ISLAMIC FINANCE AND SUSTAINABLE & RESPONSIBLE INVESTMENT (SRI)

ISLAMIC FINANCE AND SUSTAINABLE & RESPONSIBLE

Islamic finance is embedded on the principles of fairness, equality and ethics that lead to social well-being. It seeks social justice and economic prosperity for the society and encourages sustainable economic activity. Islamic finance is derived from fundamental requirements set by principles of Islamic law. Sustainable & Responsible Investment (SRI) shares a similar rationale. SRI is sometimes referred to as 'sustainable', 'socially conscious', 'mission,' 'green' or 'ethical' investing.

INVESTMENT (SRI)

Islamic finance could broaden its investor portfolio by connecting these overlapping core values it has common with SRI in order to access the large amount of SRI funds globally available today. In some markets, momentum is building toward realising the connectivity of Islamic funds with global SRI funds where the value of Islamic Finance and SRI stand at about US$3.7 trillion.

In 2014, climate themed bonds were estimated to total approximately US$502.6 billion globally (an exponential jump from US$174 billion in 2012). Estimates show that nearly US$10 trillion in cumulative capital investments will be moved towards low carbon energy alone between 2010 and 2020. Furthermore, over 1,300 signatories to the United Nations Principles for Responsible Investment (UN PRI) represent over US$45 trillion in managed assets (from US$4 trillion in 2006).

In relation to these figures, Islamic finance remains a niche area that can benefit from broadening its horizon to tap into socially conscious investments. This will appeal to and attract both Islamic capital as well as a wider global interest. Therefore, understanding the scope of SRI is pivotal for Islamic finance practitioners to match the segment opportunity available in the SRI space.

COMMONALITIES: ISLAMIC FINANCE AND SRI

Islamic finance and SRI have been two of the most rapidly growing areas of finance over the last two decades. During this period, they have each grown at rates that far exceed that of the financial markets as a whole. By some estimates, the total volume of Islamic financial assets has grown by 15 – 20 per cent a year and now exceeds US$1 trillion. In 2013, the total volume of assets held by explicitly SRI investors exceeded US$3 trillion, having increased by more than 30 per cent since 2005. In both instances, investors seek to achieve a strong return on their investments; and similarly, they also take into account social returns to society and not only pure economic return.

Ethical, equitable, social and sustainable investments are all synonymous to both Islamic finance and SRI, and global efforts have been made to integrate these commonalities. Examples among others include the UK Financial Services Authority which adopts a broad spectrum policy of fairness and justice, and similarly this policy has also been strongly endorsed for Islamic finance by the Islamic Financial Services Board (IFSB 2009b: Principle 1). Apart from the above, the UK based BMO Global Asset Management's F&C Responsible Shariah Global Equity fund which was launched in 2011, aims to achieve long-term capital growth through a portfolio of global equities and seek out companies whose products and operations are not felt to be harming the world, its people or its wildlife, and are considered to be making a positive contribution to society. Furthermore, sustainability is a key common factor between Islamic finance and SRI. A notable initiative is traced back to 2009 with Sustainable Asset Management (SAM), one of the leading asset managers in the field of sustainability investments, partnered with Gatehouse Bank to introduce the first ever Shariah-compliant water–focussed investment strategy.

SUSTAINABLE DEVELOPMENT

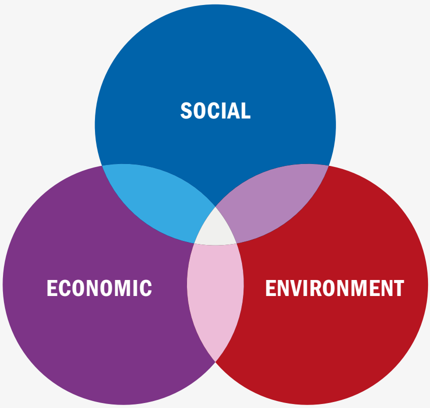

Diagram 1: Sustainable Development
Source: Adapted from *The Future of Sustainability: Re-thinking Environment and Development in the Twenty-first Century*, Adams, W.M.

SUSTAINABLE DEVELOPMENT

Sustainable development is a process whereby human development objectives are achieved through natural systems. This can be achieved by providing natural resources and ecosystem services upon which the economy and the society depends. Sustainable development is centric to the overlapping factors for both Islamic finance and SRI, which are the economy, the environment and social impact. Resorting to bearable social environments, equitable socio-economies and viable enviro-economies will result in sustainable models that will ensure the well-being of the society (*Diagram 1, left*).

