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RESPONSIBLE FINANCE REPORT 2015

THE EMERGING CONVERGENCE OF SRI, ESG AND ISLAMIC FINANCE

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Acknowledgment

The Thomson Reuters – Responsible Finance Institute (RFI) "Responsible Finance Report" provides an overview of similarities between all sectors within responsible finance (including Islamic finance) and outlines the need to develop and implement regulatory changes and standards that will enhance the availability and growth potential of all sectors of responsible finance. The report was launched at the inaugural Global Ethical Forum in Edinburgh — September 2015.

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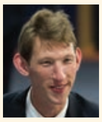

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Executive Summary

One of the fastest growth segments for responsible finance could be an approach where Islamic finance screens are combined with an ESG approach to create an opportunity that could grow to $244 billion by 2019. Responsible finance has been dominated by Western markets where it has grown dramatically but which should not overshadow the future growth potential in emerging markets. With a population of 1.65 billion Muslims, most of who live in emerging markets across the Organisation of Islamic Cooperation (OIC) countries, there is a significant opportunity from offering products which conform to their values.

The values that Muslims express when they are investing, however, have significant overlap with what is viewed as being 'socially responsible'. There are differences, however, but the biggest difference — the restrictions on companies that use significant leverage — could be used alongside ESG criteria to create a new form of responsible investing called 'prudent ESG'.

While there are many avenues for closer convergence between Western SRI and Islamic finance around shared values, the opportunity from prudent ESG demonstrates a clear tangible market that should attract both Islamic and non-Islamic investors.

For asset managers, the 'prudent ESG' approach can help build a bridge to their future growth which will be in emerging markets, including the many large Muslim-majority markets. The latent demand for prudent ESG in the 12 largest OIC markets is $23 billion by 2019, a figure which includes mutual funds only. Specifically excluded from this total are the assets of sovereign wealth funds which represent a source of significant potential upside to this estimate.

Viewing responsible finance as being wider than just SRI or ESG opens up possibilities to deepen the engagement between different segments of the market that would not otherwise collaborate towards expanding the market for responsible finance. The prudent ESG opportunity is just one relatively small but impactful example where collaboration can open up new markets geographically for responsible finance. It represents but a taste of the opportunity generated by engagement of a broader responsible finance industry.

The responsible finance industry represents a continuum of investors focused on impact and those focused on returns (including those whose focus on returns is derived from their fiduciary responsibility). This includes investors primarily focused on the impact their investments will have towards their priorities for social responsibility even if it comes at the expense of their financial returns. On the other end of the continuum are investors who are focused on maximizing their financial returns without compromising widely shared norms relating to environmental, social and governance that create negative impacts for others.

Along this continuum, there are multiple ways of operationalizing the values in day-to-day financial activities including investing, banking, insurance and charitable giving. Recognizing that the values that motivate people often lead to similar goals relating to creating public benefit and avoiding public harm should open all areas of the responsible finance industry to greater understanding of other sectors and more engagement towards common methodologies where it can help to boost the responsible finance industry.

>
Guests make their way though the atrium of the Emirates Palace Hotel in Abu Dhabi in the United Arab Emirates January 13, 2008. REUTERS/ Kevin Lamarque

> WITH A POPULATION OF 1.65 BILLION MUSLIMS, MOST OF WHO LIVE IN EMERGING MARKETS ACROSS THE ORGANISATION OF ISLAMIC COOPERATION (OIC) COUNTRIES, THERE IS A SIGNIFICANT OPPORTUNITY FROM OFFERING PRODUCTS WHICH CONFORM TO THEIR VALUES.

Connect

An aerial view of treetops and their reflections in a flooded area in Pathum Thani province, on the outskirts of Bangkok October 14, 2011. REUTERS/ Chaiwat Subprasom

Summary

1. Origins of Western socially responsible investing with Christian and Quaker opposition to the slave trade
2. Religious values drove the growth of SRI and recent efforts have added screening criteria in areas of the environment, and social or political concerns
3. Concern for the environment is the most clearly articulated area with overlap from secular and Western religions as well as other faiths like Islam
4. Broad framework for understanding all approaches to responsible finance is the concept of 'public benefit' which is more ingrained in Islamic teachings than commonly recognized
5. One can separate SRI and ESG based on whether intent puts impact or performance first, similar to Shariah-compliant or Shariah-based dichotomy in Islamic finance
6. Interest prohibition differentiates Islamic finance from other responsible finance but fits it well into conventional ideas of sustainable development

Introduction

Many professionals in Islamic finance believe the industry provides a good answer to solving the economic and social problems in the world. Many also see much in harmony with the largely secular socially responsible sector and recognize its faith-based history. However, not everyone in the Western world look at anything 'Islamic' with the same hopeful prospects but do look towards parts of the world where Muslims are the majority as areas for growth, whether these are emerging or developing markets. Correcting some of the misconceptions about the goals of Islamic finance and further illustrating the shared faith-based roots of the socially responsible sector and the parallels in belief that cross also into more secular conceptions of socially responsible or environmental sustainability can provide a way to bring the two sectors together.

In addition, Islamic finance brings a different perspective on sustainability that transcends the different asset classes and focuses on the wider economic activity that financial services enable. While much of the responsible finance industry has shifted towards viewing the investment criteria that make it 'responsible' as an addition that is added where it can be incorporated on top of financial criteria, Islamic finance puts the 'responsibility' at the center of the entire financial sector rather than viewing it as something that can be separated out.

Religious origins of Western responsible finance began with SRI

The Western origins of responsible finance begins with socially responsible investing, which in its earliest forms started within the Methodist Church and its opposition to the slave trade, smuggling and conspicuous consumption beginning from its origins in the 18th century. At the same time, the Religious Society of Friends (Quakers) began with protests against the slave trade which specifically barred people in leadership roles from involvement in the buying and selling of slaves.[1] The prohibition was extended to all Quakers in 1761 creating a full prohibition on religious grounds to an area of business that was at the time common practice.[2]

Through the 18th century and into the middle of the 20th century, the religious origins of investment screens were dominant and included, in addition to anti-slavery positions, movements that comprised of strong religious participation that emerged starting in the 1840s which focused on women's suffrage in the United States along with limiting alcohol consumption, profanity and gambling (the temperance movement).[3] However these were not directly involved in limiting investment activities or entirely done for the right reasons (the temperance movement

Big Ben and Houses of parliament in London, UK supported the women's suffrage movement in large part to advance its temperance policies).[4]

There were further efforts to improve working conditions and end child labor in the early 20th century which included the predecessor organizations to the Methodist Church officially adopting creeds that focused on these areas.[5] Since the middle of the 20th century, the specific areas of investment prohibitions were formed around many of these religiously-inspired values even as the socially responsible investment movement became more secular and adopted other screens reflecting a desire to avoid financing weapons including a specific blanket prohibition against nuclear weapons, cluster munitions and anti-personnel landmines. It also was involved in the struggle against the Vietnam War and against Apartheid in South Africa and more recently become involved with the BDS movement (boycott, divestment and sanctions) to increase pressure on Israel and Israeli companies to influence the government to improve conditions for the Palestinians.

These types of screens all share commonalities in that they revolve around affecting change by removing the financing from sectors that profit from what are believed to be socially detrimental areas. Beginning in the 1960s and 1970s, the social focus was broadened to include environmental issues primarily out of a social concern for the effects of human activity on the environment. It includes Rachel Carson's *Silent Spring* which catalyzed public understanding of the relationship between the environment and public health including in food production. Concerns about environmental degradation which only intensified after numerous environmental disasters raised public awareness. These included the Cuyohoga River Fire in 1969 which led to the first Earth Day protest in 1970 and the passage of the Clean Water Act in 1972, and the Love Canal environmental disaster in New York which persisted during the 1960s and 1970s (including evacuation of 950 families living nearby) that led to passage of the legislation that established the Superfund program. The Love Canal was added to the Superfund Priorities List in 1983 (and not removed 31 years later). Internationally, an event that catalyzed the development of the environmental movement was the gas leak from a Union Carbide plant in Bhopal, India in 1984 which killed an estimated 15,000 people living nearby.

But as the movement to restrain environmental degradation became more widely accepted, it was actually championed much earlier including by a U.S. President, Theodore Roosevelt, who was influenced by a three-day camping trip with conservationist John Muir in 1903 worried about "what will happen when our forests are gone, when the coal, the iron, the oil, and the gas are exhausted, when the soils have still further impoverished and washed into the streams, polluting the rivers, denuding the fields and obstructing navigation".[6]

Expanding to incorporate Islamic finance adds a new dimension to Responsible Finance

The discussion through this point has laid out the Western origins of the responsible finance industry that is rooted in SRI. To date, 96% of global SRI assets are based in North America and Europe. But the responsible finance universe should be considered much wider than just the historical traditions emerging from America and Europe (and from the Judeo-Christian tradition). The other major monotheistic religion, Islam, endorses many of the same ideas that have formed the basis of socially responsible investing.

The most commonly known prohibitions in Islam from the compiled list of areas where religious thought has focused is in activities that cause social detriment and that are prohibited activities for Muslims to be engaged in themselves as well as prohibited areas for them to be employed in: these activities include gambling, pornography, the production, and distribution or sale of pork and alcohol. Other areas that are excluded are the production, distribution and sale of tobacco products and weapons. While these are commonly excluded from investment, there is not consensus among religious scholars about whether there should be a prohibition for Muslims to use tobacco. On weapons, the consensus view is that the only permitted weapons are those for defensive purposes.

Beyond negative screening for investment purposes, Islamic beliefs call for ethical practices as a part of everyday life. The concept of vicegeren-

GROWTH IN RESPONSIBLE FINANCIAL ASSETS BY TYPE

	2012	2014	
Norms-based screening	3038	5534	35%
Negative/exclusionary screening	8280	14390	32%
Islamic Finance Assets	1350	1660	23%
Islamic Funds Only	57	60	3%
Positive/best-in-class screening	999	992	0%
ESG integration	5953	12854	47%
Islamic ESG Funds	0	0.3	na
Sustainability-themed investing	70	166	54%
Impact/community investing	86	109	13%
Corporate engagementand shareholder action	4589	7045	24%

Source: Thomson Reuters IFG, Global Sustainable Investment Alliance and author's calculations
Note: Islamic finance assets are as of 2012 and 2013 from the Thomson Reuters State of the Global Islamic Economy Report 2013 and 2014-15.

cy (khilafah), where all human beings are God's 'stewards' on earth[7] and are responsible for the balanced attainment of spiritual and material needs, started gaining currency in the Muslim world post-colonial independence and remains a pillar of modern Islamic Economics, which is trying to build out a framework of equitable distribution of resources based on the concept of vicegerency and other Islamic principles. Islamic Economics, however, still remains marginal to more pragmatic Islamic financial practices.

The environmental ethics that have not yet been incorporated into modern Islamic finance, but which could be, have also been expounded by modern Muslim thinkers, for example Persian philosopher Professor Seyyed Hossein Nasr's philosophy focuses on the idea that the European Enlightenment was accompanied by a shift toward "an anthropocentric order that places human beings at the center and gives them free reign, in the absence of a connection to any higher order, to exploit nature". In his opinion, this makes environmental degradation not just a crisis of the physical environment but also of the spiritual variety as well and an importance is placed on recognizing the spiritual dimension that will make its remedy more durable because it will "become [a] matter of spiritual rather than just fashionable significance".[8]

One example which demonstrates the concern in Islam for environmental sustainability is one aspect of the architectural design of the Süleymaniye Mosque in Istanbul which was completed in 1558 CE (the same feature was also used in the Sultan Ahmet Mosque which was completed in 1616 CE showing continuity in the design

"...BUT THE RESPONSIBLE FINANCE UNIVERSE SHOULD BE CONSIDERED MUCH WIDER THAN JUST THE HISTORICAL TRADITIONS EMERGING FROM AMERICA AND EUROPE (AND FROM THE JUDEO-CHRISTIAN TRADITION). THE OTHER MAJOR MONOTHEISTIC RELIGION, ISLAM, ENDORSES MANY OF THE SAME IDEAS THAT HAVE FORMED THE BASIS OF SOCIALLY RESPONSIBLE INVESTING.

focus across generations). Both mosques were designed so that the aerodynamics pushed the smoke into a chamber where the soot was collected and used for making ink and the clean air flowed outside. The design had sustainability built into the mosque's physical structure.[9] The sustainability ethic that is embodied in architectural designs like this is well established in Islamic jurisprudence that goes back to judicial reasoning (ijtihad) originating from the second Caliph 'Umar Ibn Al Khattab that, in the words of contemporary Muslim thinker and Emeritus Professor of Mechanical Engineering Salim Al-Hassani, "rationaliz[es] the exploitation of resources in ways which do not compromise the welfare of the generations to come".

The efforts to create awareness around "Islamic environmentalism" in more recent years has adopted similar practices as advocated by secular environmentalists but has framed the impetus for their actions in Islamic teachings. While there is not evidence to support or reject Professor Nasr's contention that concern for the environment will be taken more seriously if it is framed in spiritual terms, there has been advocacy that has specifically grown out of spiritual concern for the environment.[10]

One of the important theological underpinnings of the Islamic finance industry that could help incorporate things like environmental ethics into the industry as a whole is the distinction made between what may be permitted of individuals and what is prohibited for Islamic financial institutions. Islamic finance standard-setting body the Accounting and Auditing Organization of Islamic Financial Institution's (AAOIFI) Shariah standard on Corporate Social Responsibility (CSR), in defining the basis for the standard, explains that Islamic jurisprudence (fiqh) defines right and wrong in terms of a dichotomy between what is permissible and what is not permissible/not recommended which define what is 'just' and what is 'unjust'. It follows, according to the AAOIFI Shariah board, that "because IFIs are a collective religious obligation (Fard Kifayah), the definition of right and wrong are sometimes of a different nature than those that apply to individuals. This is because IFIs have a special religious and financial position in society".[11]

Their special place in society is as a result of the connection to and impact on their stakeholders and the AAOIFI standard puts, in effect, a 'comply or disclose' requirement on Islamic financial institutions in a broader way than what is commonly understood. In the operations of Islamic financial institutions, they are "perform[ing] the obligations that individuals cannot perform themselves" and also because of their role in collecting resources from their depositors and allocating towards projects, "[t]he example set by IFIs has an impact on other individuals, institutions and organizations".[12]

The Islamic financial institutions' religious obligation to act on behalf of its stakeholders in a way that is not just not 'wrong' or 'unjust' but also "encourag[es] the right type of behavior" provides a wide berth for these institutions to expand into other areas of responsible finance, and may compel them, too, within the guideline beyond what they can bear.[13] The challenge in the current practice of Islamic finance is that the theological arguments have focused primarily on defining and cataloguing the specific practices and activities that are prohibited while paying much less detailed attention to areas where financial institutions can act to encourage what is right (e.g. environmental conservation, good labor and social practices and increasing financial inclusion).

Shared concepts of public benefit support greater connection between Islamic and other responsible finance

An important source of theological support for the fiqh around financial transactions is the concept of maslahah which can be generalized as public interest and more specifically "maslahah has the same meaning as benefit and interest, which Islamic law tends to achieve for humans by way of protecting the five basic values; religion, life, intellect, lineage, and property".[14] An instructive example of one of the screens in common between Islam and other faith-based responsible finance screens that remains used even in the secularized SRI sector is the prohibition of financing alcohol production.

The Islamic perspective is in the form of an absolute prohibition of alcohol consumption, production and financing which was shared in some early Christian faith-based movements that were part of the temperance movement (which reached its apex with the imposition of Prohibition in the United States in 1920 under the 18th Amendment until it was repealed in 1933 by the 21st Amendment). While the SRI sector has moved away from being driven by religious beliefs, the screening methodology used by many SRI investors includes either a prohibition of financing the production of alcohol or limits to only 'responsible' producers of alcohol. An example of this type of screening methodology is illustrated by investment company Alliance Trust's Sustainable Future funds' position which relates its perspective on the social welfare argument for limiting its participation in financing alcoholic beverage companies:

> "While alcohol is consumed and enjoyed by a large percentage of the population, the excessive consumption of alcohol, sale to underage drinkers and irresponsible marketing of products can have negative social and health impacts. Companies selling alcohol must take steps to mitigate these impacts through responsible policies and practices."

As a consequence, they will "only invest in alcohol companies that have policies and practices to address responsible marketing, consumption and sale of their products".

For one of its funds, the Alliance Trust UK Ethical Fund, the screen is stricter and excludes all companies that "derive >10% of turnover from the production, distribution and/or sale of alcohol products".[15] This is very close to the *de minimis* screen employed in Islamic finance that allow investment in companies with up to 5% of their revenue from impermissible sources (for example, airlines that sell alcohol). And beyond the differences in thresholds used, the rationale used to reach similar conclusions is based on the common thread of a concern for public benefit, despite being formed on the basis of different conclusions.

Extending the use of public benefit to connect responsible finance

The connection for Islamic finance and other responsible finance sectors can be built around the concept of maslahah to recognize shared methodologies which are discussed in more detail in the next section. But rather than beginning the conversation looking at what is being done in common, it can start with the endpoint of what is responsible finance trying to accomplish. From this, it can guide how the various sectors approach what one another is doing and how they can be improved.

One commonality that is a starting point and would probably be undisputed by most of responsible finance is that a positive goal would be to work towards supporting economic growth that is more inclusive than it has been historically.[16] For example, the UN Development Programme describes how it can be thought of as a "human development approach [that] integrates the standards and principles of human rights: participation, non-discrimination and accountability".[17] This is similar to the basis for maslahah (protecting religion, life, intellect, lineage, and property) combined with the Islamic perspective on accountability which "flows from the vicegerency principle and denotes that individuals will be accountable to Allah for all of their actions on the Day of Judgment".[18] One connection that can be established between the concepts of maslahah which is connected with public or social benefit and the concept of vicegerency (which is often invoked to support environmental preservation) is the idea that environmental degradation is not just a violation of humankind's position as caretaker of earth, but the impacts from degradation can have negative impact on social welfare. These effects can be felt as damage to other people's life, property or intellect (e.g. environmental contamination can poison water sources, destroy agricultural property as well as causing birth defects and premature death).

Similar arguments could be applied in the context of more traditionally recognized responsible finance sectors as being the basis for many of the positive screening techniques used to broaden the impact of SRI. The shift is reflected in some ways through the change in the names used from socially responsible (which focused primarily on avoiding socially detrimental activities) to sustainable, responsible and impact investing (which focuses on a much wider scope including more environmental preservation and a greater focus on inclusive economic development).

Belief-based or belief-compliant finance

A separate area with similar methodology but different reasoning is the integration of environmental, social and governance factors into financial analysis. The reason for the distinction between SRI and ESG investing methodologies is one of intent: investors in SRI have an affirmation that they want to support more sustainable, responsible and impact investment goals. ESG investors, while they will have an impact on achieving the goals of SRI investors, are not motivated as closely with the goals as they are "motivated by economic imperatives and [see ESG as] a risk-analytics tool aimed at capturing the effects of environment, social and corporate governance considerations on the risk-adjusted return of portfolios".[19]

A similar shift (from considering negative screening criteria) towards trying to affect a positive change from using positive screens is beginning to occur within Islamic finance (and accompanied by, though not always integrated with, the use of ESG financial analysis). However, efforts are at a very early stage which makes it especially important to develop an ongoing connection with other forms of 'responsible finance'. Just as there are differences in motivation between SRI and ESG investors, as well as specific language used to distinguish and characterize their level of methodological rigor and substantive authenticity, there is a similar effort within Islamic finance to define the same forms of rigor and authenticity, albeit in very different terms.

In Islamic finance, the terms that are used with some judgment are 'Shariah-compliant" which is offered in contrast to more 'ideal' products that are "Shariah-based". The difference between compliance with and basis in Shariah refers in some way to the intent that the person viewing the transaction ascribes to the motivation of the person who structured a transaction. For example, if the perception is that the product was designed to create an equivalent risk-return outcome (to conventional finance) while working around Shariah restrictions, it would be described as being merely Shariah-compliant while if the goal in designing the transaction was to advance some aspect of Shariah (like the idea that return should be more closely linked with risks borne through profit-and-loss sharing), it would be described as "Shariah-based". In Islamic finance today, the dominant products are those that are Shariah-compliant, not Shariah-based.

