



ESG and Islamic Finance: An Ethical Bridge Built on Shared Values

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Abstract: Environmental, Social & Governance (ESG) is a trending topic worldwide which is gaining a lot of traction due to its focus on social and environmental impact, as well as its relation to improved financial performance. Similarly, Islamic Finance, which is Shariah compliant, is also another concept that is expanding globally. These two concepts have many shared values and commonalities as they both tackle social development challenges. Nevertheless, there are several barriers and challenges in terms of integrating ESG in financial institutions, as it is a new concept. Many Islamic banks have already began promoting sustainability through their financing and initiatives years ago which puts them ahead in terms of ESG. There are still many barriers that need to be tackled in order to gain the best outcome from ESG integration and Islamic Finance, however, going forward combining Islamic Finance with ESG can be the future for a positive impact.

Keywords: ESG, Islamic Finance, Sustainability, Shariah Compliant, Impact.

JEL Classifications: O16, Q56, D25

1. Introduction

Responsible Investing, with a focus on Environmental, Social & Governance (ESG) elements and ESG integration in the investment process, is an emerging trend for financial institutions. ESG factors cover a wide spectrum of issues that traditionally are not part of financial analysis yet may have financial relevance. This might include how corporations respond to climate change, how good they are with water management, how effective their health and safety policies are in the protection against accidents, how they manage their supply chains, how they treat their workers and whether they have a corporate culture that builds trust and fosters innovation.¹ As ESG continues to grow, the first quarter of 2020 saw an inflow of US\$36 billion of ESG funds globally despite the market volatility caused by COVID-19. The biggest contributor for global ESG flows was equity products, at US\$20 billion, the second highest quarterly flow number in the past decade.²

The term ESG was first coined in 2005 in a landmark study entitled “Who cares Wins” by the UN Global Compact. ESG investing is a type of ‘sustainable investing’ which is an umbrella term for investments that while seeking positive returns, also consider and evaluate the long-term impact that business practices have on society, the environment and the performance of the business itself. Strong ESG policies and practices can protect brand reputation, help recruit and retain talent, foster customer loyalty and reduce the risk of lawsuits against companies.³

ESG is important because there are several financial benefits that correlate to companies that pursue a high ESG performance. For example, green investment funds and socially responsible investors are more likely to fund companies with good ESG scores. Also, studies have shown that portfolios with high ESG scores outperformed competing investments and experience lower cost of capital, less volatile earnings and lower market risk compared to low ESG companies.⁴



2. ESG key drivers

There is an increased focus on policy setting, implementation and showcasing accountability related to ESG and impact investing. Some key business drivers include increased customer demand, which is due to higher track records and lower risk levels. Another driver is the increased stakeholder demand (e.g. NGO's, industry bodies, regulators, government, raters). In addition to that, the increased focus of companies on integrated reporting (including the value creation process of the investment decisions), creates a push towards ESG implementation. Furthermore, there is a growing need to contribute to the global environmental and social debate and challenges as awareness towards the importance of such practices increases.⁵ Governments, exchanges, and regulators are also working to drive responsible business practices. Finally, studies show that ESG integration is linked to higher returns and lower risks. The Royal Bank of Canada Global Asset Management released its global ESG survey in 2017 which sought to better understand the views of institutional asset owners and investment consultants in Canada, Europe and the United States on the role that ESG considerations play in portfolio management. The top three drivers as identified by respondents that use ESG principles in decision making are: multiple factors used in investment decision process and not just financial factors (57%); clear value proposition (higher risk/return profile; 37%); and mandates from boards and other stakeholders (36%).⁶

3. Shared values between Islamic finance and ESG

Islamic finance shares similar underlying principles as that of sustainable finance, i.e. financial stability and economic growth, poverty alleviation and wealth distribution, financial and social inclusion as well as environmental preservation. This has therefore allowed for Islamic finance to capitalize on these similarities to become a natural vehicle to propagate the elements of green finance.

Although both approaches evolved in different cultural circumstances and separate historical periods, Islamic finance and ESG investing are complementary capital-raising and investment approaches with many shared principles, such as being a good steward to society and the environment. With many more similarities than differences, both offer products that serve Muslim and non-Muslim investors alike and both possess strong practices and policies that each can learn from the other.

An important pillar of Islamic finance is the prohibition of investments in certain industries, such as tobacco, alcohol, pork, pornography, weapons, gambling, human trafficking, and other products and activities that are deemed unlawful. Shariah compliant products are screened to avoid these industries, a practice that closely parallels ESG investing. Like investors in shariah-compliant products, investors using ESG investing strategies avoid certain activities and products, so their portfolios align with the values of the beneficiaries/clients, align with the goal of developing a sustainable and fair society, and do no harm to people or damage to the environment.

