the principles of environmental, social and governance (ESG) which we see today. For example, a key pillar of Islamic finance is being a good steward to society, the economy and the environment through the prevention of harm and attainment of benefits. There is an underlying sense of social justice by supporting activities that benefit society. As a result, Islamic finance does not invest in companies that deal with gambling, alcohol, weapons, tobacco, etc, due to their potential negative impact on the community.

There is also a strong drive toward the equitable distribution of wealth by putting money to productive purposes related to real underlying assets in the economy where risks and rewards are shared. The objective behind this is to promote job creation, financial inclusion and greater well-being.

Hence, adhering to the values of Islamic social finance, Standard Chartered Bank in Bangladesh has launched a deposit account for its clients with the underlying objective of supporting the local communities.

Identifying the opportunity

Through research, we have found that socially-inclusive finance is appealing to clients looking for ethical solutions. In Bangladesh, we saw an opportunity to develop sustainable products through which clients can directly participate in the social development of their communities. The current practice is comprised of generating donations which are collected and distributed mostly through informal channels. Also, clients face challenges in identifying the segments that are truly in need of such donations.

Developing the product

How about having a savings account which helps customers contribute toward society? This question led to the birth of the **Saadiq Sadaqah Account**. It is a Shariah compliant deposit account based on the principles of Mudarabah (profit-sharing). This account is designed to support the philanthropic objectives of Sadaqah (charity) leading to the sustainable development of society.

Through the Saadiq Sadaqah Account, clients can donate the profit earned on the account to the charity of their choice. We support various causes, such as female well-being, education for underprivileged children, climate change and healthcare, which lead to the sustainable development of society. Clients can select the charity of their choice at the time of account opening and thereafter the profit earned on the Saadiq Sadaqah Account will go to the pre-assigned charity's bank account automatically.

Charities and the social impact

The following charities were shortlisted for the customers to select where they would like the profit earned on their account to be donated to:

- Jaago: Education for underprivileged students, awareness-generating programs on climate
- Underprivileged Children's Educational Programme: Skill development for women
- Friendship: Women and child health, sustainable economic development (artisan employment), climate action
- Centre for the Rehabilitation of the Paralysed: Rehabilitation and support for the disabled, and
- PFDA: Skill development in autistic children.

The benefits arising from the Sadaqah savings account are also in line with the UN Sustainable Development Goals (SDGs) pertaining to SDG 1 (no poverty), SDG 3 (good health and well-being) and SDG 4 (quality education). This provides an efficient avenue for banks and clients to contribute toward the well-being of society through supporting children education, developing skills for women, rehabilitating the incapacitated and helping local artisans.

Therefore, we can say that the Saadiq Sadaqah account is not just a Shariah compliant account, but it also meets the intended objectives of Shariah (Maqasid Shariah) which are much broader and aims to be a good steward to society, the economy and the environment.

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Solution for liquidity management in the face of concerns over rising inflation: Shariah compliant IMMC by Al Waseelah

Cash is not always king

Holding too much cash is not just an issue for banks and insurance companies whose capital adequacy calculations are impacted by not holding the 'right' kind of investments. The overall returns of family offices and asset management businesses are impacted by the near-negative rates on offer for liquidity management solutions (after-costs are quite often negative).

There are of course very effective overnight cash management and 'redeposit' solutions in the market along the lines of DDCAP, Eiger and DepositBook. Issuers of short-term papers, which would be the convention solutions, are limited to the International Islamic Liquidity Management Corporation (the overwhelming dominant market participant) and the Central Bank of Bahrain.

Accessing these alternatives is not necessarily easy for small and mid-tier investors (whether insurance companies, banks or funds). This problem is exacerbated by the limited range of currencies available, primarily the US dollar and Bahraini dinar, as well as the limited to very short duration.

Market need and opportunity

In response to the aforementioned challenges and putting them together in the face of rising inflation, Al Waseelah created a Shariah compliant short-term certificate program called IMMC. Designed specifically to be multicurrency and with a duration of up to 18 months, IMMC offers a liquidity management solution through a combination of capital market infrastructure and technology to provide a customizable, positive yield treasury and liquidity management product.

Key elements of the solution are:

1. Positive returns — where do positive yields at the short end of the market come from? With a benchmark of at least 125bps over the relevant benchmark, IMMC the target is aggressive (compared with yields for other treasury instruments). This is achieved through back-to-back sale and purchase agreements in the supply chain. This covers ready-made garments, commodities as well as consumer goods. The demand for more short-term financing of the supply chain is growing (and banks are reducing their exposure). IMMC is a key participant in a growing number of markets and in 2022 will actively support the export markets in countries like Uzbekistan, Bangladesh and Indonesia.