This distinction on the basis of intent can be seen in the distinction between ESG and SRI where the dominant form in today's responsible finance industry is ESG. A similar analysis can be applied as with Shariah-compliant/Shariah-based in that the intent around ESG is to build existing products around additional considerations with the goal creating a product as close to the 'normal' products as possible within the bounds of ESG criteria. In contrast, SRI investing is designed to have a specific agenda of creating an outcome (sustainability and impact in a responsible framework focused on social responsibility) where replicating an equivalent risk-return is not always the primary concern.

How Islamic rules on financial transactions lead towards sustainable development in a market economy

In addition to the overlapping areas discussed above and in more detail in the next chapter, there is an additional goal of Islamic finance that has received more attention than the other 'responsible' areas and that is the prohibition of interest (which is often used interchangeably with the Arabic term riba, meaning 'increase'). The prohibition of riba in Islam is quite clearly defined although all of the specific types of riba (specifically as it relates to contemporary finance) has not although from a relatively simple perspective, the definition of riba as interest works well enough, particularly when framed in the context that is in the Qur'an of being similar to trade, but different in that trade is permitted while riba is prohibited.[20]

The concept of how riba is unjust is based on the different forms of riba from the classic money-lender who doubles the amount due in exchange for extending the time until maturity, to differences in quantities exchanged in barter transactions

at one point in time, to the well-known Hadith (a saying of the Prophet Muhammad) commanding the exchange of high quality dates for cash which can then be used to purchase lower quality dates rather than exchanging unequal amounts. There is not an exactly equivalent connection between the Islamic prohibition of riba with conventional understandings of regulation of market transactions although some academics have argued that in many situations where easy-to-see exploitation is present, the prohibitions that emerge are similar to ideas about fair dealing and allocative efficiency and Pareto optimality.[21]

Two other concepts are widely referenced in Islamic jurisprudence relating to financial transactions: gharar and maysir. The latter, maysir, refers to gambling which is prohibited but also to transactions that share some of the economic characteristics of gambling in that transactions are zero-sum games where one party's gain is solely at the expense of the other. The former, gharar, is not as easy to explain but can refer to prohibition of excessive contractual uncertainty in transactions and may be best demonstrated through a simple example of the conventional insurance contract which is prohibited on the basis of gharar.[22] The problematic aspects of conventional insurance is that neither party knows the outcome of the contract (how much will be paid and received) because neither party knows whether the loss will occur and, if it does, how large it will be. In addition, the actual compensation may be less than the amounts paid by the insured and, in life insurance in particular, there is not a fixed contract period and neither party knows when it will end.[23]

Put into combination, the ideas behind the prohibitions of riba, gharar and maysir combine to favor an economic system in which transparency, 'mark to market' trading and contractual certainty are favored and where no party is able to take unjust advantage of informational asymmetries to deprive others of gains from trade. Beyond just the transactional perspective, there is a concern for the less well-off through an encouragement of voluntary charity (sadaqa) as well as mandatory alms-giving (zakat) based on an individual's wealth above a certain minimum level (nisab). Additional areas of concern are expressed by the economist Zubair Hasan who states that sustainable development would entail:

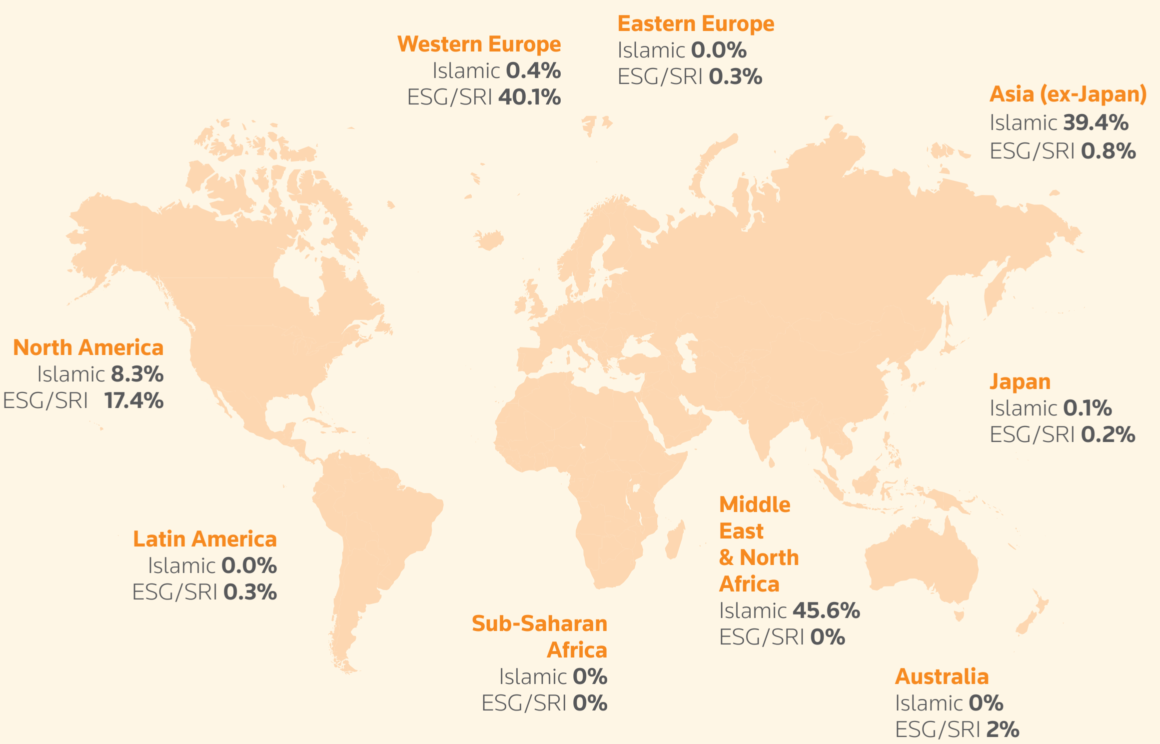
> "a sustainable rate of growth implies that the pace of development should be slower than it presently is [to] help conserve resources, lower pollution and improve distribution. Emphasis on temporal equity would demand a more even spread of resources, prosperity, and environmental damage over time. The notion implies putting the brakes on consumerism and expanding credit card culture i.e. borrowing from the future to spend now. Again, focus on environmental sustenance would eventually help in conservation of resources and may improve also the intergenerational distribution of incomes".[24]

He notes that this conventional explanation of sustainable development that he lays out "is largely in consonance with the maqasid or objectives of the Shari'ah [and because] Islam is a universal religion [it] addresses the entire mankind not [Muslims] alone".[25]

Connecting the dots

This chapter has spanned quite a bit of time in history and various traditions that provide the basis for understanding the underlying notions of what 'responsible' finance should be. There are remarkable similarities around ideas that we refer to as 'sustainable development', 'social welfare', 'efficiency' and 'Pareto optimality' that emerge from Christian movements in the 19th century, Islamic jurisprudence and secular concepts of 'social responsibility'. This similarity is not just theoretical but as the next chapter shows, is borne out in specific methodologies used by the SRI, ESG and Islamic finance sectors and can provide a starting point for convergence in the Responsible Finance Industry.

GROWTH IN RESPONSIBLE FINANCIAL ASSETS BY TYPE



Global
Islamic **5.8%**
ESG/SRI **36.3%**

Global Emerging Markets
Islamic **0.4%**
ESG/SRI **2.6%**

Source: Author's analysis of Thomson Reuters Lipper data
Note: Only mutual fund assets are included in this analysis

Converge

REUTERS Kieran Doherty

SUMMARY

1. Shift in screening methodologies has occurred to avoid stigma that responsibility puts a drag on performance
2. Need to find a balance between increasing scale and achieving tangible impact from responsible finance
3. Shift from responsible investing to responsible finance aligns values across a greater share of our financial activities, something which is already commonplace in Islamic finance
4. A common focus across all the SRI, ESG and Islamic finance sectors is the focus on norms-based screening which will be important in finding a common base for convergence
5. The overlaps between Islamic finance CSR screens and SRI/ESG norms-based screens could be used to start the dialogue
6. ESG investor entrance into key Islamic finance markets could provide support for stronger disclosure requirements, greater transparency and better corporate governance
7. Islamic leverage screens could boost performance as ESG investors become more involved in emerging markets

Introduction

Once the similar goals were laid out in the previous chapter it became apparent where some of the easily identifiable overlaps are between Socially Responsible Investing (SRI), Sustainable, Responsible and Impact (SRI) investing, Environmental, Social and Governance (ESG) analysis and Islamic finance. This chapter presents a more in-depth exploration of the overlaps between the various approaches as well as an exploration of some of the challenging areas relating to whether competitive financial performance is a requirement or a preference in the various areas of SRI, ESG and Islamic finance.

A starting point

From the previous chapter, the conventional sense in which 'responsible investment' is used is in context of a linear progression from early investors who wanted to create something socially responsible to the responsible investors of today where ESG is viewed as an integrated part of the financial analysis process. In this type of analysis, the success of the SRI sector has been to move towards greater quantitative precision with how the financial impact of ESG factors affect companies' bottom line. The ethics underpinning the desire to do so remain the same—people are still motivated by the underlying concerns about the ethical intent of responsible finance but its implementation has become divorced from its intent.

Even the shift from socially responsible investment which is a very normative way of characterizing the industry towards sustainable, responsible and impact investments has shifted the mindset towards what is being done rather than why it is being done. This has allowed the use of ESG screens to become adopted by a much wider segment of the financial and investor community, although it retains a large focus in the investment sector from which it emerged.

The sector base (in investments) for SRI reflects the origins of responsible finance which was people acting on their beliefs through avoiding financing activities that they believe to be detrimental to individuals, society or the environment.. Most of the development in the past couple of decades has been to remove the stigma of SRI investing from perceptions that by limiting the universe of permissible investments, it acts as a drag on performance. This is largely responsible for the shift towards the screens being embedded in financial analysis. For example, significant portions of the literature, particularly those related to ESG are focused on the performance aspect. A white paper on this shift from SRI to ESG released by American institutional investment firm Commonfund begins with a performance-related lede:

> "Thoughtful investment professionals continue to debate whether a portfolio's long-term performance can be enhanced by including environmental, social and governance (ESG) considerations in the security selection process".[26]

This opens up an important point about convergence, which is that it is impossible to be everything to everyone. Weighing the tradeoffs –the costs as well as the benefits—from taking a primarily performance-based methodology (we consider ESG factors because they let us unlock otherwise hidden value) rather than a values-based methodology (we do certain things because we believe they are right) is an important process of convergence. It forces balancing scale versus impact, something that is further pushed into the spotlight when impact investing is put alongside socially responsible and ESG investments. The most important thing that should come out from this part of the discussion is not that one way is better than another, but that there are truly differences which cannot be overcome that are based on deeply held beliefs about the role of investment on social change.

Stepping outside the issues around the impact versus performance realm moves into another area that is important for consideration: what responsible finance can do to advance other forms of financial intermediation. Until this point, the discussion in this chapter has focused solely as if responsible finance was limited to investments only, which would constrain investors' power to affect change through all of one's financial activities, not just through their investments, their pensions and the investments of the non-financial sector (for example, university endowments) and government sector which may be invested on their behalf.

This focus on investments ignores some of the most important financial relationships that most people have—the one with their bank that not only provides a safe place to save money and access credit, but also finances many areas of the economy using in large part the assets of the public depositors. While there is attention to the activities that banks finance, it tends to be specific to individual projects, for example influencing banks as part of the supply chain that was driving deforestation.[27]

Expanding the concept of 'responsible investment' to 'responsible finance' incorporates the role that the same principles behind responsible investment can play in other areas including banking, capital markets (not just by the end investors but by the investment banks that arrange bonds or public offerings). It also lays the groundwork for the inclusion of Islamic financial services in the 'responsible finance' rubric because this industry is primarily built around banking—assets of Islamic banks are 73% of total Islamic finance assets.[28] Even in the conventional (non-Islamic) banking sector, building out 'responsible finance' can add a huge asset base to increase the impact of responsible finance since banking assets represent about $70 trillion (45%) of global financial assets which totaled $156 trillion in 2013.[29]

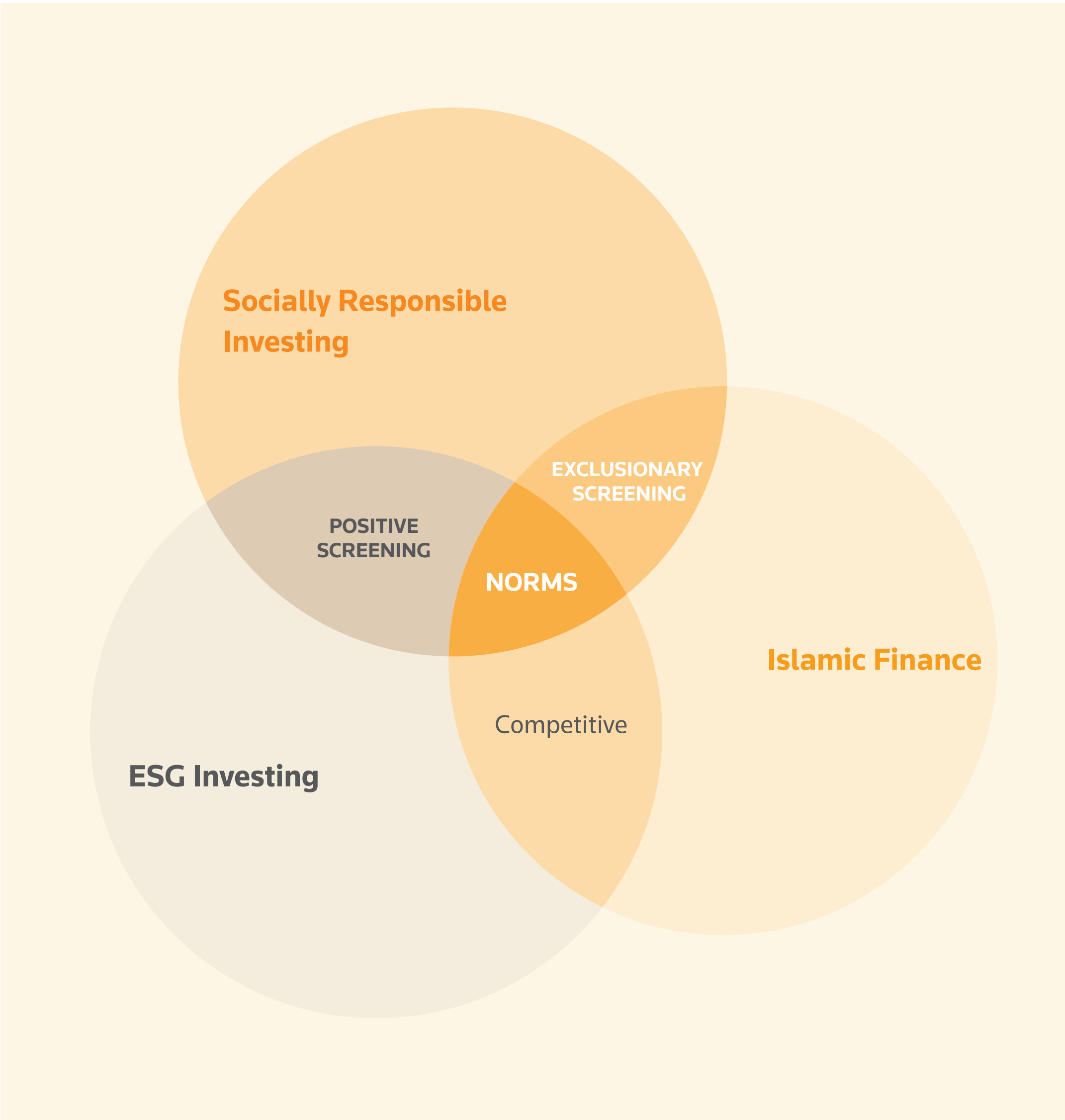
Broadening the mandate of responsible financial services from investments to finance can provide the starting point for analyzing what different sectors are doing today and where their efforts overlap which will necessarily be the starting point for further analysis into how they can begin to converge.

> The Solar Impulse 2 is seen taking off at the Mandalay international airport March 30, 2015. REUTERS/ Soe Zeya Tun

To put the areas of greatest overlap, consider a simplistic diagram of how the different sectors relate to one another in today's practice of SRI, ESG and Islamic finance.

What this diagram shows is the primary areas where there is some convergence between how the sectors act in practice, not necessarily where their values are entirely in alignment. The starting point would be the area in the center (norms) which is the clear area of overlap but also the area where there are the biggest perceived differences. Islamic investors, it is quite widely believed, have different perspectives on what sort of 'norms' are appropriate for the world and for corporate and investor behavior.

It is hoped that at least in some areas, the preceding chapter has challenged this conventional belief. Muslims, just like any other large population, are diverse in their beliefs but when it comes to investing, they share many of the same concerns about the activities they want to avoid (either in their financial activities or in their personal behavior). In addition to these common areas which are primarily negative screens—**listed in the table on the left**—there is significant theological support for and rising awareness of the need to broaden the scope of the screening activities into ESG areas.



COMMON SCREENS EMPLOYED IN RESPONSIBLE FINANCE

	SRI	ESG	Impact Investing	Islamic Finance
Norms-based Exclusions				
Alcohol	✔			✔
Animal testing	✔			
Climate Change	✔			
Ozone depleting substances	✔			
Deforestation	✔			
Genetic engineering	✔			
Non-sustainable infrastructure projects	✔			
Intensive farming	✔			
Weapons	✔			✔
Narcotics	✔			✔
Tobacco	✔			✔
Gambling	✔			✔
Pornography	✔			✔
Nuclear power	✔			
Highly indebted companies				✔
Companies with high liquid assets				✔
Companies with high interest income				✔
Best-in-class				
Social	✔	✔		
Environmental	✔	✔		
Business Ethics	✔	✔		
Labor Standards	✔	✔		
Human Rights	✔	✔		
Corruption	✔	✔		
Corporate Governance & Executive Compensation	✔	✔		
GRI reporting and transparency	✔	✔		
Global health	✔	✔		
Political donations	✔	✔		
Tax avoidance	✔	✔		
Advocacy & Engagement	✔	✔		
Community investing				
Microlending funds			✔	
Impact investment			✔	
Social Impact Bonds	✔	✔	✔	
Green bonds	✔	✔	✔	

In addition to the negative screens already in place and the ESG standards, Islamic finance has developed a specific set of standards which cover specific areas of financial services.

COMMON FINANCIAL RATIO SCREENS FOR ISLAMIC INVESTMENT

	% of Market Cap	% of Assets	% of Equity	% of Revenue
Debt	33%	33%		
Interest-based debt	33%	33%	82%	
Debt + Liquid Funds	50%			
Accounts Receivable	33% - 49%	33% - 45%		
Receivables + Cash		50%		
Liquid Assets		33%		
Cash + Interest-Bearing Securities	33%	33%		
Interest Income				5% - 10%

Source: Adapted from Table 2 (Shariah Quantitative Screens) in Ho, Catherine SF, Nurul Afiqah Abd Rahman, Noor Hafizha, Muhamad Yusuf and Zaminor Zamzamirn. 2011. "Comparison of Quantitative Shari'ah Compliant Screening Methods," *ISRA International Journal of Islamic Finance*, Vol. 3, No. 2.

In addition to these considerations for financial transactions, Islamic finance has a set of norms-based standards relating to Corporate Social Responsibility.

IDENTIFYING ESTABLISHED PRINCIPLES FOR NORMS-BASED SCREENING: ENVIRONMENT

AAOIFI Corporate Social Responsibility Standard and UN Global Compact

AAOIFI		UN Global Compact
Mandatory	**Recommended**	
Consider client impact on environment	Reducing adverse impact on the environment, efficient use of nonrenewable resources, shift to email instead of paper, recycling.	Take a "precautionary" approach to the environment and not use lack of scientific certainty as a reason to postpone cost-effective measures to prevent environmental degradation
	Environmental Impact Investment (protection, mitigation, promotion of renewable energy)	Promote greater environmental responsibility
		Encourage the development and diffusion of environmentally friendly technologies

If investors included assessment of a company's compliance with the AAOIFI corporate social responsibility standard in their investment analysis, and include the relationship between corporations and their employers, customers and suppliers, it would also likely put them into compliance with global norms-based standards used in SRI/ESG investing.