There is a great need for convergence between businesses and social interests to:

- Promote shared values emphasising ethical and socially responsible conduct.
- Broaden inclusiveness to ensure benefits are fairly shared across society.
- Achieve sustainability and better living conditions through more efficient use of natural resources and public infrastructure.

Thus, sustainable investments which are a subset of SRI may very well serve as a viable platform for Islamic finance to grow its SRI portfolio. This is because through sustainable development initiatives, it is symmetric in meeting the objectives of both Islamic finance and SRI.

SUSTAINABLE INVESTMENT MARKET IN ASIA

In Asia, sustainable investments are robust and growing. Indonesia and Singapore lead the sustainable investments sector in the Asian Market with 39 per cent and 38 per cent Compounded Annual Growth Rate (CAGR), respectively. Hong Kong and Malaysia stand in third and fourth place with 24 per cent CAGR and 23 per cent CAGR17 respectively (*Table 1, below*). In the case of Malaysia, Shariah-compliant investing represents the largest part of their sustainable investment strategy.

SUSTAINABLE INVESTMENT MARKET IN ASIA (US$ MILLION)

ASIA	2011	2013	CAGR
Bangladesh	NA	14	NM
China	1,535	1,729	6
Hong Kong	7,328	11,329	24
India	153	115	-13
Indonesia	595	1,142	39
South Korea	6,288	8,426	16
Malaysia	9,956	15,087	23
Pakistan	427	505	9
Singapore	2,967	5,660	38
Taiwan	724	714	-1
Thailand	14	20	19
Vietnam	NA	195	NM

Table 1: Sustainable Investment Market in Asia (US$ million)
Source: Adapted from *Asia Sustainable Investment Review 2014 – Association for Sustainable & Responsible Investments in Asia*

GROWTH TRENDS OF ISLAMIC FINANCE

The Islamic financial industry has experienced robust expansion in the past five years, recording a 17.3 per cent CAGR between 2009 and 2014 (*Chart 1, below*). During this period, Islamic finance activities expanded to non-key Islamic finance jurisdictions. For example, in Africa, countries such as Senegal, Kenya, South Africa and Nigeria have all made progressive efforts to tap the Islamic finance market. Moving to Asia, countries like Bangladesh and the Maldives have also shown progress in growing their Islamic finance portfolios. More developed economies such as US; Europe and Singapore have also witnessed more Islamic finance activities in their countries. Notably, the recent expansion of the industry in the latter part of the last decade has spurred further growth and developed into a more competitive and resilient industry. Moving forward, the industry's assets are expected to expand further to US$3.4 trillion by end of 2018.

GROWTH TRENDS OF SRI

As shown in the Table 2 (*right*), globally, the proportion of SRI in relation to professionally managed assets has increased to 30.2 per cent in 2014, from 21.5 per cent in 2012. Among the fastest growing regions in these two year period are US, Canada and Europe. These two regions are also the largest in terms of assets, accounting to 99 per cent of global SRI. Islamic finance requires scalability. Penetrating the SRI and conventional market will provide the impetus to mainstream Islamic finance.

COMPOUNDED ANNUAL GROWTH RATE BETWEEN 2009 AND 2014

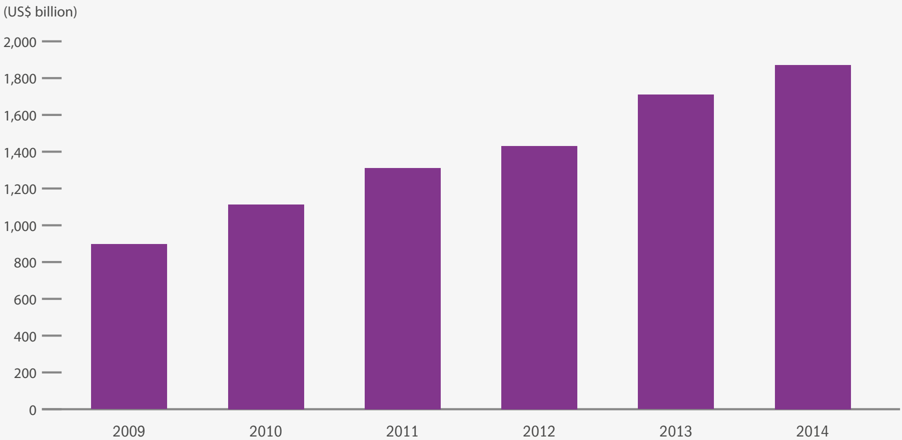

Chart 1: Compound Annual Growth Rate between 2009 and 2014
Source: *Central Banks, Annual Reports, Bloomberg, IFIS, Zawya, ISRA*