2. Flexibility — IMMC issuances by Al Waseelah in 2021 extend to 360 days (and as short as 90 days) and as cross-currency solutions (euro, pound sterling and US dollar).

3. Expertise — the IMMC solution combines the expertise of Bedford Row Capital and the legal and operational platform which is encompassed within Al Waseelah. Bedford Row Capital has experienced supply chain capabilities (boots-on-the-ground expertise over four decades in supply chain management) as well as the capital market expertise to deliver the IMMC product to the market.

4. Technology and transparency — Al Waseelah has the benefit of technology developed by Bedford Row Capital called Bondstream. This technology, as featured in the IFN Fintech Landscape, offers a Shariah compliant product management architecture for the issuance of Sukuk. Specifically for IMMC, there is a dedicated dashboard available to investors which gives real-time exposure metrics to the constantly changing exposures which underpin each IMMC issuance.

Extending the liquidity management horizon

In 2021, the award-winning Al Waseelah Sukuk issuance platform will issue more than 12 instruments at various durations and currencies. These offer a new toolkit for treasury and liquidity management professionals. Alongside the current set of offerings, IMMC will continue to provide innovative solutions, including floating rate and direct, inflation-linked options. Shariah compliant investors need more options for positive returns at the shorter end of the market; Al Waseelah's IMMC joins a limited list of options for financial institutions to deliver to their liquidity management needs in 2022 and beyond.

Cagamas: Sustainability at its core

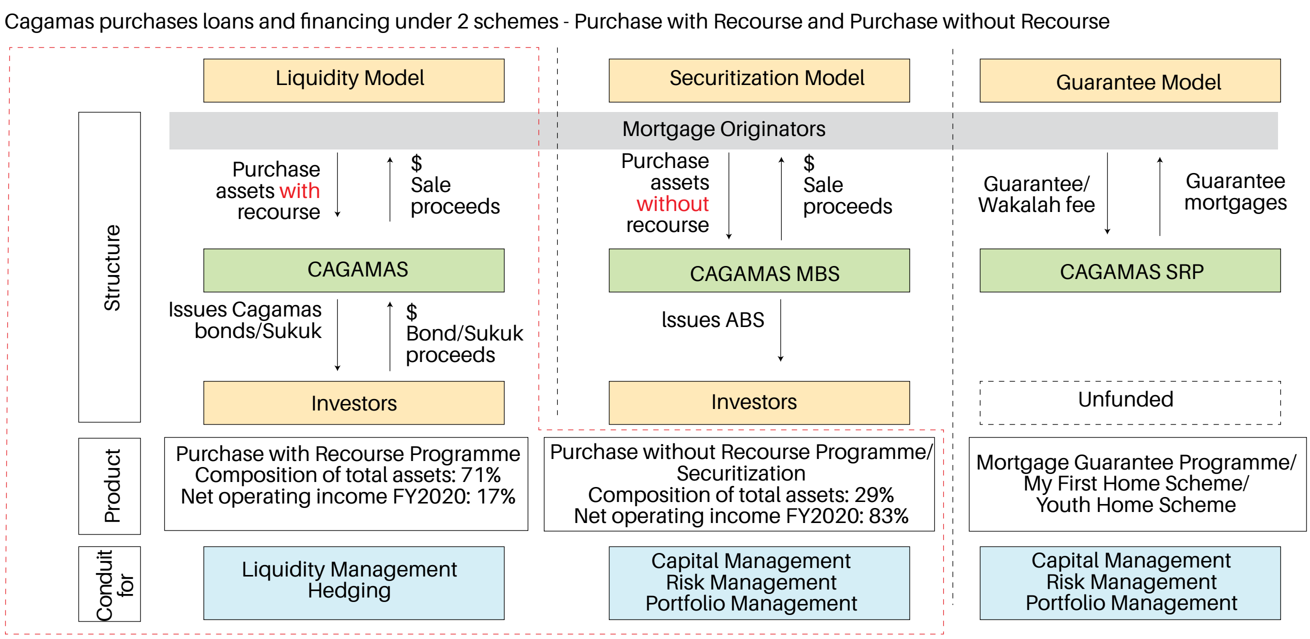
The Cagamas model: A global benchmark

Internationally recognized for its robust pioneering model, Cagamas, the National Mortgage Corporation of Malaysia, serves as a special vehicle to support the national home ownership agenda by supporting financial institutions with competitively priced funding from the capital markets. Cagamas plays a key role in promoting Islamic finance and developing the local capital markets through its regular bond and Sukuk issuances.