To take one example, the UN Global Compact's labor principles are derived from the International Labour Organization's (ILO) Declaration on Fundamental Principles and Rights at Work which require freedom of association, the elimination of forced or compulsory labor, the effective abolition of child labor and the elimination of discrimination in respect to employment and occupation.[30] The AAOIFI standards do not cover freedom of association or compulsory labor because it is focused on financial institutions where these are not often common issues.[31] It does include a stipulation that the Islamic financial institution's CSR policy for employee welfare include "elimination of child labour from the workforce and if not feasible, educational and familial support for children". In addition it covers many facets of anti-discrimination including:

- Equal opportunity regardless of gender, race, religion, disability or socio-economic background;
- Merit pay without regard to gender, race, religion, disability or socio-economic background;
- Maternity leave and flexible work hours for women;
- Prohibition of discrimination based on gender, race, religion, disability or socio-economic background and a system for complaints without recrimination;
- Pro-actively establishing, monitoring and acting on realizable quotas/targets for staff from disadvantaged backgrounds, with disabilities, from minority groups and/or from under-represented groups in the formal economy (including females); and,
- Elimination of class and race barriers between employees.[32]

One of the biggest challenges in this respect is that many of the Islamic financial institutions are based in markets with poor transparency, weak disclosure requirements and weak corporate governance. In some countries where Islamic finance is significant, the government has restricted the formation of non-governmental organizations and the types of activism that NGOs employ elsewhere that can act as a complementary force to improve companies' compliance with global norms. This is an important distinction: the current practices in countries with large Muslim populations or even where Islamic finance is significantly developed should not be used to define whether or not Islamic finance supports global norms that are important to other areas of responsible finance.

Equally as important: the current lack of inclusion of positive screening methodologies and omission in most cases of ESG screens in Islamic finance should not be used to limit the scope of what is important according to Shariah to just negative screens including the avoidance of interest. The Islamic finance industry is relatively new and also operates in markets where ESG is not commonly employed. That limits the understanding of ESG criteria and has limited the use of ESG in many Muslim majority countries. Its absence should not diminish the potential for convergence on other ethical screens that are used.

The distinction that the diagram above is trying to give in terms of positive and negative screens connects to the preceding discussion of the role of norms-based screening in the different areas of responsible finance. The discussion of overlaps between Islamic precepts and existing AAOIFI CSR standards for Islamic financial institutions provides a case where some positive screening could be easily derived from standards that already have been adopted by Islamic finance standards setting bodies. In the negative screening area, the overlap with Islamic finance is primarily with socially responsible investing where there is

IDENTIFYING ESTABLISHED PRINCIPLES FOR NORMS-BASED SCREENING: SOCIAL

AAOIFI Corporate Social Responsibility Standard and UN Global Compact

AAOIFI		UN Global Compact
Mandatory	Recommended	
Consider client impact on the economy	Social impact investment with unique criteria for IFIs	Maintain a policy on respect of human rights with specific principles linked to the business practices
Consider client impact on society	Development impact Investments	Avoid complicity with human rights violations through active complicity, beneficial complicity or silent complicity
Ethically balanced marketing to not "induce inappropriate behavior/coonsumption and unsuitable products inconsistent with Islamic, social & cultural norms"	Disclosure of policy for dealing with clients	Elimination of forced labor
Responsible terms & conditions taking into consideration abilty to repay & impact on customer's financial & overall well being	Par excellence customer service policy	Abolition of child labor
Maintain good treatment of employees, anti-discrimination policies, merit pay, maximum work hours, and employ affirmative action towards underrepresented groups in the formal economy (including women)	Disclosure of policy for employee welfare including targets/achievements relating to affirmative action	Elimination of discrimination in employment and occupations
	Micro & small business & social savings & investment	Maintain a policy on respect for right of employees to freely associate, collective bargaining and right of confidentiality in countries where countries do not respect human rights
	Charitable activities policy	Work against corruption in all forms including bribery and extortion
	Waqf management policy	

IDENTIFYING ESTABLISHED PRINCIPLES FOR NORMS-BASED SCREENING: GOVERNANCE

AAOIFI Corporate Social Responsibility Standard and UN Principles for Responsible Investment

AAOIFI		UN Principles for Responsible Investment
Mandatory	**Recommended**	
Screening clients to prevent use of IFI to engage in criminal activities (e.g. money laundering)	Disclosure of policy for social, development and environment based investment quotas	Incorporate ESG issues into investment analysis and decision-making processes
Screening clients for their compliance with AAOIFI CSR standard	Disclosure of par excellence customer service policy	Be active owners and incorporate ESG issues into ownership policies and practices
Tying compliance with contractual terms of financing with CSR screening requirements	Disclosure of policy on micro/ small business & social savings & investment	Seek appropriate disclosure on ESG issues by the entities in which signatories invest
Disclosure of CSR requirements to client prior to contractual agreement	Disclosure of policy on qard hasan	Promote acceptance and implementation of the Principles within the investment industry
Incorporating transparency relating to the obligations and rights of each party to transactions with the IFI	Disclosure of policy on charitable activities	Work together to enhance our effectiveness in implementing the Principles.
	Disclosure of policy on waqf management	Report on activities and progress towards implementing the Principles.
	Charitable activities policy	Work against corruption in all forms including bribery and extortion
	Waqf management policy	

an ethical case that is developed apart from financial impact to avoid financing a certain type of activity.

The financial impact motivation does also come into play with Islamic finance, and does serve as a point of potential overlap with conventional ESG investing which is widely touted because it can identify important facts to the valuation of a company based on environmental, social or governance factors. Likewise, a lot of attention is paid in the present-day practice of Islamic finance to ensure that the products being offered are providing a competitive product to conventional products. There are frequent qualitative reasons laid out for why Islamic finance can offer a superior return compared to conventional finance, but it is relatively unproven empirically.[33] The challenge is that the qualitative arguments usually argue that there is a transparency and fairness requirement in Shariah, as well as a preference for profit-and-loss sharing contracts.

However, in practice there is much more replication of conventional banking practices and products. This occurs for many reasons including customer preference for familiar products and regulatory requirements that inhibit some of the alternatives but has the effect of limiting the observable difference between conventional and Islamic finance apart from the negative screens employed. There is a gap between rhetoric and reality that occurs in Islamic finance as well as ESG. In Islamic finance, the accusation is that financial institutions are 'replicating' conventional products while in ESG the criticism one often hears is that companies including financial institutions are merely 'greenwashing' to make their performance look better than it is rather than making substantive changes to their business practices in areas that are in focus from ESG analysis.

The areas for convergence around ethical principles codified in global norms and the particular negative and positive screens employed are large. The biggest divergence will be with respect to Islamic finance's unique screen rejecting the conventional financial sector (including banks, insurers and fund managers) and companies that have significant interest income or expense. The post-financial crisis environment has made the financial sector unpopular because it is viewed as having grown too large, too influential in politics and having distorted the economy towards its own profit and away from investment in the 'real' (non-financial) economy.

The post-crisis environment has also made policymakers more concerned about the buildup of leverage in the economy and excessive use of leverage (for example, the widely ignored limit of leveraged loans which, under Dodd-Frank, are supposed to be no more than six times the company's EBITDA).[34] This concern is an area where Islamic finance can make a significant contribution to the discussion because it has adopted screens designed to limit companies that pay or receive significant interest income. These screens also have the effect of limiting investment in highly leveraged companies (those that have debt to market capitalization or total assets of higher than one-third in most applications).

The financial screens also limit investment in companies whose cash holdings or holding of all forms of liquid assets (cash, short-term investments and receivables) are above a fixed level. While designed to limit interest income and to avoid a situation of effectively trading money in unequal quantities today or trading a fixed amount of money for a higher or lower amount in the future, it also has the effect of limiting investment to companies engaged in the real economy and avoiding those that might be acting as shadow financial institutions.

The way that this convergence opportunity can be managed will depend in part on what it is intended to accomplish. The most straightforward approach would be to view the Islamic screens and particularly the financial screens employed in Islamic equity investments as a risk management tool that, while perhaps limiting upside during most periods, will help curtail the downside risk that an over-indebted investment or company suffers in terms of dramatic losses during periods of economic distress. The global financial crisis showed that this may be beneficial in both developed and emerging market economies (in contrast to earlier belief that

> "THE CURRENT PRACTICES IN COUNTRIES WITH LARGE MUSLIM POPULATIONS OR EVEN WHERE ISLAMIC FINANCE IS SIGNIFICANTLY DEVELOPED SHOULD NOT BE USED TO DEFINE WHETHER OR NOT ISLAMIC FINANCE SUPPORTS GLOBAL NORMS THAT ARE IMPORTANT TO OTHER AREAS OF RESPONSIBLE FINANCE.

it was primarily an emerging market problem propelled by 'hot money' flows and 'original sin'—companies whose revenue is in local currencies borrowing heavily in foreign currencies). In this way, the Shariah screening methodology can be overlaid on an ESG analysis to create a 'prudent ESG' screening methodology around which both Islamic and ESG can converge to develop something that is specifically focused on improving performance of the two working separately.

This methodology would appeal to the 'performance' angle that most ESG-focused and many Islamic financial institutions take when they decide how to design their products. The key criteria used is not solely whether they are designing a product because it is good for the environment, promotes positive governance or whether it addresses the intent (maqasid) of Shariah but whether it is in compliance with those principles while being commercially viable. The advantage to this type of approach is that it appeals to the widest universe of investors, asset owners and financial institutions because it complements rather than conflicts with their priority to maximize profits.

PRUDENT ETHICAL INVESTMENT: FILLING THE GAPS WHERE INVESTORS ARE MISSING OUT

Hasan Al Jabri, Chief Executive Officer, SEDCO Capital

HASAN has been a major player in investment banking and corporate finance in the MENA region for over 30 years. Under his leadership, SEDCO Capital became the first fully Sharia compliant asset manager and the first Saudi asset manage to become a signatory of the UNPRI.

Hasan sits on the boards and is a founder of a diverse group of industries including finance, FMCG, building materials, catering, real estate development, IT & healthcare.

Hasan was the chairman of the World's Presidents Organization Chapter in Saudi and is a BSC graduate of the American University of Beirut and an Executive Management Program graduate of Columbia University.

Our business environment is changing at an unprecedented pace. Although free market-based economics has contributed to the advancement of human kind, driven economic growth and created vast amount of wealth, it has been accompanied by heavy social and environmental costs. Further, the global financial crisis in 2008 and 2009 exposed the weak corporate governance practices, poor corporate cultures and ineffective risk controls at the heart of the global financial system.

The public outcry that followed the 2008/2009 financial meltdown shook the financial system at its core and raised serious concerns about the sustainability of capitalism in its present form. Meanwhile, responsible investment started to receive more attention from regulators and market participants as a potential part of the solution to the challenges of delivering a sustainable model of growth for the future. Responsible investment principles guide investors to take proper account of non-financial measures such as environmental, social and corporate governance issues in their investment processes. In turn, these measures should enable the deployment of a stable, well-governed and transparent financial system which contributes to the real economy, creating jobs and making it more resilient to turbulent market conditions. Bolstered by investors' rising interest, assets under management (AuMs) of the sustainable/responsible investment strategies grew rapidly in the past decade reaching a whopping $13 trillion by the end of 2014, and they are expected to grow even further[1].

The two sides of credit

When we look at the current financial system, we see that providing credit has been a major contributor to economic activity that has fuelled growth and supported small and medium enterprises (SMEs), which are an essential component of new job creation. In many cases, credit has been the lifeline for many companies keeping them afloat and saving hundreds of thousands of jobs. However, as history has repeatedly shown, excessive use of debt can have devastating financial and social effects at all levels of the economy: sovereign, corporate as well as consumer. The financial meltdown, and most recently, the Greek credit crisis are vivid examples of the magnitude of the value destruction that imprudent use of debt can cause. These effects are magnified by the use of derivatives, famously described by Warren

Buffett as "financial weapons of mass destruction."

Therefore, in our view, it is impossible to construct a responsible investment framework that ensures sustainable growth without addressing the ill-effects of excessive debt and risky speculation. To address such effects, investors shall incorporate prudence as an essential part of their investment criteria in order to curb the excessive use of leverage and set limits for risky speculation. With these two sides in mind, we find that value-creating credit at prudent levels should replace greed-driven excessive leverage. The question then becomes: what is prudence, and what is the measure to determine what is considered prudent?

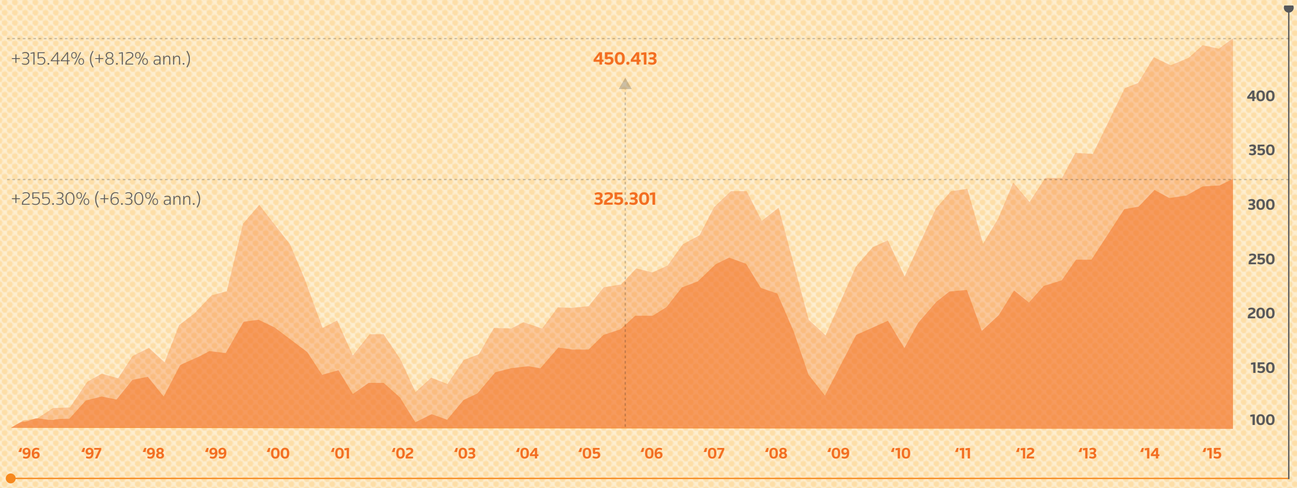
Prudence

To begin to answer this question, we start by looking at history. The 'prudent man rule' stemmed from an 1830 Massachusetts court decision directs trustees "to observe how men of prudence, discretion and intelligence manage their own affairs." Under the prudent man rule, certain types of investments, such as high-risk mortgages or new business ventures, are viewed as intrinsically speculative and therefore prohibited. The original definition of this rule gradually became irrelevant to modern day finance, as investors became more sophisticated and the financial system continued to evolve.

By examining the prudent man rule and observing the current state of our financial system, we believe that there are elements of this rule that are relevant and need to be reconsidered whilst others are no longer applicable in today's environment. For instance, while risky mortgages and uncovered derivatives have damaged the financial system posing real systemic risks, new business venture investments are essential to propel innovation and have proven to be a source of new enterprises that can create new jobs. It is, therefore, our view that the prudent man rule can be revisited with a pragmatic view in mind to be reinvigorated and help us define what is prudent in our present day environment.

As for finding specific measures of determining what is prudent, we can search for ethically-driven investment styles that have similar goals to responsible investment. When doing so, Shariah emerges as one of the most congruent investment styles to responsible investment. Namely, Shariah goals and objectives are aligned with those

> "WE BELIEVE THAT TO ACHIEVE THE GOALS AND OBJECTIVES OF RESPONSIBLE INVESTMENT, THE REDEFINED PRINCIPLES OF PRUDENCE SHOULD BE AN INTEGRAL PART OF ETHICAL AND RESPONSIBLE INVESTMENT CRITERIA, AND THE CONVERGENCE OF THESE PRINCIPLES, IN WHAT WE ARE CALLING **PRUDENT ETHICAL INVESTMENT (PEI)**, IS THE NEXT STEP OF EVOLVING THE RESPONSIBLE INVESTMENT STRATEGY...



of responsible investment, and the screens used by both investment strategies have significant overlap. Therefore, we find that Shariah quantitative leverage thresholds and qualitative limitations on risky speculation would be a good source of reference for measuring prudence.

Prudent Ethical Investment (PEI)

We believe that to achieve the goals and objectives of responsible investment, the redefined principles of prudence should be an integral part of ethical and responsible investment criteria, and the convergence of these principles, in what we are calling **Prudent Ethical Investment (PEI)™**, is the next step of evolving the responsible investment strategy. For example, Shariah-compliant investment style achieves the prudent ethical investment criteria as it combines both sector and leverage screens. From a financial performance perspective, when combining these screens, we noted that returns have not suffered; rather, they have been enhanced.

Considering public equity indices as a proxy, we find that Dow Jones Islamic Index (DJIDEVT) has outperformed its benchmark MSCI Total Return World (NDDUWI) by 182 Bps p.a. since inception in 1996. (Note: further details of the performance analysis will be discussed in a whitepaper).

Prudent Ethical Investment (PEI) Whitepaper

To further explore the idea of the convergence of these two strategies, we, at SEDCO Capital, have embarked on a research initiative to examine the effects of combining these principles which will be in a whitepaper published by the end of 2015. The paper will begin by taking a deep dive at responsible investment going back to its historical roots to reveal the underpinnings of such strategy and better understand the objectives behind this investment philosophy. Based on that analysis, the paper will then introduce the concept of Prudent Ethical Investment (PEI)™ in more detail and discuss the rationale and merits of why prudence is a crucial element for the responsible investment selection criteria. The paper will then summarize the empirical research results and reveal the impact analysis on risk-adjusted performance when prudent screens are included. Finally, the paper will seek to translate theory to practice, highlighting some of the practical matters related to investing according to PEI investment philosophy including the routes to access such investment products.

At SEDCO Capital, we continue to seek paths for collaboration and convergence that will add value to the financial system and enhance both the Shariah-compliant and responsible investment practices, and we look forward to working with industry leaders to bring about these positive changes.

NOTES

1. Source: Eurosif SRI Study, USSIF (2014)

However there is a sizeable group (perhaps a large minority or small majority) of people within the SRI and Islamic finance sectors who believe that action cannot only be taken where it is convenient and where it creates direct financial benefit. There are, these critics would highlight, certain behaviors that should take place regardless of whether they are profitable on their own. As a result, limiting Islamic finance activity to providing the same outcome as conventional banks betrays what it is intended to accomplish although it may be more profitable to do it this way than to, for example, incorporate greater profit-and-loss sharing. Or an ESG-based financial analyst may recommend investment in a company with a poor track record on environmental protection because it is 'best-in-class' when compared to its industry peers.

Neither of these examples crosses a line of encouraging behavior that is contrary to the stated principles of either Islamic finance on the one hand or ESG/SRI on the other. But it indicates the presence of different expectations among different stakeholders in each. It highlights the tremendous need to find some consistency in what is meant when something is defined as being ESG-compliant or Shariah-compliant. There are different levels of rigor between screening a portfolio to identify added value or avoided risks and one which accepts that to make an impact, there may be short-term (or even long-term) sacrifices of value to preserve values.

Neither is 'right' nor 'wrong' and each contributes positively against the entirely unscreened methodology that can preserve funding access to outright harmful activities without requiring mitigation. What is needed is a consistent way to tell one apart from the other and for different areas to share experiences. For example, pro-poor financial intermediation using interest-free loans, as the non-profit Akhuwat in Pakistan does, can be more financially sustainable and promote more sustainable growth in its own activities than would otherwise be anticipated by those familiar with the business models of conventional microfinance institutions. An approach it could lead to would be conventional microfinance institutions using its model to expand outreach and to find ways of controlling costs to lower the overhead required to service its many clients.

> THE AREA WHERE CONVERGENCE WOULD BENEFIT IS BY BETTER DEFINING HOW INVESTORS, ASSET OWNERS AND FINANCIAL INSTITUTIONS ARE INVOLVED IN USING SRI, ESG OR SHARIAH SCREENING IN THEIR INVESTMENT PROCESS

The area where convergence would benefit is by better defining how investors, asset owners and financial institutions are involved in using SRI, ESG or Shariah screening in their investment process to provide their stakeholders with a clearer understanding of what they are already doing and offering a better perspective on similar approaches used by other institutions. The collaborative part of the convergence process is to identify ways that additional screening can be practised in a way that is applicable in both the conventional SRI and ESG areas as well as with Islamic financial institutions, that advances the ethical agenda of all. There may be differences of opinions in some areas but it is hoped that the discussion to this point illustrates how many points of overlap there could be.