PROPORTION OF SRI RELATIVE TO TOTAL MANAGED ASSETS (PERCENTAGE)

Location	2012	2014
Europe	49.0	58.8
Canada	20.2	31.3
US	11.2	17.9
Australia	12.5	16.6
Asia	0.6	0.8
Global	21.5	30.2

Table 2: Proportion of SRI relative to total managed assets (percentage)
Source: Adapted from the *Global Sustainable Investment Review, 2014*

GLOBAL INITIATIVES – ISLAMIC FINANCE AND SRI

Recent years has seen great development, particularly in the capital markets, in both Islamic finance and SRI. Some key developments such as Social Impact bonds (SIB), Green Bonds and SRI Sukuk initiatives should be extended to further explore avenues in which these two sectors can converge.

SOCIAL IMPACT BONDS AND SUKUK

Social Impact Bonds (SIB) sees private investors invest capital and manage public projects, usually aimed at improving social outcomes for at-risk individuals, with the goal of reducing government spending in the long term. Governments will only pay out if projects achieve specific outcomes and investors are typically non-governmental organisations (NGOs), charities and foundations. For example, in 2010, Social Finance UK launched the first SIB with an oversubscribed fund of £5 million (US$7.57 million) to finance prisoners' rehabilitation program.

Similarly, in 2012, the state of Massachusetts, US, became the pioneer state to use a competitive procurement process to secure social innovation financing of US$50 million for social services from an allocated US$100 million SIB pilot scheme set up in 2011. On the sukuk front, the International Finance Facility for Immunisation (IFFIM) Company issued a US$500 million Immunisation Sukuk in November 2014. The proceeds are to be utilised for vaccination programmes under the Global Alliance for Vaccines and Immunisation (GAVI).

GREEN BONDS AND GREEN SUKUK

Green bonds are issued to raise financing for climatic change solutions and environmental causes. The first widely known 'green bond' was issued in 2007 by the European Investment Bank. These instruments were well received by SRI investors. The Islamic finance sector in Malaysia, as of last year, contributed almost 20 per cent or RM300 million (US$80.78 million) of the RM1.5 billion (US$403.9 million) financing for 120 projects approved by the Malaysian Green Technology Financing Scheme. The Green Sukuk and Working Party (GSWP) have been established by the Clean Energy Business Council (MENA), the Climate Bonds Initiative and the Gulf Bond and Sukuk Association (GBSA), to promote and develop Shariah-compliant financial products to invest in climate change solutions. However, it has yet to make its debut.

SRI SUKUK

To further promote SRI sukuk, key Islamic finance jurisdiction such as Malaysia has recently issued this type of sukuk. For example, in 2015, Khazanah Nasional Bhd through a Malaysian-incorporated independent special purpose vehicle (SPV) Ihsan Sukuk Bhd established a RM1 billion (US$225 million) SRI sukuk programme which was the first of its kind to be approved under the SC's SRI Sukuk Framework. Bursa Malaysia is also working with the FTSE to implement the FTSE4Good Index series based on companies listed on the Malaysian exchange. This ESG Index series is expected to attract US$3.4 trillion SRIs from around the world.

MOVING FORWARD

Central values in Islamic finance and SRI could be matched to optimise prospects for Islamic finance to tap a large pool of global SRI funds. Moving forward, greater interplay between these markets should be explored. Key stakeholders on both ends including financial experts, research centres, rating agencies, non-governmental organisations and even regulators should pursue ways to consolidate the connectivity of these markets.

Source: Securities Commission Malaysia (ICM Bulletin as of December 2015)

FREQUENTLY ASKED QUESTIONS (FAQS)

Fixed Income, Islamic Capital Market (ICM) and Sustainable Responsible Investment (SRI)

Q What are the essential differences between normal/conventional bonds and sukuk, Shariah-compliant bonds (Islamic fixed income instrument)?

A The essential difference is that conventional loans are defined as interest-bearing debt while Islamic fixed income instruments or sukuk, utilise sale and trade principles as a basis for financing (e.g. sale and leaseback, sale and buyback, agency). A conventional bond cannot tap the Islamic investor base, while a sukuk can tap the conventional and Islamic investor base.

There is no asset requirement for conventional bonds, while there is an asset requirement for sukuk. Finally, a sukuk issuer must be engaged in business activities which are permissible under Shariah.

Q What are the advantages of sukuk for issuers and investors?

A Issuers would be able to increase their recognition and awareness of their profile in Islamic-centric markets and tap a major source of funds for on-going and future capital raising exercises including equity financing. With sukuk, it will help to increase the exposure to new segments of investors around the world and be able to source funding through a new asset class.