ESG investing strategies often assess the financial value of environmental, social, and governance factors and integrate that value into the investment analysis, decision, and process. Active ownership activities (i.e., company engagement and voting) may also be a part of ESG strategies, to mitigate risks, enhance returns, and improve ESG performance and disclosure of companies/issuers.⁷

4. Challenges and barriers

ESG is still a relatively new topic with no right or wrong way of integrating it, as it differs from company to company, as well as the absence of concrete frameworks for it. A lack of robust data is currently the biggest obstacle to ESG integration, however there are other challenges and barriers that companies face when it comes to ESG integration.



- Evidence of investment benefits: Despite the huge library of academic research and practitioners' research proving otherwise, many people still perceive that ESG integration means sacrificing performance because they believe that ESG integration is that the same as screening out companies and sectors from their investment universe.
- Understanding is low regarding the different ESG issues: The ESG criteria used to assess issuers, and what is considered to be good versus bad ESG performance. For example, one investor would agree that auto electrification may be good for society; while another investor may not agree as it requires more platinum, which suggests more mining and greater ESG risk.
- Materiality: Portfolio managers, ESG professionals, companies, and other stakeholders can have different definitions of materiality. Materiality can differ tons counting on the perspective; it's really within the eyes of the beholders. So, what could be material for the employees, could be quite immaterial for clients; what is truly material for the shareholders can be totally immaterial for NGOs.⁸

5. The role of Islamic banks in promoting sustainability through their financing

As ESG is becoming more important, many Islamic banks are promoting sustainability through their financing and initiatives. Examples of financing include Al Baraka Banking Group, which became the first bank in the West Asia region to officially sign the new Principles for Responsible Banking, which were developed through an innovative global partnership between banks and the UN Environment Programme Finance Initiative (UNEP FI). By committing to these principles, Al Baraka is also the first in the Islamic banking sector to do so. Al Baraka pledged \$197 million for 2019-2020 in support of renewable energy and energy efficiency projects in the bank's operating countries.⁹ Furthermore, Bank Islam Malaysia aims to expand its green financing book by another RM800 million in 2020, as the country's largest Islamic bank is set to increase the segment's revenue contribution to 20% by 2021 from 14% presently.¹⁰

In terms of green sukuk, in November 2019, the Islamic Development Bank (IsDB) successfully finalized a Sustainable Finance Framework and become the first AAA-rated institution to issue a Green Sukuk. Together with the European Investment Bank (EIB), IsDB signed a Memorandum of Understanding (MOU) to strengthen cooperation and committed €1 billion each in co-financing through to 2024.¹¹ Not only are banks issuing green sukuks, Majid Al Futtaim, a UAE-based developer and shopping mall operator, has hired banks to arrange a potential issue of U.S. dollar-denominated "green" sukuk.¹² This marked the listing of the world's first benchmark corporate Green Sukuk and the first Green Sukuk issued by a corporate in the MENA region.

Focusing on ESG as a whole, HSBC in Malaysia launched the first Environmental, Social and Governance ("ESG") Islamic Structured Product in the Malaysian market which is in line with Bank Negara Malaysia's Value Based Intermediation ("VBI") initiative. Essentially, the ESG-related Islamic Structured Product offered by HSBC Amanah provides customers the opportunity to invest in a product that matches their values when it comes to environmental and social causes.¹³

6. Where shariah compliant equities stand now in terms of ESG?

Research has been done by Refinitiv to find out where compliant stand in terms of ESG and the correlation between them. The data collected demonstrates that Shariah compliance screening can do much to improve ESG performance. ESG scores from Refinitiv's EIKON database of over 5,000 non-financial companies suggest a direct correlation between Shariah compliance and higher ESG scores. Shariah-compliant companies — to which Islamic financial institutions will direct capital — have ESG



scores that are on average 6% higher than for those excluded by the Shariah screening process. For non-financial companies, the difference rises to 10%. ESG scores for Shariah-compliant companies ranged from 3.0% higher for governance to 7.3% and 7.0%, respectively, for environmental and social issues.