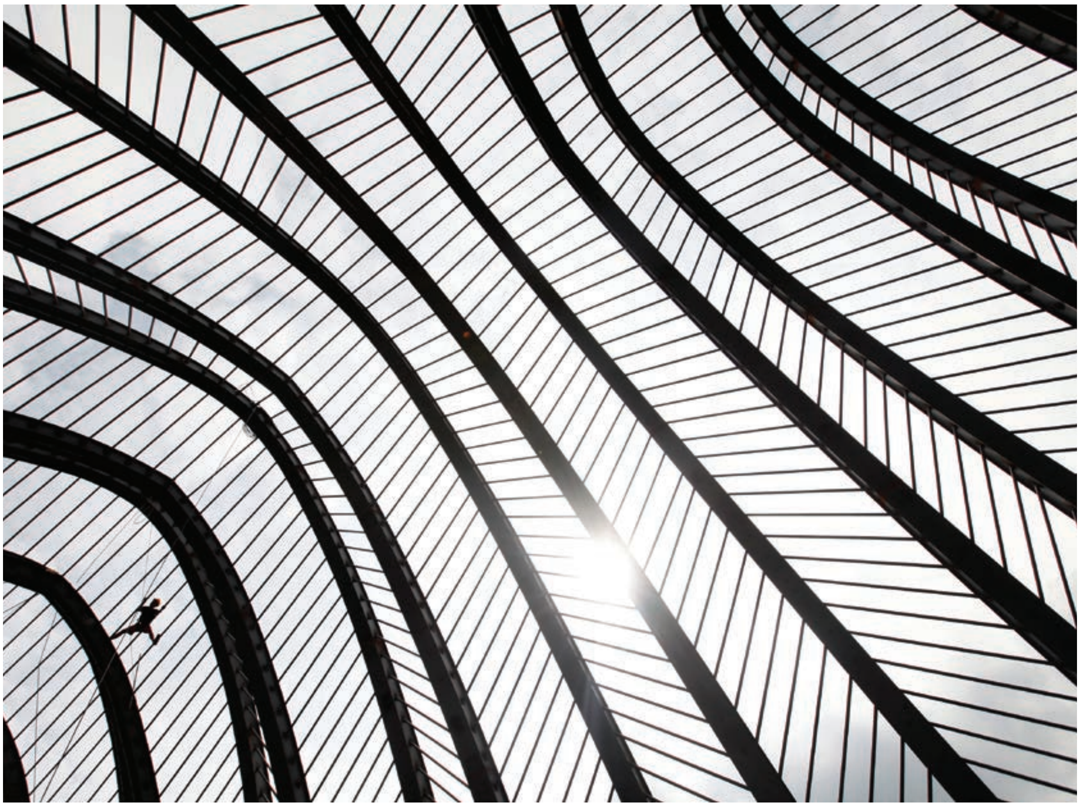
Champion

A man flies a kite at the Peace Park in San Jose, January 10, 2013. REUTERS/Juan Carlos Ulate

SUMMARY

1. Islamic finance faces unique challenges from the regulatory side with respect to tax policy and capital adequacy implications of profit-and-loss sharing products that can make Islamic finance more costly/less profitable
2. Most countries have opted to regulate Islamic and conventional finance in the same regulatory system although countries like Bahrain are important exceptions
3. Regulatory challenges to Islamic banks could make non-bank financial institutions preferable although many jurisdictions have made their laws facilitative for Islamic finance
4. Key regulatory facilitation for SRI/ESG is current understanding of how it interacts with fiduciary duty for many asset managers
5. Freshfields report and Fiduciary II support ESG analysis and the shift has begun to ESG being compliant with fiduciary duty to being required as a part of it
6. ESG reporting by companies is becoming commonplace and mandatory

Introduction



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A labourer paints the framework as he stands on the roof of a building at a construction site in Wuhan, Hubei province August 26, 2011. REUTERS/Stringer

The regulatory area is important for any form of responsible finance because finance relies on maintaining trust and confidence of the population in how their assets are being protected and managed on their behalf by financial institutions. The way in which the regulations are designed and enforced (as well as how the governments tax the activity to fund itself) incorporates what governments value and understand. It has been more difficult for Islamic finance to offer a truly different alternative because Islamic financial institutions have to manage not just consumer preferences and competition from conventional institutions, they also have to fit within a regulatory system built around interest-based financial institutions. Combined with often unfavorable tax policies for the ways they find of working in these interest-based financial systems leaves Islamic finance criticized for not being 'authentic' enough to its underlying principles.

Other forms of responsible finance do not face as challenging an environment and are also beneficiaries of some of the efforts to promote regulatory improvements. For example, managing the impacts of laws and court decisions relating to fiduciary responsibilities has an impact on the ability of investors to incorporate non-financial factors like those relating to the environmental, social and governance impacts of the companies they invest in. The other area where regulation can play a major role in supporting responsible finance is by setting out clear, consistent guidelines for companies and investors in reporting how they report data relating to ESG considerations.

Implications of regulatory and tax policy drives structure of Islamic finance...

Tax and regulatory policy are highly impactful for Islamic financial products. Financial institutions are more heavily regulated than other sectors and have been built around interest-based activities that do not always mesh well with the ideal for the profit-and-loss sharing that is widely represented for Islamic finance.[35] The biggest area where this impact is felt is with Islamic banks that are subject to the same regulatory system as conventional banks. While some regulators (e.g. the Central Bank of Bahrain) have established parallel regulatory systems for Islamic banks, these regulatory systems are still focused around the idea that 'banking' is taking deposits as loans from customers and lending out these funds, along with funds acquired in the money market and the bank's capital with similar buffers and limits on leverage.

The concept of 'leverage' receives pushback by many Islamic bankers who say the concept should not be applied to Islamic banks because the only form of lending allowed in Islam is benevolent (interest-free) loans known as qard al-hasan. Financing activity (as the assets on a bank's balance sheets akin to 'loans' are referred to) should have built in flexibility that ties risks to the underlying real economy activity and is distinct from lending with interest. In contrast, Islamic banks have most of their assets in products that produce the economic result of a conventional loan, often benchmarking the return to interest rate benchmarks including LIBOR and various local interbank offered rates.

This asset side structure is a consequence of the regulatory system that treats the bulk of the financial assets as 'loans' and weights according to the risk using the same metrics as for conventional banks. The risk-weighting of assets favors debt-based modes of finance like murabahah (a cost-plus sale) and ijarah (similar to a finance lease). The profit-and-loss sharing products that many hold up as an example of Islamic finance's differentiator represent minimal shares of the bank's balance sheet, due in large part to the capital charges they would require that would make them much less appealing for the bank and would require higher cost to the customer to deliver the same return on capital which would make the Islamic bank less competitive.

The challenges facing Islamic banks on the asset side also impacts the liabilities and equity side of the balance sheet, in particular the relationship with depositors. Most regulatory approaches characterize depositors, and in particular, small depositors as a special class of unsecured creditors of the banks and have developed deposit insurance programs to protect these deposits and also prevent traditional bank runs.[36] This regulatory priority which is based on many decades of policy experience has an unintended impact on Islamic banks whose depositors are supposed to take risk in exchange for having exposure to rewards. The protection of depositors (and in many countries requirement that all banks participate in the deposit insurance scheme) introduces a rigidity into Islamic banks. It moves risk that would otherwise be borne by depositors expecting to earn a return on their deposits (referred to as investment account holders, or IAHs) onto the bank's capital.

Islamic banks have to account for this risk (referred to as displaced commercial risk) through holding additional capital they would not need if the IAHs could bear the risk from the assets their deposits are financing. Some jurisdictions have allowed banks to take credit against their capital requirements if their depositors bear some risk by reducing their capital requirements on assets financed with IAH deposits by a fraction set by the regulator that is called 'alpha'.[37] Banks also establish investment risk reserve from profit payable to depositors above the amount paid, and profit equalization reserves from profits attributable to both IAHs and shareholders before it is split between the two. These are retained at the bank when depositors leave but they remain owned by depositors and depositors/shareholders, respectively.[38]

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THE TYPE OF LEGAL SYSTEM MATTERS QUITE A BIT IN BOTH ISLAMIC BANKING TRANSACTIONS AND IN SUKUK AND OVERLAYING A MAP OF THE JURISDICTIONS WHERE ISLAMIC FINANCE HAS SUCCEEDED VERSUS STRUGGLED CAN IN LARGE PART BE DESCRIBED BASED ON WHETHER THE UNDERLYING LEGAL SYSTEM IS BASED ON COMMON OR CIVIL LAW

The consequence of the regulatory-driven shift for Islamic banks to use debt-based structures for their assets and guaranteed principal IAH accounts for deposits is to remove the flexibility that would otherwise be built into the Islamic banking system through profit and loss sharing on both sides of the balance sheet. There are, of course, many areas where that would require additional regulatory tools to ensure that the rights of the IAHs were protected (since unlike shareholders, they don't get voting rights). It would also require a different deposit insurance scheme to account for the need for Shariah-compliant principles and investments, as well as perhaps different pricing since the likelihood it will be needed will be more closely linked to the assets funded by the deposits insured.

However, banks are not the only game in town for Islamic finance with takaful (Islamic insurance that is a hybrid between the corporatized and mutual insurance models), Islamic funds and sukuk. The good news is that Islamic funds generally face few regulatory or tax restrictions because the pass-through of profit-and-loss with either a fixed fee (wakalah) and/or profit-sharing (mudarabah) are very compatible with the traditional fund structures. The situation with takaful is more complicated because unlike the other areas, there isn't yet a common practice for how takaful can be structured to protect policyholders, produce profits and operate efficiently for shareholders and manage to gain market share in generally underdeveloped insurance markets in countries where Islamic finance is widely used.

Sukuk represent the cutting edge product that has only developed in the past 15 years since Malaysia successfully issued its first international sukuk in 2002, although the very first sukuk ever issued was a local currency MYR-denominated sukuk from Shell MDS Sdn Bhd in 1990. The growth since has been extraordinary and 2014 saw a real blossoming of new issuers from non-conventional markets for sukuk with sovereign issues from South Africa, Hong Kong SAR, Luxembourg and the United Kingdom. One common thread among these issuers and the primary markets for sukuk in the Gulf Cooperation Council (GCC) and Malaysia is that with the exception of South Africa and Luxembourg, they are all common law systems.

The type of legal system matters quite a bit in both Islamic banking transactions and in sukuk and overlaying a map of the jurisdictions where Islamic finance has succeeded versus struggled can in large part be described based on whether the underlying legal system is based on common or civil law. The biggest reason for this is that Islamic finance structures typically rely on transferring of (beneficial) ownership to a Special Purpose Vehicle (SPV) that is run by a trustee for the benefit of the sukuk holders. A very common sukuk structure that is used is an ijarah sukuk where the originator sells an asset to an SPV that issues sukuk certificates to investors to fund the purchase. The SPV then leases the asset back to the originator and at the termination of the lease, sells the asset back to the originator under a purchase undertaking granted by the originator to the SPV.

THE GREEN SUKUK MARKET: OPPORTUNITIES AND HURDLES

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The Islamic community appears to be embracing the trend toward sustainable investing, creating potential for a "green" sukuk market. The integration of sukuk into the green bond market makes sense when considering that they share more similarities than differences. The green bond community has a history of being inclusive and appealing to a broad range of issuer types and structures. Similarly, integrating fiscal stewardship and business practices within the context of environmental and social concerns is far from new to Islam.

Current estimates indicate Shariah-screened investments account for approximately US$3.6 billion in assets under management that integrate environmental, social, and governance (ESG) factors.[1] Movement to establish a framework integrating Islamic finance and ESG is underway and taking shape, in part through the efforts of the Securities Commission Malaysia (SC) launching the Sustainable and Responsible Investment (SRI) Sukuk framework in August 2014.[2]

Sukuk

In many aspects the growth of Sukuk, has paralleled the early growth characteristics observed in the green bond market.

Sukuk share similarities with conventional bonds in that they typically provide a fixed income payment to the investor. However, sukuk are distinct in form and substance to meet strict prohibition of the payment of interest (*riba*) under Islamic law.[3] The sukuk market has experienced rapid growth, with new sukuk issuance exceeding US$100 billion in 2013 and 2014.[4]

Green Sukuk: A Collaboration

Collaboration between the green bond and sukuk communities is taking hold, with the first socially responsible sukuk issued in November 2014 for US$500 million by the International Finance Facility for Immunization Company (IFFIm). The proceeds funded children's immunization in the world's poorest countries through Gavi, the Vaccine Alliance.[5]

Khazanah Nasional Berhad, Malaysia's sovereign investment fund, followed shortly with the first social impact sukuk in June 2015, raising RM1 billion (US$266 million) dedicated to educational projects.[6]

Sukuk structures facilitating green issues

Asset-backed financiers may find sukuk an alternative financing mechanism when conventional instruments fail to offer favorable terms. Among some of the early adopters of sukuk finance were non-Islamic organizations, such as U.S.-based Shell Oil, East Cameron Partners in 2008 (now defaulted), and General Electric in 2009, all eager to obtain favorable financing and to extend their investor base.

Furthermore, the Islamic community already has a long history and extensive experience with energy project financing and may be more comfortable with non-carbon-based green energy financing.

Hurdles: Legal Structure and Liquidity

Despite the bright outlook for green sukuk issuance, there are several hurdles that remain before these instruments attain greater appeal and broader support among the investor community.

The first and most important issue relates to the complexity of sukuk structuring and questions of legal jurisdiction, particularly in the event of a default. A majority of sukuk investment prospectuses reference 'English Law' as the primary governing framework, with the issuer reserving the right to use its country of domicile's legal jurisdiction over the investment certificates. This in turn has created issues in which Shariah law has been rejected as the governing law of a contract in English courts. For example, in the case of Beximco Pharmaceuticals Ltd. v. Shamil Bank of Bahrain the court ruled that a contract can have only one governing law and that parties to a contract can agree only to adopt the law of a country as the governing law of a contract.[7]

The issue of defaults adds another layer of complexity from an Islamic law perspective. If a defaulting debtor is willing but unable to pay its obligations, the creditor ought to "bestow compassion and offer a period of grace requiring the defaulter be given respite until he is able to pay."[8]

Clearly, conventional finance has a different view and application with respect to a debtor's inability to meet its obligations. The U.S.-based East Cameron Partners deal, which later defaulted, marked an important legal precedent in which creditor rights were upheld, forcing their claim to the assets. The primary reason for the success from a legal perspective was that the investment certificates originated and were issued in the U.S., along with the assets remaining within U.S. boundaries, hence subject to U.S. legal jurisdiction.[9] The East Cameron Partners deal should be viewed as an exception since the issuer and assets more typically reside in different locations subject to multiple legal jurisdictions.

Beyond the jurisdictional legal issues, sukuk are Islamic securities, and in order to obtain that status they are subject to Shariah governing principles. All investment securities must undergo review and approval by *Shariah* scholars, known as a *fatwa*, to ascertain they meet the standards of Shariah compliance prior to issuance.[10]

Lastly, the liquidity characteristics of sukuk differ from those of conventional bonds. Liquidity in sukuk markets is developing but remains a long way from the depth and breadth commonly associated with conventional bonds.

Islamic law tends to discourage active trading based upon the principle that it engages excessive uncertainty and ambiguous outcomes, called *gharar*, which is prohibited.[11] These instruments therefore typically do not actively trade in the secondary market given Islamic investors' interest to hold the issues. Green bonds tend to have a higher liquidity profile than sukuk since green bonds are essentially traditional bonds enhanced with qualifications on the usage of proceeds.

The outlook is positive for the growth of the green sukuk market as current investor demand for sukuk issues is extremely robust, frequently surpassing bid-coverage ratios typically seen in the green bond market.

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THE OUTLOOK IS POSITIVE FOR THE GROWTH OF THE GREEN SUKUK MARKET AS CURRENT INVESTOR DEMAND FOR SUKUK ISSUES IS EXTREMELY ROBUST.

This type of transaction raises few regulatory issues because it is very similar to sale-and-lease-back transactions. However, the requirements connected with the transfer of legal ownership is challenging in civil law jurisdictions where trust structures are not recognized.[39] Even jurisdictions friendly to the creation of trusts may see challenges to structuring sukuk. The UK had to make two changes to facilitate sukuk issuance. One was to remove double taxation under the stamp duty land tax for Islamic finance products which had to be subsequently amended in 2008 to limit it just to its intended purpose since it opened up a tax loophole for commercial property investors.[40] The other was to enable sukuk to be "regulated in the same way as comparable conventional debt securities" and not as collective investment schemes which would have created a higher regulatory burden.[41] Similar challenges have occurred in Hong Kong, Singapore and Australia and not every jurisdiction has been able to make the regulatory changes needed to facilitate Islamic finance. Despite progress being made to identify how to reform the tax rules in Australia to be facilitative of Islamic finance, changes remain unfinished.[42] Singapore and Hong Kong, in contrast, have made the changes necessary and their central bank and government, respectively, have each issued sukuk.

Even where issues of stamp duty are not present such as in the United States, there are hurdles about whether the tax treatment of the profit payments made on Islamic mortgages would qualify for the mortgage interest tax deduction (or similar allowable expenses for businesses). The existing statutes suggest they wouldn't although a substance over form analysis suggests they would and the Internal Revenue Service has not ruled on whether or not this would be improper.[43] The substance over form treatment of Islamic finance products is the basis by which murabahah and ijarah have been made available to banks in the U.S. by the Office of the Comptroller of the Currency.[44]

In the U.S. there have been issues relating to Islamic finance in the context of a mosque financed using an Islamic mortgage which sought a retroactive tax exemption for a period when it was being used as a mosque but the deed had been transferred through an Islamic finance transaction by Devon Bank, which is not a non-profit organization and so not eligible for the tax exemption. The application was denied on the grounds that it would have to be "owned by an exempt institution in order to qualify for exemption; further, such exemptions are non-transferable".[45]

...while regulatory policy plays a facilitative role for ESG

Unlike Islamic finance, other areas of responsible finance generally operate within the existing regulatory framework and are not disadvantaged relative to their non-SRI/ESG competitors in the same ways as Islamic finance is. That does not make regulatory rules irrelevant for the development of SRI/ESG-focused responsible finance; it just alters the types of changes that are important for those involved in SRI/ESG-focused responsible finance.

The first issue to consider is making the distinction between SRI and ESG investments in how they potentially impact the regulatory and legal view of investment firms. The ability to engage in ESG activities is much wider than SRI because of considerations relating to fiduciary duty. The distinction comes from the role in the financial analysis where ESG is considered to 'enhance and supplement' the financial analysis performed on companies, leaving a full universe open for investment. In SRI, by contrast the potential complication would come from "avoid[ing] an evaluation of the potential merits of investing in certain companies based on their business involvement".[46]

Specifically excluding particular types of investments on non-financial grounds (apart from the non-financial factors like ESG that can be incorporated into the formal investment analysis) is widely believed to raise portfolio risk by limiting the universe of investments made. Based on the experience of signatories to the UN Principles of Responsible Investing, there has not been a similar issue raised for investment fiduciaries that create portfolios in a way that factors in the financial impact from environmental, social and governance factors.

ESG integration seems inevitable given its strong position in the fiduciary equation.

The evidence from the Fiduciary II report (see prior footnote for full citation) complements analysis done by Freshfields Bruckhaus Deringer in 2005 (widely referred to as the "Freshfields" report).[47] The Freshfields report considered nine countries and found that "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions".[48] The difference between the impact of ESG analysis and SRI screening is one that is quite clear and which draws the line in the sand in how far they can consider different responsible finance factors in what they recommend and how they develop their investment analysis when they are acting as fiduciaries.

Considering the impact of ESG factors in developing their financial modeling and within their investment process works within the established precedent for fulfilling their fiduciary duty and may eventually become stronger. There may be a requirement for fiduciaries in some markets that the consideration of ESG factors must be part of their investment process. This distinction is very important and moves in the opposite direction discussed in the prior chapter where Islamic finance and SRI share a priority of putting 'values' ahead of 'value' and are looking for opportunities to make their investment process more comprehensive in how it prioritizes making an impact in line with a set of moral values over the requirement to maximize profits.

As the understanding of what fiduciary duty requires and what it allows evolves, there may be a blurring of the distinction between ESG focus for responsible investing and the types of exclusionary screening used in SRI that is widely considered to be incompatible with most investment managers' fiduciary duty. One of the leading institutional asset managers for responsible investment, Norges Bank, which manages Norway's sovereign wealth fund, is permitted to make exclusions of individual companies or products as it describes in its Principles for Responsible Investment Management principles:

> "Observation and exclusion of individual companies or product groups are regulated by separate guidelines set by the Ministry. Evaluation of companies by the Council may be on the initiative of the Council itself or of Norges Bank. Norges Bank will make product-based exclusions from the portfolio in accordance with the guidelines".[49]

This shows the flexibility that may eventually become more widespread where an asset owner will see an exclusion-based screening methodology as not being inconsistent with its responsible investment mandate.