Cagamas primarily extends liquidity to financial institutions through its unique mortgage purchase mechanism, via its purchase with recourse product. The Cagamas model benefits both homebuyers and institutional investors and has been recognized by the World Bank as the most successful secondary mortgage liquidity facility undertaken by a secondary mortgage corporation.

Since its establishment in 1986, Cagamas has been an active issuer of corporate bonds and Sukuk to finance the purchase of housing loans and receivables from financial institutions, selected corporates and the public sector. It is rated 'AAA' by RAM Rating Services (RAM Ratings) and Malaysian Rating Corporation, and rated 'A3' by Moody's Investors Service, in line with Malaysia's sovereign rating.

Chart 1: The Cagamas model



*Assets acquired under PWOR are potential securitization asset at a future date   Cagamas Berhad

Source: Cagamas

Apart from the liquidity model, Cagamas has also undertaken mortgage securitization transactions as well as having built a successful mortgage guarantee model in its strive to promote homeownership.

Cagamas's capital market contributions cannot be understated. Through the corporation, Malaysia became one of the first in the region to establish a secondary mortgage market. Cagamas also spearheaded the growth of the corporate bonds and Sukuk market, which was largely absent prior to Cagamas's formation.

Today, Cagamas is Malaysia's largest issuer of corporate debt instruments in terms of total issuance size. As at the end of 2020, it had supplied RM339.5 billion (US$81.93 billion)-worth of investment grade corporate bonds and Sukuk. Since its inception, Cagamas has cumulatively refinanced housing loans and house financing in the secondary market amounting to RM171.2 billion (US$41.31 billion), equivalent to two million houses in aggregate as at the end of October 2021.

Sustainability in DNA

With its mission to increase affordable housing for Malaysians from the low- and middle-income brackets, Cagamas's operational model has always centered on sustainability. In January 2019, the corporation enhanced its sustainability core by launching its Sustainability Bond/Sukuk Framework (Cagamas Sustainability Issuance Framework, Framework).

A second opinion report was issued by RAM Sustainability to align the Framework with international standards. The Framework is an integral part of the broader Cagamas Group's sustainability framework.

The Cagamas Sustainability Issuance Framework reaffirms and deepens Cagamas's mission and raises awareness about the importance of sustainable development. It was formulated based on international best practices and supports four out of the 17 UN Sustainable Development Goals.

It outlines two social solutions: affordable housing and employment generation via SMEs; and five green solutions, namely renewable energy, energy efficiency, green buildings, low-carbon transportation, as well as sustainable water and wastewater management.

The framework consolidates important processes which embed sustainability into Cagamas's DNA, and also allows it to anticipate and manage risks in a structured manner. It also bolsters transparency with regards to the corporation's value creation as far as the society, environment and economy are concerned.

The framework guides Cagamas into the next chapter by embedding climate change mitigation and adaption attributes into its sustainability journey, as it continues to increase homeownership among Malaysians while supporting green and environmental-related initiatives, build sustainable developments and drive economic growth.

Investing in sustainability

Since the release of the Cagamas Sustainability Issuance Framework, Cagamas has made landmark offerings, raising the profile of the Malaysian capital markets, particularly within the Islamic finance sphere, and helping to place the country on the global map of sustainable finance. It is worth noting that the company's first official foray into the sustainable fixed income space has been through an Islamic finance route, demonstrating its commitment to developing Shariah compliant financial instruments as well as the natural affinity between Islamic finance and sustainable finance.

Its groundbreaking debut took place in October 2020: the company successfully priced issuances of ASEAN Sustainability SRI [Sustainable and Responsible Investment] Sukuk and ASEAN Sustainability Bonds, raising a total of RM200 million (US$48.26 million). The issuances consist of a three-year RM100 million (US$24.13 million) SRI Sukuk and RM100 million multi-tenured sustainability bonds. The proceeds from the SRI Sukuk were used to fund specifically the purchase of eligible Islamic financing for affordable housing while the proceeds from the sustainability bonds were used to primarily fund the purchase of eligible noncarbon emitting industrial hire-purchase receivables for SMEs that contribute to environmental sustainability.

Assigned the highest social benefit rating of Tier 1 by RAM Sustainability under the Cagamas Sustainability Issuance Framework, the immense positive response to Cagamas's maiden SRI offering underscores the latent demand, and commercial opportunity for ethical and sustainable Islamic financial instruments and bodes well for social finance.