Nevertheless, while screening for Shariah compliance can help identify many ESG issues, there are shortfalls in certain areas and geographies that can leave financial institutions exposed to unnecessary risk, particularly in emerging and frontier markets. It is possible that in emerging markets there is greater complementarity between Shariah and ESG screening methods, which would minimize the difference in scores, although Shariah screening in these markets does seem to positively impact social quality in relation to workplace issues and human rights. The research suggests that even if Shariah and ESG screening show some correlation, combining the two could improve overall risk-adjusted returns. This may occur whether the investment is in the form of equity held in listed companies or in the financing provided by an Islamic bank.¹⁴

Table 1. Shariah compliant vs. Not Shariah compliant equities' ESG scores

No. of companies	Type	Global	Environment	Social	Governance
6,554	Full sample	50.5	50.6	50.6	50.2
2,387	Shariah-compliant	52.3	52.8	52.8	51.2
4,167	Non-Shariah compliant	49.4	49.3	49.4	49.7
ESG Score Gap (Compliant vs non-Compliant)		5.9%	7.3%	7.0%	3.0%

Source: Refinitiv Islamic Finance ESG Outlook 2019 – Shared Values

7. How Islamic finance can aid with the battle against COVID-19

This year, the world was faced with one of its most challenging ethical and social dilemmas with the emergence of COVID-19, millions of people suddenly found themselves unemployed, broke and living in poverty. To address this, financial institutes partnered with preexisting Zakat funds for them to support those facing financial insecurity, as one of the main rules of Zakat is that it needs to be distributed within one year of it being collected, this urgent factor suits the nature of the pandemic. A successful example of such partnership is the one formed between UNDP and BAZNAS, Indonesia's national Zakat collection agency.

Another way for Sharia-compliant financial institutes to be supportive and beneficial during this time is for it to launch financing instruments that would allow business owners to continue functioning sustainably and avoid layoffs and closure, they can also run incubation and acceleration programs that would guide and invest in entrepreneurs through nurturing them and supporting their solutions to combat COVID-19.

Qard Hassan is one of the most convenient short-term financial vehicles, as it is a loan granted for welfare purposes where the borrower is required to repay the principle without interests. This could provide a way for individuals and corporations to function until the environment stabilizes.¹⁵

Waqf (endowment) is also another important contributor to the fight, dedicating financial and non-financial assets such as lands or buildings to social purposes or as a supporting mechanism to the needy



would create a long-term impact to the beneficiaries. For example, The Ministry of Justice in Bahrain has waived off the lease fees for three months to all their tenants as a way of supporting them during this pandemic

Furthermore, Social sukuk can be an important source for governments and organizations, by partnering with NGOs such as the UNDP, they can commit to long term funding of development projects. They can also use this instrument to support educational institutes that were affected by the crisis, as well as provide support to the health care industry that is in the front line of the battle, by seeking investors who are looking for social investments.¹⁶

Table 2. Islamic Finance instruments to help offset COVID-19 effects

Stage	Instruments	Features & benefits
Short term: Emergency support	Zakat	- Immediate disbursement - Poverty alleviation impact - Cash transfers
	Qard Hassan	- The borrower is required to repay only the principal
	Individual philanthropy and corporate giving	- Breadth and flexibility - Strategic impact
Medium term: Response & recovery Asset and trade financing		- Supports businesses and individuals in securing means of livelihood
	Impact investing	- Prioritizes the flow of private capital to businesses with social impact
Long term: Recovery & resilience	Sukuk	- Provide long term funding to governments and businesses
	Waqf endowments	- Provide permanent assets for sustainable social development

8. Conclusion

Overcoming the barriers and challenges related to ESG integration are one of the first steps to achieving a better ESG score. Some of the solutions include knowledge sharing and training for all staff, which improves awareness and understanding on the topic. Investment teams need to be thoroughly educated on the topic because they are responsible for making sure that ESG is integrated suitably, which includes understanding the company’s transparency regarding environmental and social practices. Additionally, a flexible ESG materiality framework can be developed, reviewed and updated overtime to cope with the changes of social and corporate governance norms, as well as environmental issues.

Evidently, Shariah compliance screening can do much to improve ESG performance as they share many commonalities. Nevertheless, combining the two could improve overall risk-adjusted returns. ESG integration and active ownership activities are less common in Islamic finance. Although a focus on social issues characterizes both Islamic and ESG investment approaches, environmental considerations currently seem to be less of a focus in the Islamic finance industry.

However, ESG integration and active ownership practices complement Islamic finance practices, and environmental issues are consistent with the fundamental principles of shariah. As Islamic investors pursue sustainable risk-adjusted investment returns, more are likely to integrate ESG factors into their



decision making and engage in active ownership activities to improve investment performance while aligning financial objectives with social and environmental goals. 14 Eventually, integrating ESG and Sharia-compliant practices will lead to improved societies and higher employee commitment as well as better financial performance.

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