There are, of course, limits to the degree which exclusion can be used without affecting the manager's and the fund trustees' fulfilment of their fiduciary duty. Provided that they set out clear guidelines, there may eventually grow a consensus around the possibility for exclusionary-based responsible investment screens to be employed without presenting a fiduciary risk as part and parcel of a responsible investment mandate.

Today in the institutional investment marketplace, however, the fiduciary responsibility of investment managers will continue to require that, unless instructed by the beneficiaries to abide by moral values that cannot be added onto investment analysis, the priority remains on maximizing performance.

A Massachusetts Water Resources Authority wind turbine turns in front of a 1951 megawatt fossil fuel power plant in Charlestown, Massachusetts September 18, 2013. REUTERS/ Brian Snyder

Geographical expansion of ESG is not done

As the overview above makes clear, the integration of ESG at a minimum seems like a foregone conclusion. It holds the key to the largest pools of global money by being considered a permitted or even required part of institutional fiduciaries' duty. There are significant concerns about the role of investment consultants in raising the profile of ESG considerations when they issue tenders for investment managers but as the Fiduciary II report makes clear (quoting Quayle Watchman Consulting):

> In tendering for investment mandates, it would be expected that the investment consultant or asset manager would raise ESG considerations as an issue to be taken into account and discussed with the client even if the pension fund had not specified ESG considerations as material to the tender. If the investment consultant or asset manager fails to do so, **there is a very real risk that they will be sued for negligence** on the ground that they failed to discharge their professional duty of care to the client by failing to raise and take into account ESG considerations".[50] (emphasis added)

A significant challenge facing investors who want to consider ESG in evaluating a company's prospects is that there are widely different measures of reporting ESG areas. This has led to charges of 'greenwashing' for companies as they position themselves as being more attractive to investors who incorporate ESG into their portfolios. It also makes it difficult for investors outside of developed market publically-traded equities because the information they need to inform their analysis tends to be less available and in alternative asset classes, the sub-managers (e.g. hedge or private equity fund managers) are not as aware of the importance of ESG to many of their limited partners.

Emerging and frontier markets also tend to have less transparency overall, although some like South Africa and Brazil have tried to use integrated reporting requirements as a way to increase investor flows into their markets. In South Africa, a study found a notable impact on sustainability reporting by and no evidence that the disclosure harmed shareholders.[51] The same study found no significant impact of increased requirements for reporting on Malaysian firms suggesting that not all types of reporting requirements will be effective in all situations.[52]

One of the ways in which sustainable investing is promoted by governments eager to leverage the private sector to make change is by requiring reporting of sustainability information to allow investors to include this information in their analysis when making investments. One common platform of standards that have been developed for this purpose is the Global Reporting Initiative, which was established in 1997 by CERES with support from the UN Environmental Program which has regional offices around the world.[53] These have been used along with other standards like the UN Global Compact principles, OECD guidelines and ISO 26000 standards to build a reporting framework although "the risk of overlapping, conflicting, and even competing standards is even greater [in 2013] than in 2010".[54]

Despite the potential for conflict and competition between the different standards, the overall direction is overwhelmingly positive in broadening the geographic reach of sustainability reporting and increasing the regulatory muscle behind it by making the reports mandatory. The *Carrots & Sticks* report cited above presents data from 2013 that 45 countries & regions now have sustainability reporting guidelines and 72% of them are mandatory. This is a significant rise from the 19 countries/regions that had reporting guidelines in 2006 where just 58% were mandatory.[55]

The positive moves indicated by the direction and increasing strength of sustainability reporting requirements should be cause for celebration but not complacency because there remain areas where disclosure could be more significant,

> REGULATION SHOULD BALANCE THE NEED TO PROTECT BENEFICIARIES WHILE ALSO ALLOWING FOR PRODUCTS THAT MEET THE NEEDS OF INDIVIDUALS AND INSTITUTIONS

more frequent and investor attention towards them could be enhanced. While the ability to incorporate ESG into investment analysis can be shown to be in harmony with, not in conflict with, fiduciary responsibility, there is more that can be done too that can piggy-back off of the increasingly tight reporting requirements relating to ESG factors. As has been mentioned throughout this report, ESG analysis can help bring the widest base of investors to bear on ESG issues. However, there is also the role for increasing the cooperation between investors using ESG and those who choose to go one step further and prioritize their values over the principle of maximizing value at all costs.

Regulation should balance the need to protect beneficiaries (e.g. by maintaining stringent requirements on fiduciaries) while also allowing for products that meet the needs of individuals and institutions that want to include other considerations that cannot be demonstrated to have a neutral or positive impact on the bottom line. The common ground between these investors and more 'mainstream' ESG focused investors is in building a common regulatory requirement for companies—private and public—to report on sustainability/ESG issues. That allows for ESG investors to find hidden value in long-term focused companies that benefit from their management of ESG risks and for others to take more activist roles in defining their investment criteria in terms of their values.

Engage

Kyaw Thiha plays during heavy rainfall at Shin Ohtama Tharya monastery in Yangon May 31, 2011 REUTERS/Soe Zeya Tun

SUMMARY

1. Opportunities exist not just for Islamic finance to adopt positive screens but for ESG and SRI to embrace leverage limitations to reduce risk
2. Find common ground where it exists but don't expect complete harmonization across countries or investors —mainstreaming of cluster munitions/ anti-personnel landmine bans offer an illustrative example
3. ESG analysis as a potentially performance-boosting addition to screening methodologies may be the easiest to convince Islamic investors to adopt
4. May not be possible to use fossil fuel-free strategies in many popular jurisdictions for Islamic finance so fossil fuel reduction strategies may have to be used instead.
5. Engagement is an as-of-yet-unexplored area of Islamic finance but could benefit from ESG investor participation in markets where Islamic finance is well developed.
6. Leverage can benefit companies and investors but beyond a modest level it experiences diminishing returns on a risk-adjusted basis.
7. Impact investing including social investment bonds is an area where participation by SRI and Islamic finance investors could support innovation.

Introduction

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Employees of a solar farm company take notes between panels at the farm in Nakorn Ratchasima province, Thailand, October 3, 2013. REUTERS/Athit Perawongmetha

The disparate sectors of the Responsible Finance Industry today occupy largely separate worlds where they pursue different mandates with different criteria for investment. However, as has been discussed through this report, there are many common areas of interest between the SRI, ESG and Islamic finance sectors that can provide a baseline for engaging institutional investors and asset owners in working across the traditional boundaries. One particularly important area where there can be some engagement is in bringing positive screening and ESG analysis to Islamic finance.

In return, the SRI and ESG sectors should find value in considering for adoption the limits imposed on financial leverage for Islamic investors. Even though the motivation for the limits in Islamic finance is to limit investments to permissibly low exposure to the payment and receipt of interest, the financial leverage screens have benefited Islamic investors and could benefit other responsible financial institutions and investors. Finally, there exists a gap in the participation by SRI and Islamic investors in impact investments that should be considered as impact investment grows in size.

Building blocks for a common standard

The approach of this report is to find areas where there are shared ethical foundations and shared visions for the types of outcomes that responsible finance is designed to create. This does not mean there can be a complete harmonization around 'responsible' finance standards that are applicable for the entire 'responsible finance' industry. Just as within each sector (SRI, ESG, Islamic), there are differences which may be insurmountable about what is acceptable as either a minimum standard or a long-term aspiration, there will be differences between the sectors about what areas are deserving of special priority.

In addition, there may be international differences in what areas are most important to leave as voluntary standards that investors can choose to adopt versus ones that are determined to be important enough to make mandatory. One example of a widely accepted standard that is mandatory in several countries is a prohibition of companies engaged in the manufacture of cluster munitions and anti-personnel landmines (CM/APL). Estimates from the European Social Investment Forum (Eurosif), which only includes voluntary CM/APL in Europe, found that the voluntary exclusion on these grounds reached 30% of the European investment market, valued at €5 trillion.[56]

These types of exclusions already have a basis in international law with 2008 Convention on Cluster Munitions (116 state parties) and the 1997 Convention on the Prohibition of the Use, Stockpiling, Production and Transfer of Anti-Personnel Mines and on their Destruction (162 state parties).[57] As successful as the CM/APL exclusions have been (though the United States remains a notable outlier in the two treaties), it has not necessarily led to investors using this exclusion to conduct a more intensive ESG screening. A large proportion of those investors who use CM/APL use them exclusively and perform no further SRI/ESG screening.[58]

The success of efforts to make CM/APL exclusion 'mainstream' have been largely successful but demonstrate an example where there is not necessarily follow-through for investors and asset managers who adopt one standard into other areas of the responsible finance sector. The CM/APL exclusion is a very limited exclusion and does not necessarily lead towards other parts of responsible finance. Yet, it does represent a limited adoption of negative screening which, at least in theory, would depress returns by limiting the portfolio selection (in countries where it is not mandatory).

As discussed in the previous chapter, the negative screening methodology is being superseded by the incorporation of ESG criteria into financial analysis. The reason behind the shift is that it is less risky for those acting in a fiduciary capacity to add screening criteria that are motivated by enhancing the financial analysis than it is to focus on exclusionary screening methodologies. These exclusionary screens, which the CM/APL exclusion would be a part of, limit the universe of potential investments.

Because there is a growing literature that ESG financial analysis can enhance performance and because they have already adopted a norms-based exclusionary screening methodology, the investors including in this group who have not moved beyond CM/APL exclusion could find value from expanding their responsible finance remit to include ESG screening. Furthermore, because they are already engaged in exclusionary screening (and would be therefore less likely to have fiduciary-related problems with other exclusionary methodologies), they may want to expand with other exclusionary screening including some of the screening methodologies around ethical screens, or leverage from the Islamic finance methodology.

From the perspective of Islamic finance, there is already a prohibition that is widespread of financing the production of weapons, although some screens permit investment in weapons solely for defensive purposes. The challenge of defining the intent of the purchasers of weapons from companies manufacturing or selling these products means that for all intents and purposes, the prohibition extends to all weapons and should therefore provide an easy overlap within Islamic finance. This easy fit should apply regardless of whether or not governments in the markets where Islamic finance is particularly well developed is a party to the two conventions. Out of the top 10 countries in the ICD-Thomson Reuters Islamic Finance Development Indicator[59], none are parties to the Convention on Cluster Munitions while six are party to the Anti-Personnel Landmines Treaty.

Despite the limited governmental activity in regards to these treaties on CM/APL, there is still an opportunity to engage with investors on this issue on the basis of the religious screens employed by Islamic (or Shariah-sensitive) investors. It also can illustrate a wider point about the perception that many Western investors and institutions may have about the Muslim world by judging simply on what the governments do, allow, prohibit or discourage. Furthermore, assuming about Islam what the people who speak the loudest in proclaiming that they speak on behalf of Islam is also likely to lead to more misunderstandings, incorrect beliefs about both Islam and the Islamic finance industry. Whatever one thinks about a government's policy or current events in a region as broad and diverse as the entire 'Muslim world', OIC countries or the Middle East, it would be incorrect to use it to define what is expected of "Islamic" finance.

The CM/APL screen may serve as a starting point for common exclusion policies for responsible finance and will likely be the easiest because it involves removing the smallest number of companies from the investment universe and many of these companies would be already excluded for Islamic investors by the Shariah screens. Beyond this type of screening, ESG presents a fruitful opportunity to expand the screening done on Islamic finance investments because it is less of a norms-based screen and more of an opportunity to generate additional financial returns.

IDENTIFYING OVERLAPS: ISLAMIC FINANCE MARKETS AND CONVENTION ON CLUSTER MUNITIONS (CCM)/ ANTI-PERSONNEL LANDMINE (APL) TREATY SIGNATORIES

Country	IFDI	CCM	APLT
1. Malaysia	93.18	No	Yes
2. Bahrain	76.41	No	No
3. Oman	63.79	No	Yes
4. United Arab Emirates	57.44	No	No
5. Qatar	39.58	No	Yes
6. Kuwait	38	No	Yes
7. Jordan	36.39	No	Yes
8. Pakistan	34.39	No	No
9. Saudi Arabia	30.64	No	No
10. Brunei Darussalam	29	No	Yes

The Monitor http://www.the-monitor.org/index.php/cp/display/region_profiles/find_profile/BN/2014
APLT/CCM: Yes = Any Affirmative Status; No = Not Joined

> "THE ATTITUDES OF MANY ISLAMIC FINANCIAL INSTITUTIONS IS THAT SOCIALLY RESPONSIBLE INVESTING IS EITHER PART OF THE CORPORATE SOCIAL RESPONSIBILITY THEY ALREADY DO OR IS UNNECESSARY, THE REASON IS THAT THEIR EXISTING SHARIAH-COMPLIANT MANDATE COUPLED WITH THEIR CORPORATE SOCIAL RESPONSIBILITY ACTIVITIES FULFILL THEIR "SOCIAL RESPONSIBILITY".

The attitudes of many Islamic financial institutions, driven largely by the limited use of ESG in the emerging and frontier markets in which they are located, is that socially responsible investing is either part of the corporate social responsibility they already do or is unnecessary. The reason it is viewed as being unnecessary is because in the perspective of many Islamic financial institutions, their existing Shariah-compliant mandate coupled with their corporate social responsibility activities fulfill their "social responsibility".

As a result, framing the issue of ESG as an 'add-on' financial screening methodology that is complementary to the exiting Shariah compliance screening is likely to be the most effective route. Many Shariah-sensitive select the investments they do because they have a mandate to only invest in Shariah-compliant investments and there is a limited universe of these investments which, like SRI, has led to a mixed track record for empirical studies of performance versus the unconstrained investment universe. As a result of the performance gap and the limited universe of investors who will solely accept a product on its Shariah compliance, there is always a need to find ways to increase returns and reduce risk in Shariah-compliant portfolios relative to the conventional equivalents.[60]

POSITIVE SCREENING IN ISLAMIC FINANCE AND THE ROLE OF SHARIAH SCHOLARS

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The Shariah scholar plays an important role in contemporary Islamic financial practices especially in product structuring and development as well as in overseeing the application of different aspects of the Shariah in Islamic financial institutions. The role involves *ex ante* and *ex post* aspects of Shariah governance, including Shariah pronouncements (*fatawa*), supervision (*raqabah*) and review (*mutaba'ah*). The Shariah scholar certifies each and every product, finance structure and service provided by the Islamic financial institution that he or she represents.

The role and responsibility of Shariah scholars is very much prevalent in making Shariah decisions related to all aspects of Islamic finance operations. This requires great intellectual effort from Shariah scholars to understand both the sources of Islamic law (*nuṣūṣ*) and the context of economic and financial practices and operations (*wāqi'*). Therefore, the approaches taken to understand the texts and contexts should be appropriate so that the decisions made are correct.

Shariah: No distinction between legal imperatives and moral obligations

Shariah is the source in developing Islamic finance. It provides guidance on how an ethical mode of finance can be established and it also sets the rules on what is allowed or prohibited in financial activities such that Islamic ethical principles are upheld in financial activities. These rules set the framework that would eliminate potential conflicts, injustice, exploitation, and other unethical actions, in order for mutual consent in a financial transaction to be achieved.

Law and ethics, from the Shariah perspective, should not be viewed as separable and should not be made contradictory in developing Islamic finance, as the Qur'anic worldview recognizes no distinction between legal imperatives and moral obligations.

The legal compliant structure of Islamic financial products should essentially reflect the spirit of Islamic values that represent the hallmark of financial dealings among the contracting parties to gain mutual benefit or reach a win-win situation.

Islamic financial contracts would not recognize any financial dealing that has no solid ethical ground and that would lead one party to gain from the transaction and the other party to lose. Shariah scholars play a significant role in ensuring that financial transactions are legally and ethically compliant with Shariah.

Islamic finance product structuring: marrying form and substance

In developing Islamic finance, efforts are directed not only to transforming the financial and banking system to conform to the Islamic law in legal compliance per se, but also in a comprehensive manner of ethical value commitment. In other words, the concern is not merely to secure the narrow legal compliance of banking and finance practices by screening negative elements in conventional financial practices, but a more substantive movement towards inspiring a good financial system enshrining Islamic ethics and principles as implied in the concept of *maqāṣid al-Shari'ah* (the goals of Shariah).

In this regard, *maṣlaḥah* (benefits) and *mafsadah* (harms) of financial products and transactions would also be taken into consideration. Shariah aims at realizing *maṣlaḥah* that would facilitate benefits, fairness, justice and goodness and removing *mafsadah* that would implicate to the harms, injustice, exploitation, and dispute in financial products and transactions.

Negative screening by cleansing conventional financial practice of prohibited elements, such as interest (*riba*), gambling (*maysir*), uncertainty (*gharar*) and other prohibited (*haram*) elements commonly found in financial services, aims at ensuring that all *mafsadah* are eliminated from financial products structuring.

Likewise, positive screening by infusing positive aspects of Islamic teachings and ethics into the structure of financial products and services aims at ensuring that all *maṣlaḥah* would be upheld and realized in financial products and transactions.

Ethics 'inescapable element' in Islamic financial transactions

In this endeavour, ethics is an inescapable element in Islamic financial transactions that would determine the parameters for establishing a good social order within the system is upheld. Islamic finance in this regard is very much aware of the moral failure of unethical motives and actions in financial practices that could lead to financial crises.

Ethics is an integral aspect of Islamic finance to be a sound financial system. In an integral ethical system, financial institutions would not be viewed as mere intermediaries but as enabling institutions that can empower people and companies to pursue and achieve their goals. This would systematically reshape the industry and guide it towards a proper direction.

Islamic financial ethics calls for the interplay between ethics and financial transactions. It is put forward as part of the larger Islamic ethical system since the financial aspect in Islam is considered part of 'religion' whereby all business activities, wealth creation, economic development, wealth distribution, and human welfare are also considered the 'business of religion'.

1. The approach in Islamic finance product structuring and transaction is done in three general steps: Negative screening by removing the prohibited elements in the conventional structure. The exclusion of negative elements in conventional finance structure such as *riba* (interest), *gharar* (excessive uncertainty), *qimar* (gambling), pornography, production and distribution of alcohol, tobacco, employing un-

deraged workers, damaging the environment and other prohibited transactions.

2. Adopting Islamic ethics and integrating Islamic values in financial products and services.

3. Applying Islamic principles and appropriate Shariah contracts to the different types of financial transactions and also to seek opportunities to blend Islamic contracts with conventional structures.

The process implies that Shariah compliance is not meant as merely complying with the Islamic legal principles in their structural forms, but also, in satisfying the substantive spirits of ethical and moral imperatives and Shariah objectives.

The following table explains some of the examples of the negative and positive screens in Islamic financial practices.

Islamic finance industry needs to do more to incorporate positive screens

The notion of positive screening is 'embedded' in the concept of Shariah itself which promotes positive actions in financial activities. In line with the concept of maqāṣ id al-Shariah positive values are promoted and implemented in financial activities and could be set as positive screens in ethical investing. Positive elements include factors such as environmental protection, pollution control, community engagement, energy conservation, sustainability, consumer protection, human rights, product safety, improved working condition for employees, seeking renewable energy, and others.

Moving forward, positive screens will be more prevalent in Islamic financial activities. This requires a concerted effort by regulators, industry players, activists, academicians and Shariah scholars to elucidate the criteria and quantitative benchmarks for the implementation of positive screens. At the moment such methods of screening are not emphasised to a large extent as the primary concern of Islamic financial institutions is whether their activities are halal or not.

Shariah scholars particularly should play their role in validating positive values which are appropriate with Islamic ethical system. Their role should not be restricted to simply examining the "halal" dimension in screening but should be extended to include the "tayyib" (meaning good, referring to a holistic and universally-beneficial ethical and wholesome framework beyond mere adherence to 'technical' aspects of Shariah) dimension as well, which is in line with the maqasid al-Shariah. This could possibly be better achieved if membership of Shariah advisory boards could include scholars or practitioners from other fields, or setting up other committees to work together with Islamic finance Shariah scholars.