Cagamas built upon this milestone with yet another SRI Sukuk offering less than a year later, which was again assigned a Tier 1 social benefit rating by RAM Sustainability. In August 2021, the company printed its first twin offerings of an ASEAN Sustainability SRI Sukuk and ASEAN Sustainability Bonds, totaling RM300 million (US$72.39 million) under the existing RM60 billion (US$14.48 billion) Islamic/Conventional Medium-Term Notes Programme, to mobilize funds to acquire Islamic financing and housing loans for affordable housing.

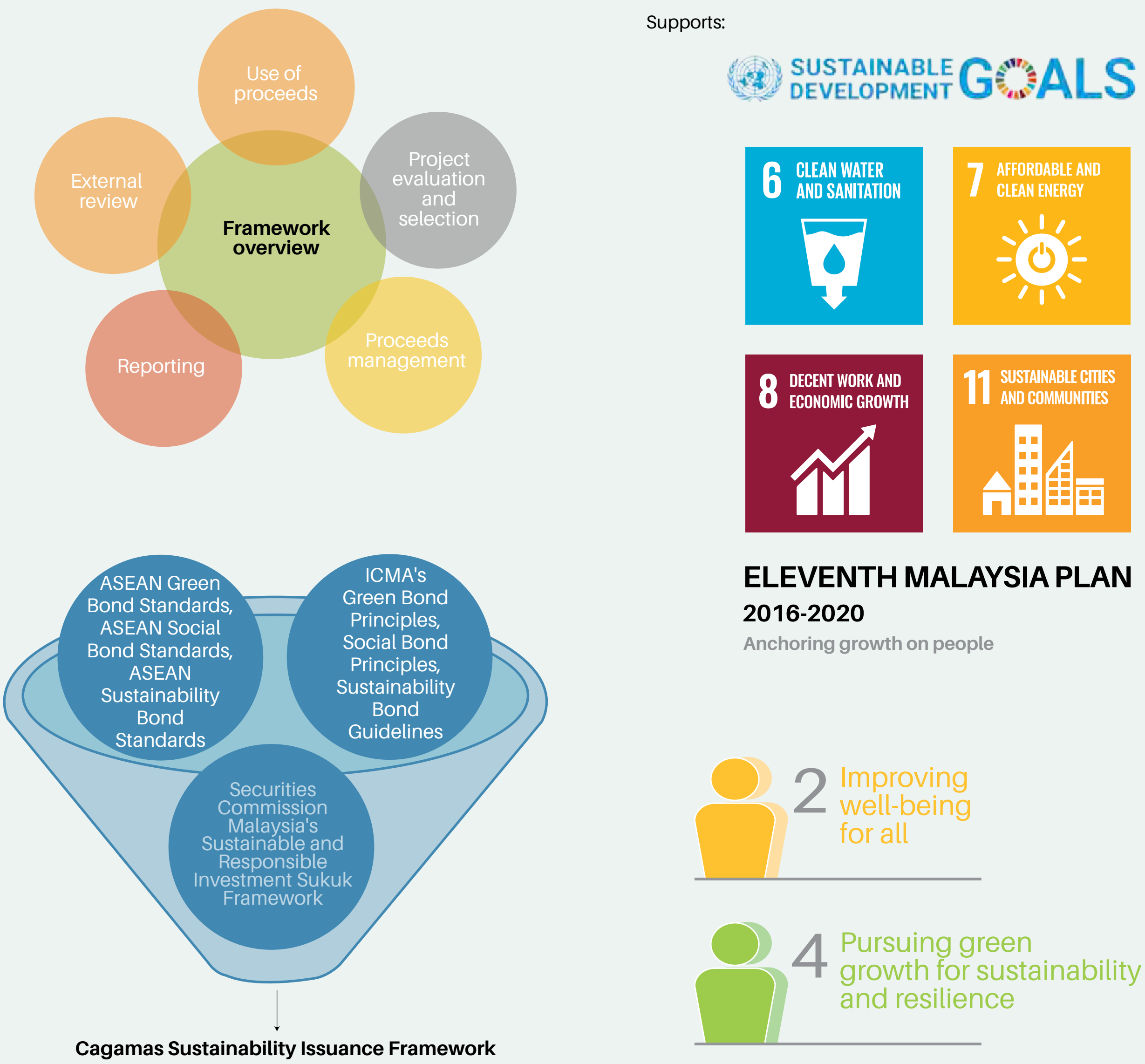
The corporation continued its sustainability momentum with a RM300 million (US$72.39 million) issuance, through a two-year ASEAN Sustainability Bonds offering in October 2021.