For instance, in Malaysia, there will be a tax deduction on expenses incurred in the issuances of Sukuk Ijarah and Wakalah, which is extended until the year of assessment 2018.

Investors will be able to further diversify their fixed income exposure into a new asset class, which can lessen volatility while still performing similarly to conventional fixed income instruments. Their investments would be based on more acceptable approaches that are sustainable and responsible and may deliver comparable returns to conventional investments over longer periods (5-10 years).

Q When looking at equities, which class of investments is not Shariah compliant? For example, are conventional banks permissible investments?

A Generally, sectors which are precluded from investment include companies whose businesses are predominantly in conventional banking, insurance, gambling, liquor, weapons, tobacco, entertainment, and other activities deemed non-compliant.

In Malaysia there is a 5% benchmark limit for Shariah non-compliant business activity which cannot be breached. For share-trading, stockbroking business and rental from Shariah non-compliant activities, the benchmark limit is 20%.

(More on next page)

Furthermore, these companies must meet financial ratio benchmarks of 33% for cash over total assets and debt over total assets, whereby cash and debt will include only conventional cash and interest-bearing debt in the calculation.

Conventional banks are not permissible investments, given that the dominant business activity is interest-bearing deposits and debt.

Q What are the main advantages of ICM and what can it progress to, in the future?

A The main advantage of Islamic capital market instruments is that it has a wider investment base, as both conventional and Islamic investors can utilise them. As more companies seek for Shariah-compliant status to tap the wider investor base, the permissible investment universe becomes larger, providing a more robust selection of companies to investors seeking an Islamic investment approach.

For example, institutions in Malaysia like KWAP and EPF, have said that they will be introducing a Shariah-compliant EPF option for their members. Collective investment schemes like unit trusts and private retirement schemes (PRS) as well as takaful companies are also providing private sector demand for Islamic capital market instruments to meet their investors' and policy members' risk and reward appetites.

Q How do SRI and ICM have similar characteristics?

A Sustainable and responsible investment caters for both financial and societal objectives. Over time it has moved from negative screening to more proactive adoption of environmental, social and corporate governance (ESG) considerations in investment and business practices.

These have served to align risk and reward in a more sustainable manner. Islamic finance is a well-established component of responsible finance and is similarly rooted in a financial and social welfare orientation. This includes the promotion of risk sharing that fosters entrepreneurship and equitable distribution of wealth based on the real economy.

Therefore, Islamic finance also serves as an effective model for responsible finance. Responsible finance can evolve beyond finance's traditional role as a passive intermediary of funds to have the potential to enable and shape social outcomes.

Q How have various institutions in Malaysia implemented ICM into their compliance framework?

A Bank Negara Malaysia is promoting the wider integration of socially responsible principles through Islamic financial institutions (BNM Financial Sector Blueprint 2011) and proposing for Islamic financial institutions to disclose their Corporate Value-Intent as a measure of their performance and commitment towards value creation for stakeholders.

The Securities Commission Malaysia's proposed draft of the Malaysian Code on Corporate Governance 2016 highlights the significance of sustainability in strategic planning, board and management performance assessment and corporate reporting.

Bursa Malaysia is promoting sustainability reporting and disclosure by listed companies.

Other institutional investors are embracing the sustainability agenda in building true value in its investee companies.

Q How important is SRI and what will it mean for the future?

A Businesses have an impact on the environment and the communities around them. It is important for companies to assess their suppliers, partners and customers and develop a sustainability risk framework because it is the right thing to do and because not managing this issue poses a risk to the long-term viability and success of a business.

Similarly for an investor, more and more, the long-term stability and performance of an investment portfolio needs to take this same sustainability risk into consideration and identify measure and manage this risk effectively, together with the other investment risks, e.g. concentration risk.

Q What are ICM's current trends and in what area can ICM be leveraged on in the future?

A Infrastructure financing, with its focus on long-term and socially impactful considerations, is an area of finance that can be instrumental in filling the vast development needs of many emerging economies, with an estimated global funding demand of about US$57 trillion by 2030, or about US$1 trillion a year.

The sukuk market has been an effective avenue in bridging this financing gap. Since 2003, an estimated US$115 billion of infrastructure sukuk has been issued by more than 10 different countries, which has been vital in contributing towards the long-term development of these economies.

In Malaysia, the sukuk market has similarly been pivotal in supporting infrastructure financing, with Malaysia-domiciled infrastructure sukuk accounting for 79 percent of the issued global infrastructure sukuk in in 2015.

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