Conclusion

As a conclusion, Islamic finance is concerned with values and ethics that would determine good finance. Ethics annihilation in financial practice might lead to invalidity of a transaction. In other words, in Islamic finance, ethics and law are integrated that would equate to the meaning of bring 'Shariah-compliant'. In Islamic finance both screening criteria of negative and positive screening are used in developing Islamic financial products. In positive screening, Islamic finance also adopts good values, which are not contradictory to Islamic values, in the issues of environmental, social and governance (ESG) issues.

TABLE 1: POSITIVE AND NEGATIVE CRITERIA ACCORDING TO SHARĪAH RULINGS

Negative Screening	Positive Screening
Transactions involving *ribā* (interest, usury) e.g. interest-bearing savings accounts, interest-bearing bonds, investment in equities or other securities issued by heavily indebted companies.	Payment of compulsory alms (*zakah*) and voluntary charity (*sadaqah*) which helps in the development of a social conscience through the sharing of one's resources with the under-privileged.
The manufacture, supply or service of impermissible (*harām*) goods and services e.g. alcohol, tobacco, drugs, pornography, prostitution, gambling, gaming, armaments, animal experimentation, human experimentation like genetic engineering as well as specifically mentioned *harām* products like pork meat or products, other non-*halāl* (non-permissible) meat, statues, idols, intoxicants (*qamr*), the entertainment industry including music and cinema.	Moderation, balance and harmony in life e.g. fair competition, justice, protection of the weak, pursuit of genuine profits, protection of the market mechanism, abidance by the legal system, transparency in dealings, dissemination of reliable information, safeguarding of individual rights and obligations, sanctity of contracts and contractual obligations.
Economic activities involving uncertainty or ambiguities (*gharar*) as they entail deception and injustice.	Promotion of trade (*bayʿ*) and fixed return modes of financing, incorporating the real exchange of goods and services, including the exchange of usufruct (services) generated by durable assets. E.g. *murābaḥah* (cost plus profit sale); *ijārah* (leasing involving sale of usufruct); *salam* and *istiṣnāʿ*.
Dealings in unfair practices e.g. monopolies, price fixing, price manipulation, hoarding, bribery, money laundering.	Profit and loss sharing between the investor (capital provider), the financial intermediary (Islamic bank) and the entrepreneur (user of funds) through financial contracts like *muḍārabah* (passive partnership) and *mushārakah* (partnership) (Iqbal et. al., 1998: 15).
Activities that would cause environmental damage or imbalance.	Environmental sustainability which is concerned with waste and excessive exploitation of non-renewable resources and promotes the maintenance of ecological balance.

> "THE FIRST STEP TOWARDS ADOPTING POSITIVE SCREENS IS TO FIND AREAS WHERE THERE IS CLOSE OVERLAP BETWEEN THE SCREENS EMPLOYED BY SRI WHICH ARE NOT YET EMPLOYED BY ISLAMIC INVESTORS AND FINANCIAL INSTITUTIONS.

Furthermore, because most of the assets of Islamic finance are held in banks which have a fiduciary duty to their depositors, the addition of ESG criteria in their financing decisions can have the biggest impact sooner on the types of projects and companies funded. The equity markets in many emerging and frontier markets is relatively less developed and private and state-owned companies play a relatively bigger role. Traditional ESG investors are largely focused on the public equity markets and building reporting requirements for the information needed to evaluate ESG risks. Complementing these efforts with more focus on ESG screening by Islamic banks (and the small domestic Islamic fund universe focused on home market investing) can increase the familiarity of management of both public and private companies of ESG risks and eventually increase transparency.

There is more overlap for Islamic finance and ESG/SRI than just including the additional financial analysis of ESG risks by Islamic financial institutions: the exclusion-driven model of Islamic finance can more easily adopt other screening methodologies both in exclusion (norms-based) screens and in the positive screening approach that represented the second step from a negative-screening-focused SRI sector towards the positive screening techniques of best-in-class. The first step towards adopting positive screens is to find areas where there is close overlap between the screens employed by SRI which are not yet employed by Islamic investors and financial institutions.

FROM RESPONSIBLE TO SHARIAH INVESTING: INSIGHTS, PROCESS AND PERFORMANCE

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JAMIE JENKINS is Head of the Responsible Global Equities team. Jamie joined the firm in 2000 and is co-manager of the F&C Responsible Global Equity Fund and the F&C Responsible Sharia Global Equity Fund. Prior to joining the firm, Jamie worked at Hill Samuel Asset Management as a Japanese Equities Fund Manager. He holds an MA in History from the University of Edinburgh, has IMC and IIMR qualifications and is a member of the CFA Society of the UK.

With hindsight, it makes perfect sense that a large Middle Eastern client would approach us with seed capital to set up a Shariah-compliant global equity fund. BMO Global Asset Management has a long track record of innovation and commitment, and particularly in the responsible and environmental, social and governance (ESG) space. We have a policy of focusing closely on client needs too, and setting up innovative investment solutions to meet those needs. Current estimates indicate Shariah-screened investments account for approximately US$3.6 billion in assets under management that integrate environmental, social, and governance (ESG) factors.[1] Movement to establish a framework integrating Islamic finance and ESG is underway and taking shape, in part through the efforts of the Securities Commission Malaysia (SC) launching the Sustainable and Responsible Investment (SRI) Sukuk framework in August 2014.[2]

We were also very sympathetic to the idea of creating a Shariah-compliant fund. As pioneers in responsible investing, we knew that a high-conviction portfolio that followed a disciplined ethical strategy – and demanded a deeper appreciation of risk factors - could produce competitive investment returns.

Indeed, we now have third party confirmation of this. A recent meta-study of more than 190 pieces of research by Oxford University's Smith School of Enterprise* shows that 80% of studies reveal that solid ESG practices had a positive effect on operational performance, and 80% showed a positive correlation between sustainability practice and stock price performance.

BMO Global Asset Management and responsible/ESG investing:

A track record of innovation and commitment

- **Launch of Europe's first ethically-screened fund in 1984**
- **Founding signatory of the UN PRI**
- **Comprehensive suite of responsible investment funds and services**
- **Commitment to engagement in ESG issues in the companies we invest in**

But how easily would our expertise in responsible investing cross over into expertise in Shariah? How well would we collaborate with Shariah scholars, or their representatives?

Common ground — Ethics, faith and investment objectives

As it happens, many of the religious sensitivities expressed in Shariah were already reflected in the collaborative approach of our Responsible Global Equities and our Governance and Sustainable Investment (GSI) teams. After all, our original impetus to develop our responsible investing funds had its roots in Quaker principles.

Our teams also took the view that there was a natural and pronounced alignment between responsible and Shariah values. Clearly, both approaches have a strong ethics foundation. Commonalities include a concern for human rights and the environment, a focus on long-term sustainability and success, and an avoidance of aggressive leverage. By creating our responsible screen, we had already done much of the heavy lifting for populating a Shariah-compliant fund.

So we were confident that our responsible screen provided a valid and robust starting point for constructing a Shariah-compliant portfolio. For example, our Responsible Global Equity fund already excludes companies associated with Shariah-prohibited activities such as gambling and alcohol.

Given that robust basis, we were confident we could proceed to set up a second, Shariah screen. At this point, as Shariah compliance excludes companies with excessive cash reserves or leverage, we were prepared to address the issues of cash balances and debt liabilities. However, there was a complication. There are different ways to assess cash and debt ratios.

Balance sheet neutrality, from an assets perspective

We discovered that there were differing opinions among Shariah authorities as to how a company's debt or cash levels should be measured. This could be based either on the company's market cap, or on a calculation of the company's total assets. In the end, in consultation with our agency Ideal Ratings and their affiliate Shariyah Review Bureau, we settled on the total assets model as giving a better measure of a company's financial stability. So we now filter out companies that show either a debt/asset or a cash/asset ratio of over 33%.

Altogether, it took us over 12 months to set up the fund, and make sure that our client's demands were met, and that all our investment and Shariah conditions and objectives were aligned.

The double-screening process

So, how big an effect does introducing the Shariah screen, with its extra exclusions, have on our universe of responsible stocks?

While we are now BMO Global Asset Management, our funds are still branded as F&C funds (BMO Global Asset Management acquired F&C in 2014). However, the same fund management team has been connected with the responsible and Shariah portfolios, providing continuity of expertise.

The chart on the next page shows the double-screening process and its effect on the stock universe.

Our responsible stock universe decreased by more than 60%,which means that our challenge has been to find enough high-quality companies, from a double-screened universe, to populate a successful high-conviction global equity fund.

Fortunately, these 350 stocks are all effectively pre-screened as quality companies, which still gives us plenty of scope to construct a high-conviction portfolio.

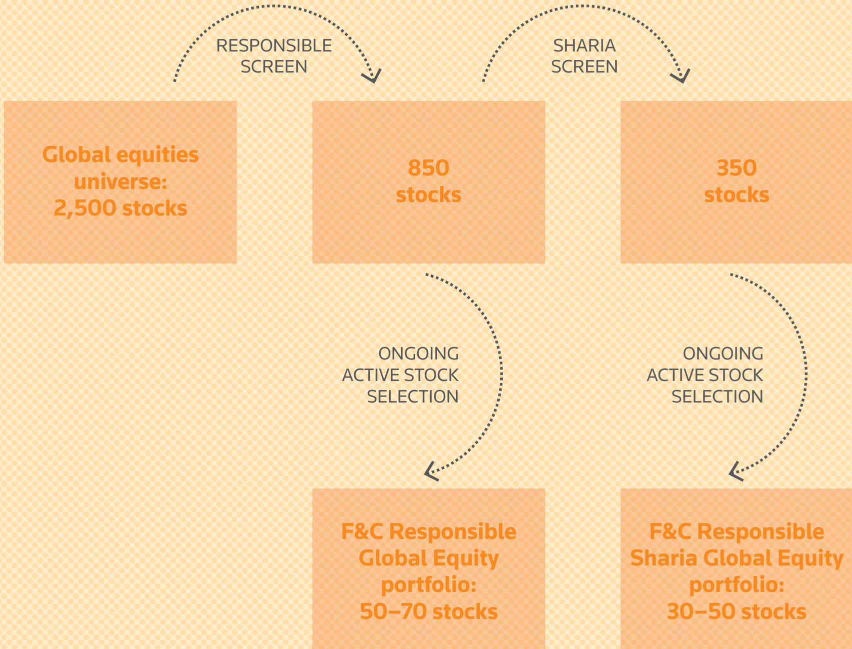
Similar but distinct portfolios

As at 31 May 2015, the two funds held a total of 32 stocks in common, though in different weightings (for example, of the top ten holdings in each fund, only four are common).

There is clearly a high degree of overlap between the two portfolios, as around 70% of the stocks selected for the F&C Responsible Sharia Global Equity fund are also held in the F&C Responsible Global Equity portfolio.

Nevertheless, there are differences. For example, the Shariah screen further constricts the universe of energy stocks. While the energy component of our responsible portfolio is already 4.3% underweight compared to the benchmark, this rises to 12.7% underweight in our Shariah portfolio because of the greater weight of the energy sector in the MSCI Islamic index. We have balanced this with an equally significant positive allocation to industrials, where we are 10.1% overweight in our Shariah portfolio, as opposed to just 4.7% overweight in our responsible portfolio. (All figures as at 10 July 2015.)

So how would this differing portfolio selection, with the Shariah portfolio picked from a double-screened universe, affect the performance of the F&C Responsible Sharia Global Equity fund? Four years from inception, we can provide at least a provisional answer.



Broadly correlated but diverging performance

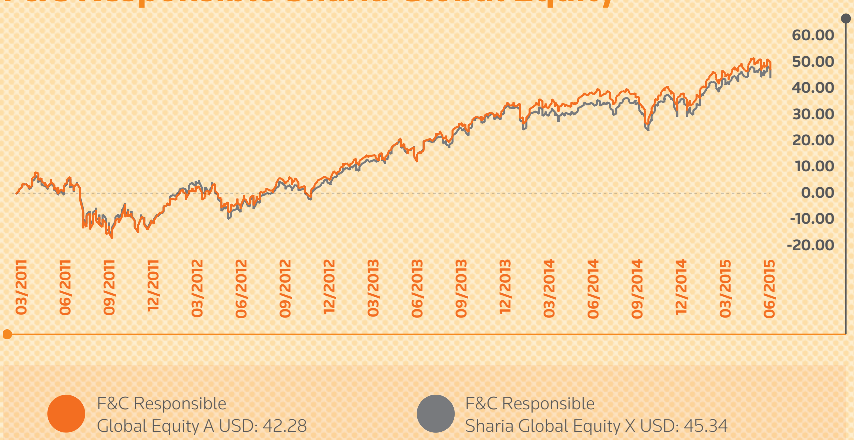
The chart below tells the story. Both funds feature high-conviction portfolios built using a bottom-up stock-picking approach and are aimed at delivering strong risk-adjusted returns.

As you can see, since its launch our Shariah-compliant fund has in fact outperformed, not underperformed, its sister fund. So while we may have initially supposed that a double-screened fund, with a much smaller universe of stocks to draw on, would have a constrained performance — the reverse has been proven to be true.

To explain this, we propose that the double-screened universe produces a portfolio with a still higher level of conviction. It may also be the case that the additional financial screening reduces the tail risks associated with companies that are either highly leveraged or cash rich.

Past performance is no guarantee of future performance. There are many factors in the world economy and in the changing balance of asset classes that can affect our portfolios in unpredictable ways. The present beneficial effect of double-screening may not persist — though we remain optimistic about results going forward.

F&C Responsible Global Equity and F&C Responsible Sharia Global Equity



Source: Lipper, percentage growth in US dollars between 22 March 2011 and 30 June 2015

Counter-intuitive

The enhanced performance of the F&C Responsible Sharia Global Equity fund compared to that of the already impressive F&C Responsible Global Equity fund is an interesting and somewhat counter-intuitive result. I believe this is something we could only have learned by creating and running the F&C Responsible Sharia Global Equity fund.

At BMO Global Asset Management, we have confidence in our long-term commitment to responsible investing. A bottom-up, defined stock-picking approach that focuses on finding leading global companies who operate sustainably and with highly ethical corporate management can produce competitive and potentially superior investment results. Now we know that adding a Shariah screen to this process does not constrain the investment managers. Based on the first four years of the F&C Responsible Sharia Global Equity fund, it seems our faith in Shariah-compliant investing has been rewarded.

*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281

The most common types of exclusionary screens used in SRI which are not used in Islamic finance are largely grouped into the areas of environmental protection and animal welfare, each of which could find support in the Shariah but may pose more difficulties on a political level than from a Shariah perspective. It is no secret that the wealthiest Muslim majorities (like the nations in the GCC for example) where Islamic finance has developed the furthest are the most dependent on fossil fuels for this wealth. Many of the environmental screens focus on carbon emissions and climate change which have become embedded into investment strategies as 'fossil fuel-free' portfolios. Given the economies' high reliance on fossil fuels for a large share of total economic activity (directly and indirectly through the financial institutions that finance the oil production or industries that benefit from the high energy subsidies), it is not entirely realistic to exclude fossil fuel-related portfolio components.

As a result, it may be better to direct the energy around addressing climate change and carbon emissions in investments in these countries by using best-in-class methodologies that identify the companies that are making changes to their production methods to reduce carbon emissions not just compared to their own (perhaps high) baseline but compared with the top share of oil companies globally. In addition, some of the countries with the highest production of oil are shifting towards renewable sources in a self-interested effort to preserve the production from remaining reserves for export to provide wealth to future generations and build an electricity export industry powered by renewable sources, something Saudi Oil Minister Ali al-Naimi said could happen by the mid-21st century.[61]

Incorporating positive screening methodologies that overweight the companies developing, installing and operating these new renewable

ISLAMIC FINANCE MARKETS: CHALLENGING GOVERNANCE ENVIRONMENT FOR GLOBAL INVESTORS

Country	IFDI	Doing Business (Overall)	Getting Credit	Protecting Minority Investors	Registering Property
1. Malaysia	93.18	18	23	5	75
2. Bahrain	76.41	53	104	104	17
3. Oman	63.79	66	116	122	19
4. United Arab Emirates	57.44	22	89	43	4
5. Qatar	39.58	50	131	122	36
6. Kuwait	38	86	116	43	69
7. Jordan	36.39	117	185	154	107
8. Pakistan	34.39	128	131	21	114
9. Saudi Arabia	30.64	49	71	62	20
10. Brunei Darussalam	29	101	89	110	162

Higher is better for IFDI ranking while lower numbers are better for the Doing Business rankings which rank 189 countries.
Source: Thomson Reuters-ICD IFDI and World Bank Doing Business Ranking

energy projects in oil-rich countries as a way to reduce their energy usage could also serve as an effective shift away from fossil fuel investments. It would allow more financing to be directed towards environmentally-friendly companies that help mitigate climate change without totally excluding the entire fossil fuel sector which may be impractical or impossible in some countries where Islamic banks represent a large share of the economy.

The use of these other exclusionary screens (either negative screens that eliminate entire sectors or positive screens that select the best-in-class companies from problematic sectors) is one way to expand the sustainable focus of Islamic investments and Islamic financial institutions. The industry may be more amenable to exclusionary screens because it already relies on (other) exclusionary screens. A shift towards ESG may complement the development of Islamic finance by improving performance and aligning its activities more closely with other responsible finance sectors to expand into markets where it does not have a large presence. The final area of ESG/SRI screening that Islamic finance could incorporate is the 'engagement' route.

Broadly speaking, engagement involves the investors being more active in pushing investee companies to prioritize things which management may not want but investors see as creating long-term value for shareholders. For most conventional investors, the engagement centers around how companies manage ESG risks that the investors see as affecting the long-term value. Islamic investors may want to be active shareholders in these areas as well (and could cooperate with other investors) but will likely have additional concerns relating to areas that are of importance from a Shariah perspective like the use of interest-based debt and involvement in prohibited areas (which may also be in focus from the ESG angle).

In most Muslim majority countries where Islamic finance is well-developed, corporate governance is weak and investors are not as active as in Europe and North America. As a result, shareholder engagement may be more difficult or just not commonly done. A shift in this area is not likely to happen quickly, but finding ways to demonstrate financial value from responding to long-term ESG risks can push investors and financial institutions more effectively in the direction of making the risks explicit in the financial valuation of investments. Doing so will not make engagement happen but it can better highlight the costs for companies that do not manage their ESG risks to the extent that shareholders expect.

As described above, there are possible ways that conventional investors (i.e. those that do not consider Shariah screens in their investment methodology) could benefit from Islamic screening methodology. They could, as many SRI investors already do, share exclusionary screens for sectors like alcohol, tobacco, weapons, pornography and gambling. Or they could see overlaps with the Islamic exclusion of pork products with SRI concerns about animal welfare because most meat production (pork included) is done in factory farms where maximizing efficiencies is prioritized over animal welfare or the welfare of farmers.[62] Another exclusion that could have some overlap in the conventional SRI sector is the exclusion of conventional financial sector companies which is due to the Islamic prohibition of interest but could be extended into the SRI space on the grounds that the macro financial sector has contributed to rising income inequality and was a key reason for the financial crisis.

While these areas have some overlap potential and could help Islamic investment funds expand to serve SRI investors and vice versa, there is a much bigger opportunity in the financial screens employed by Islamic investors (Presented in Chapter 2 Converge) which were designed to help investors find companies that have some interest income or expense but not "too much" where too much is relatively subjective since interest is prohibited by the majority of Shariah scholars. However, the effect of the prohibition of "too much" interest income or expense has the effect of excluding highly leveraged companies (which would include banks if the leverage screen were performed on its own).