The continued success of the sustainability issuances strongly attest to the crucial role entities like Cagamas play to develop industry-led sustainable product offerings for the collective benefit of society. It also demonstrates how investors can efficiently deploy capital toward essential social needs without necessarily compromising on profits.

Moving forward

With the persistence of industrialization and the rise of unsustainable growth sweeping across the world at the cost of the environment and wider society, the private sector, governments as well as other

Cagamas Sustainability Issuance Framework



Cagamas's inaugural ASEAN Sustainability SRI Sukuk RM100 million (US$24.13 million) under RM60 billion (US$14.48 billion) IMTN/CMTN program 26th October 2020	
Issuer	Cagamas
Structure	Murabahah
Purpose of issuance	To fund specifically the purchase of eligible Islamic financing for affordable housing
Issue size	RM100 million – ASEAN Sustainability SRI Sukuk
Tenor	Three years
Annual profit rate	2.23%
Lead arranger	RHB Investment Bank
Method	Public book-building
Currency	Malaysian ringgit
Governing law	Malaysian law
Rating	'AAA/Stable' by RAM Ratings 'AAA_{IS}' by Malaysian Rating Corporation
Tradability	Yes under Scripless Securities Trading System

Cagamas's Multi-tenured ASEAN Sustainability Bonds totaling RM100 million RM100 million (US$24.13 million) under RM60 billion (US$14.48 billion) IMTN/CMTN program 27th October 2020	
Issuer	Cagamas
Purpose of issuance	To fund specifically the purchase of eligible non-carbon emitting industrial hire-purchase receivables for SMEs that contribute to environmental sustainability
Issue size	RM100 million – ASEAN Sustainability Bond
Tenor	One year | Two years | 2.5 years
Annual coupon rate	2% | 2.13% | 2.18%
Lead arranger	CIMB Investment Bank
Method	Private placement
Currency	Malaysian ringgit
Governing law	Malaysian law
Rating	'AAA/Stable' by RAM Ratings 'AAA_{IS}' by Malaysian Rating Corporation
Tradability	Yes under Scripless Securities Trading System

Cagamas's double issuances of ASEAN Sustainability SRI Sukuk and ASEAN Sustainability Bonds RM300 million (US$72.39 million) under RM60 billion (US$14.48 billion) IMTN/CMTN program 5th August 2021	
Issuer	Cagamas
Structure	Murabahah (for Islamic Issuance)
Purpose of issuance	To fund the purchase of eligible Islamic financing and housing loans for affordable housing
Issue size	RM100 million (US$24.13 million) – ASEAN Sustainability SRI Sukuk RM200 million (US$48.26 million) – ASEAN Sustainability Bonds
Tenor	Three years
Annual profit/ coupon rate	2.67%
Lead arranger	Hong Leong Bank
Method	Private placement
Currency	Malaysian ringgit
Governing law	Malaysian law
Rating	'AAA/Stable' by RAM Ratings 'AAA_{IS}' by Malaysian Rating Corporation
Tradability	Yes under Scripless Securities Trading System

Cagamas's ASEAN Sustainability Bond RM300 million (US$72.39 million) under RM60 billion (US$14.48 billion) IMTN/CMTN program 29th October 2021	
Issuer	Cagamas
Purpose of issuance	To fund the purchase of eligible sustainability assets for affordable housing
Issue size	RM300 million (US$72.39 million)
Tenor	Two years
Annual coupon rate	2.52%
Lead arranger	RHB Investment Bank
Method	Public book-building
Currency	Malaysian ringgit
Governing law	Malaysian law
Rating	'AAA/Stable' by RAM Ratings 'AAA_{IS}' by Malaysian Rating Corporation
Tradability	Yes under Scripless Securities Trading System

stakeholders play an instrumental role in redefining business practices for the positive benefit of economies. The financial sector in particular holds substantial power to mobilize funding for good and to bring mainstream attention to this collective cause.

Cagamas is cognizant of its national developmental role in providing liquidity in the secondary mortgage market to ultimately support homeownership and its strategic role in promoting green and social impact financing to facilitate the domestic transition toward more inclusive and green economic activities. The company's sustainability framework and ongoing efforts into sustainability issuances reflect its solid commitment toward a better world through ethical finance.

Cagamas

National Mortgage Corporation of Malaysia