The benefit from this may not necessarily show up in a year-in year-out performance gain because leverage can amplify returns when there are good outcomes. The benefit from the leverage restrictions inherent in the Islamic investment

COMMON SCREENS EMPLOYED IN RESPONSIBLE FINANCE

	SRI	ESG	Impact Investing	Islamic Finance
Norms-based Exclusions				
Alcohol	✓			✓
Animal testing	✓			
Climate Change	✓			
Ozone depleting substances	✓			
Deforestation	✓			
Genetic engineering	✓			
Non-sustainable infrastructure projects	✓			
Intensive farming	✓			
Weapons	✓			✓
Narcotics	✓			✓
Tobacco	✓			✓
Gambling	✓			✓
Pornography	✓			✓
Nuclear power	✓			
Highly indebted companies				✓
Companies with high liquid assets				✓
Companies with high interest income				✓
Best-in-class				
Social	✓	✓		
Environmental	✓	✓		
Business Ethics	✓	✓		
Labor Standards	✓	✓		
Human Rights	✓	✓		
Corruption	✓	✓		
Corporate Governance & Executive Compensation	✓	✓		
GRI reporting and transparency	✓	✓		
Global health	✓	✓		
Political donations	✓	✓		
Tax avoidance	✓	✓		
Advocacy & Engagement	✓	✓		
Community investing				
Microlending funds			✓	
Impact investment			✓	
Social Impact Bonds	✓	✓	✓	
Green bonds	✓	✓	✓	

> “IN MOST MUSLIM MAJORITY COUNTRIES WHERE ISLAMIC FINANCE IS WELL-DEVELOPED, CORPORATE GOVERNANCE IS WEAK AND INVESTORS ARE NOT AS ACTIVE AS IN EUROPE AND NORTH AMERICA.

process comes during periods of stress when cash flow tightens like a noose around the neck of the most highly leveraged companies. Those companies that use lower leverage are better able to manage the tightening cash flow during periods of economic stress and may be able to benefit through acquisitions of the higher leveraged, distressed companies at more attractive prices. Companies with higher leverage, in contrast, often use the leverage to finance acquisitions or stock buybacks (frequently at high valuations) and when the interest payments become more difficult to manage, they have to sell assets when valuations are low, exactly the opposite of the 'buy low, sell high' mantra that managers and investors try to maintain.[63]

If higher leverage is associated with lower stock returns as empirical research indicates, then an investor that adopted the Shariah screening (at least the financial leverage ratio restrictions) could increase their returns compared to a benchmark which includes companies with low leverage as well as those with higher leverage. In addition, the potential for high levels of leverage to contribute to a deleveraging cycle with crisis-like characteristics (as in 2007-2009 or Dubai's debt crisis which followed in 2010) has a social cost from factors like a steeper drop in employment. If adopting leverage restrictions, as Islamic investment criteria do, it could encourage more companies to limit their leverage and possibly help arrest or limit the effects from a debt-deleveraging cycle in a future crisis. This would not just provide a financial return for investors who avoided the most leveraged firms, but it would also contribute to a healthier real (non-financial) economy as well. This effect isn't always picked up by the SRI/ESG methodologies because it is not viewed as being a 'socially responsible' criteria or a factor in most ESG risks but perhaps it should be.

Moving in another direction, both Islamic finance and SRI commonly focus on maximizing returns within the constraints of their rulebooks, while ESG focuses on using environmental, social and governance risks to avoid losses or increase returns. Neither has an explicit focus on the social impact that their financing plays. Additionally, neither is commonly focused on not solely maximizing returns to increase their social impact the way that impact investing is. Impact investing is a new area of SRI which "channel[s] funding to social organisations or enterprises that seek to tackle specific social challenges through market mechanisms".[64]

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A sunset is seen through a wind farm near Puck, northern Poland, July 22, 2015. REUTERS/ Kacper Pempel

THE WORLD'S FIRST RINGGIT-DENOMINATED SRI SUKUK

Mohd Izani Ghani, Chief Financial Officer, Khazanah Nasional Berhad

MOHD IZANI GHANI has been the Chief Financial Officer of Khazanah Nasional Berhad since May 2010 and has been its Executive Director since October 1, 2012. Previously, he served as the Vice President of Finance at Khazanah Nasional Berhad. At Khazanah, Mr. Ghani was deeply involved in the issuance of the world's first exchangeable sukuk for $750 million in 2006, followed by other landmark exchangeable sukuks in 2007 and 2008. He joined Khazanah Nasional Berhad.

He graduated from London School of Economics (LSE), University of London in 1991. Thereafter he obtained professional qualification from Association of Chartered Certified Accountants (ACCA) and was conferred fellowship in 2000.

The first SRI Sukuk, issued by the Malaysian government's strategic investment fund Khazanah, presented a new method of funding Trust Schools through the private sector via the debt capital markets. Previously, the funding of Trust Schools was done solely by Khazanah through its CSR annual budget allocation.

In early 2015, Khazanah Nasional Berhad, via a Malaysian-incorporated independent special purpose vehicle (SPV) Ihsan Sukuk Bhd, established a Ringgit-denominated SRI Sukuk Programme of RM1.0 billion to fund eligible Shariah-compliant SRI projects as defined under the Securities Commission Malaysia's guidelines, which aim to: (a) preserve and protect the environment and natural resources; (b) conserve the use of energy; (c) promote the use of renewable energy; (d) reduce greenhouse gas emission; or (e) improve the quality of life for the society. Khazanah's Sukuk Programme is the first to be approved under the SC's SRI Framework introduced in August 2014 and it was rated AAA(s) by RAM Rating Services Berhad.

Under this sukuk programme, on 18 June 2015, Khazanah successfully issued Malaysia's first SRI Sukuk, a RM100 million sale with a periodic distribution rate of 4.30% per annum. The proceeds from this 7-year sukuk issuance is used to fund the roll-out of 20 Trust Schools under Yayasan AMIR's (YA) Trust Schools Programme for 2015.

Yayasan Amir is a not-for-profit foundation incorporated by Khazanah to improve the accessibility of quality education in Malaysian Government schools through a Public-Private Partnership with the Ministry of Education. YA's Trust Schools Programme began in 2011 and provides an avenue for students under its programme to excel in both academic and non-academic areas through its holistic approach in education. The Trust Schools Programme was conceived to undertake the challenge of transforming the entire education system through a paradigm shift with the end goal of maximizing student potential, regardless of geographical school location or type of schools.

The Trust Schools Programme is an implementation model which focuses on school-wide transformation carried over the course of five years. As at December 2014, there were 30 schools on the Trust Schools Programme, which spans across urban and rural states in Malaysia and impacts the lives of more than 20,000 students nationwide.

Each progress, issue, challenge, milestone and outcome is monitored and recorded to assist in the implementation of the programme at future schools. The strategic goals of the Trust Schools Programme focus on all stakeholders; i.e. the school leaders, teachers, students, parents and community, concurrently. The inception of YA's Trust Schools Programme is in line with the aspiration of the Malaysian Education Blueprint 2013-2025 which aims to provide opportunities for students to flourish and become knowledgeable Malaysians who are able to think critically and creatively, and are equipped with leadership and communication skills.

Structure and features of the SRI Sukuk

CIMB Investment Bank Berhad was the sole Lead Arranger and sole Lead Manager for the SRI Sukuk, while Amanie Advisors Sdn Bhd and CIMB Islamic Bank Berhad were the joint Shariah Advisors for the deal.

The Islamic principle used in this first SRI Sukuk is wakalah bi al-istithmar, which further affirms Khazanah's continued effort to push the envelope on transaction innovation and the positioning for Islamic structures. The structure allows the issuer to use a combination of tangible assets and commodities and is relatively asset efficient and thus suitable for the issuer, SPV, and Khazanah. The wakalah structure is approved by the Securities Commission Malaysia's Shariah Advisory Council and qualifies for certain tax incentives accorded by the Malaysian tax authorities.

Another unique feature of this sukuk is that it also allows sukukholders to convert their investment in the sukuk into a donation at any point during the tenure. The sukukholders will be entitled to receive tax vouchers from YA, through Khazanah, for an amount equal to the amount waived or reduction in the nominal value of their respective sukukholdings. We believe this is a balance between managing for downside risk and contributing to social good while reducing the commercial return. Of course, it would be even better is if the investors convert all their investment into donations and forego the lending relationship.

> “ON 18 JUNE 2015, KHAZANAH SUCCESSFULLY ISSUED MALAYSIA'S FIRST SRI SUKUK, A RM100 MILLION SALE WITH A PERIODIC DISTRIBUTION RATE OF 4.30% PER ANNUM.

The sukuk's KPIs

Unlike a typical fixed income instrument, the repayment and performance of the SRI Sukuk is dependent on the eligible SRI project's ability to meet identified key performance indicators (KPIs) which are assessed over a five-year observation timeframe.

If at maturity the KPIs are fully met, sukukholders will forgo or contribute up to 6.22% of the nominal value due under the sukuk, which in effect will reduce the profit rate to 3.5% p.a. The adjustment is considered as part of sukukholders' social obligation in recognizing the positive social impact generated by the Trust School Programme. If KPIs are not fully met, sukukholders will receive up to the nominal value due under the sukuk as agreed at issuance of 4.30%.

The 2015 KPIs for the first SRI Sukuk covers four aspects: minimum number of schools selected under the Trust Schools Programme, proficiency of the selected Trust Schools' teachers, proficiency of the selected Trust Schools' senior leadership team and proficiency of the students including set targets in relation to discipline, literacy and numeracy skills for the said students. The performance criteria include both output (eg. school performance in exams) and input (eg. student attendance) indicators. The KPIs will be audited by an independent audit firm at the end of the fifth year and a report will be distributed to the sukukholders

This first SRI Sukuk also differentiates itself from other issuances in the global markets due to the 'Pay for Success' mechanism set in place to ensure that beneficiary of the funds (i.e. Yayasan Amir) uses the receipts from the issuance in an efficient and effective manner. By incorporating into the SRI Sukuk structure pre-determined KPIs, investors are able to monitor the success of the initiative that they are funding, giving them assurance that their money is being put to good use, whilst making the YA accountable for the use of the funds. This ensures that sukukholders are able to see tangible results from their investments, as well as motivates YA to put the funds to good use in achieving the set KPIs.

Attracting and educating investors

Due to the unique structure of this first SRI Sukuk , the investors required more time to familiarise themselves with the structure and the mechanics of the sukuk. A two-day roadshow was organized to educate and reach out to both frequent and new fixed income investors.

The distribution of the sukuk was targeted at corporates and foundations as part of their social responsibility initiatives. Some of these corporates and foundations were not regular sukuk investors, thus the issuance also opened up the opportunity for not-for-profit institutions to participate in the capital markets as a way of channeling funds to socially responsible and charitable causes.

The sukuk is intended to complement Khazanah's existing work in Corporate Social Responsibility (CSR). With good financial innovation, this structure brings a whole new class of investors and hopefully in time, they or their foundations will see the value of investing for good CSR initiative. Investor participation includes foundations, corporates, banks, pension funds and asset management companies. The SRI Sukuk provides the investor a platform to invest for a good cause and to instill greater performance and accountability within the social impact sector.

"Tremendous" growth potential

Although the global SRI market is still nascent, we see tremendous growth potential given Malaysia's leadership in the global Islamic finance market as well as the increasing global and domestic demand for greater governance and ethical investment. In Malaysia, for instance, we see this in the various government initiatives in developing green energy. The depth of the local currency market along with heightened consciousness on corporate social responsibility, makes for a potent combination. This is also in line with the Shariah principle which outlines the purpose and wisdom prescribed in Islamic principles in all its rulings, to protect and preserve the benefits and interests of society.

The issuance of this sukuk, which combined the education and Islamic finance sectors along with socially responsible investments through an innovative structure, demonstrates impact investing at its best, whilst being executed at competitive rates. The SRI Sukuk is a new and powerful concept and hopefully investor awareness and responsiveness will increase further over time. This first-ever SRI Sukuk issued marks another milestone in product innovation from Malaysia in the Islamic capital market. This achievement also reinforces the universality of the value proposition of Islamic finance and creates a new asset class in the Malaysian Islamic finance industry.

It is hoped that more good standing issuers will undertake this structure and it could be replicated for other social impact initiatives such as affordable housing, healthcare, environmental protection and others. The sukuk will act as a catalyst for other global and Malaysian companies to follow suit and serves as a benchmark for other issuers tapping the Malaysian sukuk capital market for socially responsible financing in the future. The first SRI Sukuk is also a historic achievement in the development of Malaysia's capital markets and will further enhance the country's value proposition as a global center for Islamic finance.

"THE ISSUANCE OF THIS SUKUK, WHICH COMBINED THE EDUCATION AND ISLAMIC FINANCE SECTORS ALONG WITH SOCIALLY RESPONSIBLE INVESTMENTS THROUGH AN INNOVATIVE STRUCTURE, DEMONSTRATES IMPACT INVESTING AT ITS BEST.

One of the related forms of 'impact investing' is the development of Benefit Corporations (B-Corps), where companies put shareholder return on par with or below the goal to generate a social impact. Some of the social stock exchanges like the Canadian Social Venture Connexion use existing standards for B-Corps from the B Lab while others use varying standards to require that all listed companies have social impact as either a core or primary purpose.[65]

PROMINENT B: CORPORATIONS

- Natura
- Kickstarter
- Green Mountain Power
- Etsy
- Ben & Jerry's
- Warby Parker
- Method
- Cabot Creamery

Source: The Guardian Sustainable Business, http://www.theguardian.com/sustainable-business/2014/dec/12/b-corps-certification-sustainability-natura

A notable challenge to the development of social stock exchanges is that the return on capital is lower than other businesses and there is not an established understanding of impact investing as an asset class. If it were viewed more as a separate asset class, the valuation of companies relative to non-impact peers would be less important and the relative valuation of impact investments would matter more. However, to be long-lasting, it is likely that investors (and particularly their fiduciaries) would need to have an explicit impact mandate to consider lower returning investments through social stock exchanges.

Another type of impact investing are social impact bonds which tie financial returns to investors social outcomes. Based on the newness of the concept (the term 'impact investing' was coined at the Bellagio Summit convened by the Rockefeller Foundation in 2007), the size of impact investing funds is much smaller than other areas of SRI (an estimate from Eurosif put the total impact investing assets at €20.3 billion in 2013 compared with total SRI assets using an exclusion methodology which was €6.9 trillion in the same year).[66]

The future growth in this area will be relatively small in absolute size but because it leverages private capital that aims to generate financial returns while also making a positive social impact, it has a tremendous opportunity for other sectors of responsible finance including Islamic finance.

Social Impact Bonds

Social Impact Bonds are a new form of impact investing where a financial return is viewed as important alongside the social benefit it can provide. Social impact bonds (also called pay for performance bonds) are designed to attract private sector financing for projects that have a positive social impact. In general, they are structured with an agreement between a delivery agency (which works through a service provider) and a government agency.[1]

The issuer—a government or nonprofit—raises the funding with a promise to repay later depending on the success of the project in meeting its social impact objective. The first social impact bond issued in Peterborough, UK in 2010 with the aim of reducing recidivism rates of former prisoners among their release from prison. The offering raised £5 million ($8 million) from mostly charitable investors who will receive their money back (with interest) from the British government if the rates of recidivism are more than 7.5% lower than a control group of prisoners.

If the reduction is less than 7.5%, the investors lose their money and the returns increase based on the amount by which the reduction in re-conviction rates exceeds 7.5% up to a 13% annual return. In 2014, the first measurement of the impact was released by Social Finance who arranged and managed the SIB finding that the recidivism rate declined 8.4%.[2] This exceeds the 7.5% threshold but not enough to make payments to investors until at least 2016 (the minimum rate of return on the bonds is an annual return of 2.5%).

Social Impact Bonds are new innovations but have attracted criticism that by injecting the profit motive into social services, it could distort the quality and the type of services provided to the end recipients by focusing only on those with empirical data which are likely to be the ones with the most existing funding sources. As a result of focusing on the programs that are the easiest to measure rather than the ones necessarily with the greatest impact, it could just shift funding sources for existing programs without increasing the level of social program funding available overall.[3] These criticisms don't entirely invalidate the prospects for SIBs but they should temper some of the excessive optimism and focus not just on the structure of the bonds themselves but also how they are used.

1. Nicholls, Alex and Emma Tomkinson. 2013. "The Petersborough Pilot Social Impact Bond," Said Business School Working Paper, October 2013. https://emmatomkinson.files.wordpress.com/2013/06/case-study-the-peterborough-pilot-social-impact-bond-oct-2013.pdf (Accessed June 25, 2015).
2. Ganguly, Brinda. "The Success of the Peterborough Social Impact Bond," *Rockefeller Foundation Blog*, August 8, 2014. https://www.rockefellerfoundation.org/blog/success-peterborough-social-impact/ (Accessed June 25, 2015)
3. Cohen, Rick. 2014. "Eight Sobering Thoughts for Social Impact Bond Supporters," *Nonprofit Quarterly*, June 12, 2014. http://nonprofitquarterly.org/2014/06/12/eight-sobering-thoughts-for-social-impact-bond-supporters/ (Accessed June 25, 2015).

^ A Haitian worker selects beans of coffee at Don Jimenez Estate coffee farm in San Jose de las Matas May 20, 2011. REUTERS/ Eduardo Munoz

Expand

A tree is pictured in a blooming rapeseed field on a spring morning in Vufflens-la-Ville near Lausanne April 23, 2015. REUTERS/Denis Balibouse

Summary

1. Growth across responsible finance sectors has not yet translated to growth in overlap between the different sectors, particularly across the conventional/Islamic finance lines

2. A Thomson Reuters report earlier this year estimated growth in Islamic fund assets to $76 billion by 2019

3. Twelve large OIC markets could bring an additional latent demand of $23.0 billion for funds that offer both Shariah compliance and ESG screening ("prudent ESG" funds)

4. Biggest "OIC-12" opportunities for prudent ESG funds include Saudi Arabia, Malaysia, UAE, Turkey, Iran and Qatar, representing 84% of the forecast OIC-12 potential

5. Inclusive of non-ESG Islamic funds and prudent ESG funds, the total likely supply of Islamic and prudent ESG funds in 2019 is $107 billion, a 39% increase over the likely supply of only Islamic funds

6. Growth potential comes from rising awareness of the importance of ESG and the potential to attract non-Muslim investors to Prudent ESG funds

7. Analysis only covers the limited share of the responsible finance cross-over market in funds where the fewest regulatory barriers exist

Introduction

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A boy hugs a tree trunk as he prepares to take part in an attempt to create a Guinness World Record for the most number of people hugging trees for two minutes in Kathmandu June 5, 2011. REUTERS/ Navesh Chitrakar

The demand for responsible finance has been rising and is growing across all sectors—SRI, ESG and Islamic finance. The universe of ESG and SRI finance has been catalogued by the regional Sustainable Investment Forums' (SIFs) biannual reports and the Global Sustainable Investment Alliance's recent reports that combine estimates from the regional SIFs.[67,68] The Islamic finance industry overall and the Islamic funds industry have been catalogued by Thomson Reuters as well.[69] However, there exists no high quality estimate for the potential overlap between Islamic finance and other responsible finance sectors.

The methodology employed in this report to estimate the potential overlap between Islamic finance and other responsible finance sectors uses the one used in the Thomson Reuters *Islamic Asset Management Report 2015* and expands upon it to look at the new markets across the Organisation of Islamic Cooperation (OIC) countries where Islamic and other responsible funds will find growth in future years. This source of opportunity will complement the possibilities for Islamic funds to add ESG criteria in their methodology which could be offered as an add-on to traditional sustainable investing, a 'prudent ESG'.

A unique opportunity to expand responsible finance through collaboration

There are not very good estimates of the potential universe of the Responsible Finance sector's future growth trends because the fundamental drivers of its growth are not particularly well mapped out and a lot of the research has focused on qualitative studies of "Where are we today?", "How did we get here?", and "Are we performing up to expectations of conventional benchmarks?" The key growth metric that this study will consider is the opportunity for crossover mutual funds between the responsible finance sectors through 2019.

The Thomson Reuters *Islamic Asset Management Report 2015* methodology looks for fund demand based on the available investable funds, and this report looks for the possibility for Islamic finance growth into new markets to meet demand of consumers who are either involuntarily or voluntarily financially excluded due to religious belief. It also considers the experience of Islamic finance managers in majority non-Muslim markets like the U.S. to gauge growth potential outside of the Muslim demand for 'prudent ESG' funds.[70] The track record of the Amana Funds in the U.S. provides a useful metric because they are some of the world's largest Islamic funds and there are various tax and regulatory reasons that limit the appeal of these products to non-U.S. investors. Their meteoric growth from the year 2000 through today is in large part due to their solid performance that may be due, at least in part, to their Islamic screening methodology. This provides a way to control for the flow of funds from OIC investors that would skew the estimates if the methodology considered the UCITS market which has a global investor base.[71]

Combining these metrics, we open the door to get a unique look into the crossover expansion potential for ESG investment funds to generate growth in key emerging markets with large Muslim populations (primarily the OIC markets). The analysis includes the opportunities for Islamic fund managers into the large, deep and still rapidly growing ESG sector in developed markets.

Methodology

The first part of the analysis (the 'established market' forecast) takes the growth forecasts for Islamic funds which is separated into a forecast of supply (funds offered) and latent demand (from investors) for Islamic funds and considers the share of these assets that could suitably incorporate ESG criteria to offer a unique value proposition beyond the core Shariah-sensitive market and pick up share among a wider market of ESG sensitive investors.

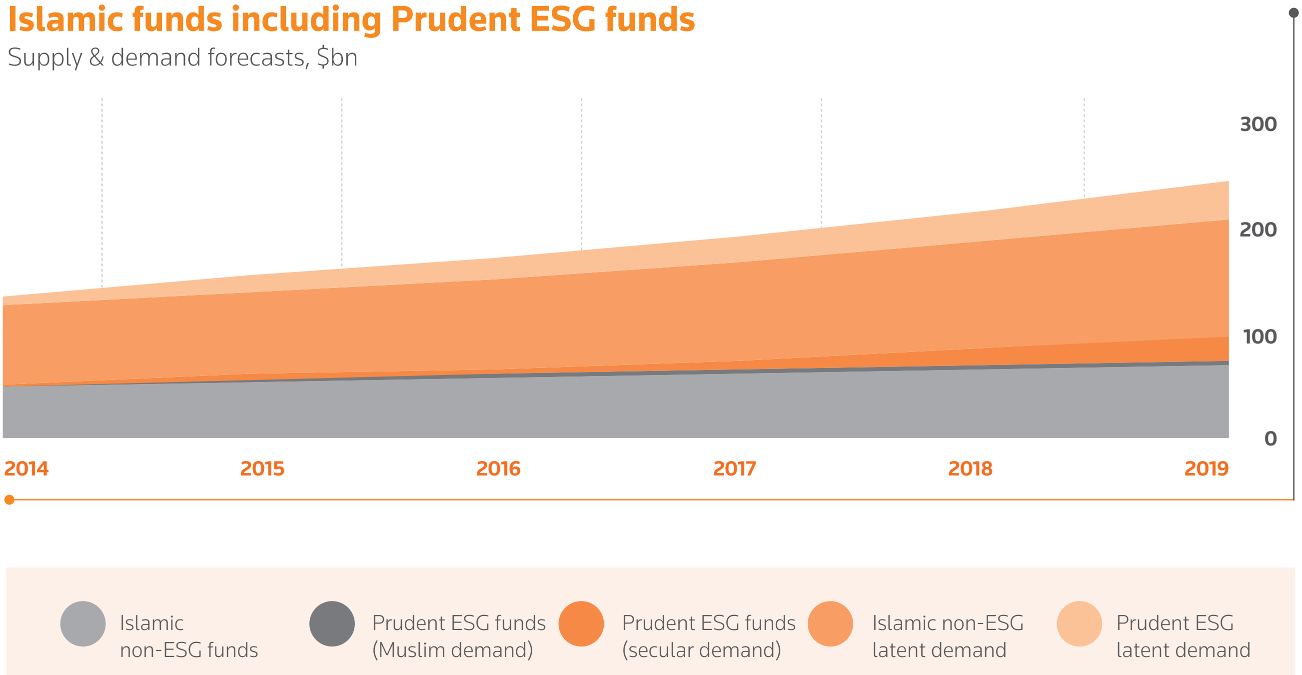
The process can be separated out into two analyses:

Part 1: "Islamic Demand". Take Thomson Reuters Islamic Asset Management Report 2015 forecast for Islamic funds (blue + green) and separate out the two elements. This will be based on the uptake of ESG funds out of the entire universe with any adjustments based on the current state of the Islamic funds market and customer perceptions of the need to include ESG criteria (e.g. greater awareness of the impact of climate change now than when ESG/SRI were first getting going; less need to educate on ESG, offset with any factors that would limit acceptance of ESG in jurisdictions where Islamic funds are significant, such as dependence on fossil fuels for export earnings or perceptions that the Islamic screening process covers all required social responsibility areas).

The methodology for doing this is to look at the history of SRI and ESG screening and discount that growth to get a conservative estimate for how prudent ESG could develop. While the growth of the global SRI market is still in its early years, there has been data collected

Islamic funds including Prudent ESG funds

Supply & demand forecasts, $bn



Source: Thomson Reuters estimates

on its size and growth dating back to the late 1990s in some regions. The data from USSIF on the size of SRI investing goes back to 1999 when roughly $2.1 trillion were invested in SRI investments, a level which grew only 2.9% per year through 2007.

The European marketplace, which has become a huge part of the responsible finance universe is even younger with the first Eurosif study coming out just in 2003 and finding €336 billion in SRI-managed assets. The growth in European SRI assets, however, was phenomenal with an average annual growth rate between 2003 and 2007 of 75.1% per year.[72] To further emphasize the huge growth in European assets, it is useful to compare the ratio of US SRI assets to European SRI assets which dropped from 5.2:1 in 2003 to 0.7:1 in 2007. The growth in Europe continued from 2007 to today with the latest figure of €7.5 trillion in SRI screened assets representing about one-third of the all European assets and representing an annual growth rate of 18.8%.

Data on the global share of SRI screened assets is relatively new; the first Global Sustainable Investment Alliance (GSIA) estimate for the share of SRI screened assets as a percentage of global assets dates to 2011. We use the share of these assets as a share of the total using data from the Investment Company Institute on the mutual fund assets globally going back to 2006. The extrapolated estimates for total assets don't match up entirely with the total mutual fund assets but the share of mutual fund assets in the total assets used by GSIA are relatively stable at around 40%. In order to reduce the forecasting error due to changes in the mix of mutual funds and other assets in which wealth can be invested, we use 2007 as the base year for the pre-widespread adoption share of assets invested in SRI funds or with consideration for environmental, social and governance (ESG) factors.

Using these estimates, the range of ESG assets in mutual funds and other forms amounts to 9.5% of total assets in the United States to 12.5% in Europe. The latter figure rises to 33.5% by 2013 while the former rises "only" to 18.4% in 2014. This gives us confidence that using a prudent ESG asset share of all Islamic funds (which themselves represent well below 10% of total Islamic finance assets) of 10% by 2019 is conservative.

Based on this analysis, the supply of ESG-screened Islamic funds for Muslim investors will rise from $0.3 billion today to $7.7 billion in 2019.

Part 2: "Secular Demand". Take the asset management's latent unmet demand gap (shown in grey) and estimate how much of the conventional ESG space could find appeal (latent demand) from the Islamic screens and in particular for the following reasons: 1) leverage screen for limiting excessive risks post-credit and Euro crises (both of which were compounded by excessive leverage); 2) avoiding the financial sector as a means of strengthening the 'S' in ESG (for social risks) that have largely left in many banks that are blamed for causing the financial crisis.[73] In the chart above, the orange and the yellow sections are the unmet demand gap and the ESG funds (secular demand) components, respectively.

The graph below shows how the Islamic ESG space alone could be represented separately from the rest of the Islamic funds space to show:

1. ESG pull from within Islamic funds;
2. additional assets drawn to Islamic funds through offering products that are both ESG- and Shariah-compliant; and
3. the increase in the latent demand by appealing into the ESG sector where getting even a small percentage of assets turns into a huge growth prospect for the Islamic funds space.

The key result is that the bulk of the new supply of Islamic funds is not going to come from existing fund managers adding ESG screens but from ESG managers adding Shariah screening although this will take education and advocacy on the part of fund managers and investors looking to expand opportunities to invest in line with their values.

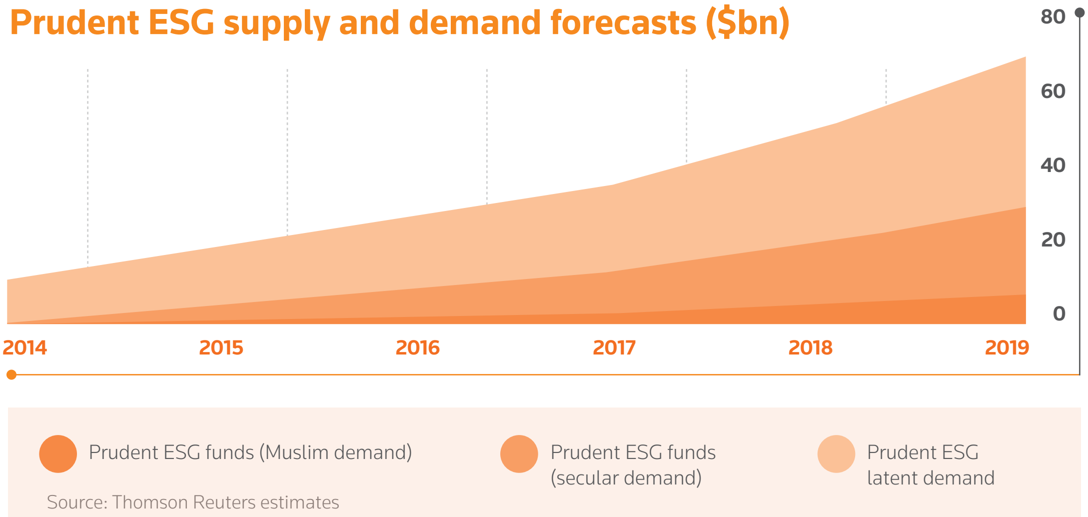
Forecasting tomorrow's "prudent ESG" demand from OIC countries

The universe of investable funds deployed into prudent ESG will be broader than either the current ESG universe (where estimates are based on American and European assets) or just the Islamic finance universe from key OIC markets from the *Islamic Asset Management Report 2015*. We have to also include the growing financial system assets from the Muslim majority countries that are members of the OIC as these markets' economies grow and more wealth is generated that will be invested domestically using the prudent ESG strategies.

As these OIC financial markets develop, some assets may be drawn back into these countries from abroad (principally from European and US assets) which will increase further the potential for prudent ESG investments in OIC markets. However, since it is impossible to disentangle these assets from the other assets native to the US and European financial sectors, and since we are speaking solely of prudent ESG assets, a € moving from a prudent ESG investment in Europe to one using similar screen in the OIC will create a net impact of zero. This may create some double-counting when combining the Western assets and those in OIC countries although this double-counting should be more than offset by the conservative estimates used in forecasting OIC fund supply and latent demand.

This forecast builds upon the methodology used in the Thomson Reuters *Islamic Asset Management Report 2015* which takes an estimate of investable funds viewing them as a share of the funds allocated into funds and bank deposits. However, while the *Islamic Asset Management Report* bases forecast on the share of deposits help within Islamic banks, this analysis considers a wider universe of those assets in the financial sector that might be drawn to prudent ESG investing either by the Shariah compliance aspect or the ESG aspect (or a combination of both). This broadening of the universe of investable funds also makes the analysis simpler by allowing the use of monetary aggregates (principally M2) plus total mutual fund assets to measure the universe of available investable funds now in the banking system or in existing mutual funds.

Prudent ESG supply and demand forecasts ($bn)



Source: Thomson Reuters estimates

Returning to the ESG world of today, the small share of total assets today in emerging markets is affected more by the inability of developed market funds to invest in emerging markets as well as the limited transparency within emerging markets comparable to what has emerged in developed markets, particularly in Europe. However, the inflow into emerging markets by developed market fund managers working through multi-stakeholder initiatives like UNPRI will improve the transparency that can unlock domestic efforts in ESG. A survey by EIRIS found that nearly one-quarter of the investors they surveyed increased their exposure to emerging markets after the financial crisis.[74] This represents a sizeable push of assets towards emerging markets whose managers will demand to the best of their ability the information and transparency that is needed to perform their ESG analysis. There is also a shift within many emerging markets towards greater ESG transparency.

For example, in 2011, China's "State Council's Assets Supervision and Administration Commission (SASAC) issued a notice stating that all state-owned companies should have released a corporate social responsibility (CSR) report by the end of 2012".[75] While we do not consider China a key market for the prudent ESG strategies in this report, improvements in transparency in China can be viewed as a barometer for the transparency available in other emerging markets because Chinese companies and state-owned Chinese companies in particular are known to be very opaque.[76] It was considered the least transparent market according to a Transparency International study about investment disclosures.

By contrast, a couple of Islamic markets where prudent ESG approaches have significant potential are among the most-improved list of five countries including Turkey (#3) and Malaysia (#4) which follow the two leading countries for requiring integrated ESG reporting: Brazil and South Africa.[77] This is a positive indication for the future of ESG investing in these markets and we believe these make our assumptions regarding the potential for ESG investments likely to be conservative. Despite moves towards ESG reporting requirements, we assume that in 5 years, the ESG share of invested assets in these markets will only reach half the level present in developed markets today.

Islamic Fund Demand and supply model was based on a number of assumptions that are backed up by historical data on funds and banking assets for both conventional and Islamic. On the supply side, we have projected growth of Islamic funds in the next 5 years at a conservative 8% per annum.

On the other hand, in order to measure the current latent demand and potential future demand for Islamic funds, we used the ratio of Islamic mutual funds to total available Islamic investments, and benchmark this against the prevailing ratio within developed markets. Our assumption is that the Islamic finance market (which covers predominantly the developing economies of MENA and Southeast Asia) will follow in the same path as the developed markets and that eventually the percentage growth of Shariah-compliant market segments and asset classes should grow to the same levels as their peers in developed markets. We took the top 8 Islamic finance markets that presents around 90% of total global Islamic banking assets. Based on average Islamic banking growth, we conservatively estimate that Islamic banking deposits will grow 8% per annum up to 2019. Eventually we target a ratio of 18% only (compared to 36% in the developed markets) Islamic mutual funds to total Islamic investable funds to be conservative which drove the latent demand size.

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A Malaysian Muslim women is silhouetted after reading the Koran during the holy month of Ramadan inside Sultan Salahuddin Abdul Aziz Shah mosque in Shah Alam outside Kuala Lumpur July 14, 2014. REUTERS/Samsul Said

One factor which could make these estimates even more conservative than they are is if the convergence towards prudent ESG asset methodologies draws in large global asset managers. Most Islamic mutual funds are dominated by retail investors, in contrast to the global (and particularly ESG) mutual funds. A shift towards fund managers with longer track records managing institutional money with the ESG focus could, if they add in an Islamic screening methodology to their mandate, bring maturity to the Islamic fund market and potentially draw in sovereign wealth fund (SWF) assets.

Many SWFs are becoming cognizant of their responsibility to be long-term stewards of both the capital entrusted to them and to the values of the beneficiaries of their assets. In some countries that has led to adoption of ESG principles, including by Norges Bank which manages the Norwegian Government Pension Global.[78] Malaysia's Employees Provident Fund has plans to launch the largest Islamic fund through a split of its assets into conventional and Shariah compliant by 2017 with 40% of the assets expected to be Islamic by 2020. The fund today has $160 billion in total assets.[79] A shift by any of the major sovereign wealth funds in OIC member countries could lead the present estimates to be significantly below the future growth.

The forecast methodology is based on a similar methodology to the Thomson Reuters *Islamic Asset Management Report 2015* but with a slightly different mix of countries.[80] Based on a PwC analysis of banking in 2050 which included Turkey and Indonesia, we expect that it is reasonable to continue using the 8% annual growth rate for banking assets assumed in the Asset Management report (the rate implied in PwC analysis for Turkey and Indonesia was 6.7% and 9.7%, respectively).

One difference in the methodology is in where we get data on deposits. Whereas the *Islamic Asset Management Report* estimates the total deposits based on total Islamic banking assets, this report uses both conventional and Islamic deposits, so we can use the broad money indicator of M2. To this total, we add an estimate of the domestic mutual fund assets in the countries which are taken from the St. Louis Federal Reserve Bank's FRED database which covers all countries except for Iran.[81] Estimate investable funds are calculated as:

Available Funds for Investment/ Deposit = **M1 (currency and demand deposits)** + **(savings deposits and money market funds, which together equal M2)** + **domestic mutual funds**

Of this investable universe, estimate total mutual fund latent demand at 18% of total investable funds using the same methodology as the Islamic Asset Management Report (see box above), or

$3.076 trillion x 18% = $553.8 billion (as of 2013)

Taking this estimate, we estimate 2014 and 2019 forecasts using the same 8% annual growth used in the Islamic Asset Management Report which gives $598.1 billion by 2014 and $878.8 billion by 2014 for the total investable funds that we estimate will go into mutual funds.

Of this latent demand for funds, we use the midpoint of the average ESG share of European and American assets, and the share of ESG assets globally, with the resulting low and high estimates using a 50% haircut to these values.

Method 1 (European/American Average):

50% * (33.5% + 18.4%) = 26.0%

Method 2 (Global ESG asset share):

30.2%

After 50% Haircut:

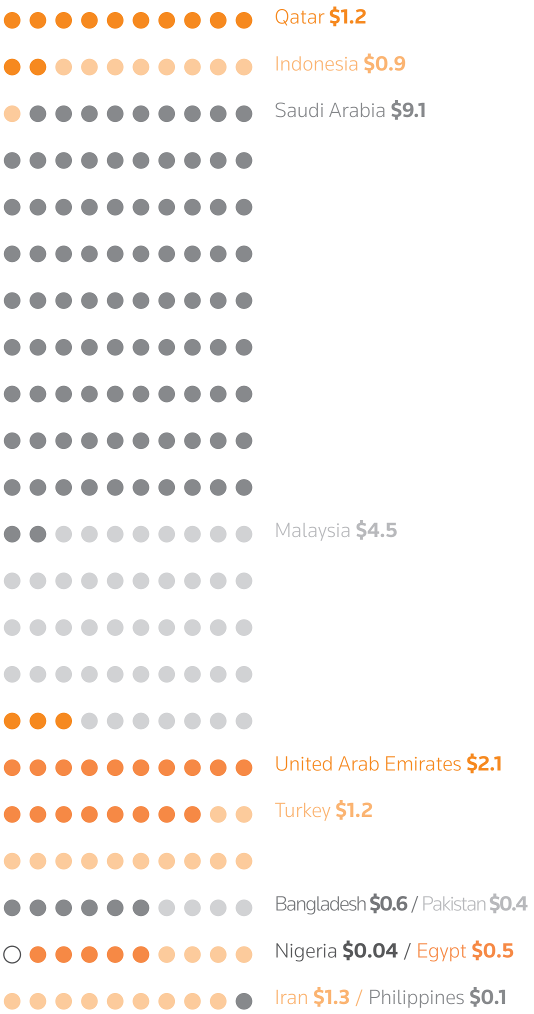
50% * (1 / 2) * (26.0% + 30.2%) = 14.05%

This represents the latent demand for ESG assets in these 12 countries. The 'prudent ESG' (which will be ESG funds that are also subject to Shariah screens) will be a share of these assets which we assume will follow the share of the total Islamic banking assets in the country.

Totaling our country-by-country estimates for the OIC-12 markets gives an estimated prudent ESG latent fund demand of $ 15.7 billion in 2014 and $23.0 billion by 2019.

Below is a chart showing the distribution of these assets in 2019 (all numbers in US$ bn, labels only on countries with more than $1.0 billion).

Prudent ESG Demand in the OIC-12 (2019, $bn)



Islamic Banking Share of the OIC-12 Markets

- **Qatar – 23.6% ***
- **Indonesia – 5.5% ***
- **Saudi Arabia – 48.9% ***
- **Malaysia – 20.7% ***
- **UAE – 21.4% ***
- **Turkey – 5.9% ***
- **Nigeria – 1.0% (1)**
- **Bangladesh – 15% (2)**
- **Pakistan – 9.5%**
- **Egypt – 5% (2)**
- **Iran – 100%**
- **Philippines – 1% (3)**

* Source: World Islamic Banking Competitiveness Report 2014-15.
(1) Based on SBP report that cites Nigeria as having penetration under 1%
(2) Estimated based on chart on Page 13 of the WIBCR 2014-15
(3) Only one very small Islamic bank in the Philippines with negligible assets as a share of the country's total

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A woman rests at her apartment's balcony in a residential building in north western Tehran May 17, 2008. REUTERS/Morteza Nikoubazl

"OUR ESTIMATES FOR ISLAMIC + PRUDENT ESG ASSETS IN 2019 IS FOR $107.0 BILLION, WHICH MEANS AN INCREASE OF $30 BILLION (+39%) FROM THE ESTIMATE OF ISLAMIC FUND ASSETS ALONE.

The World View

The charts in the first section show just Islamic funds and the funds in developed markets that represent a crossover from conventional ESG into prudent ESG. In that section, we assumed that 10% of the 2019 Islamic fund assets will be in ESG-screened funds. Since these assets are primarily in the OIC-12 markets, we need to remove them to avoid double-counting, we will remove the assumed Islamic ESG estimates (and reduce comparably the Islamic Funds estimate). **Our estimates for Islamic + Prudent ESG assets in 2019 is for $107.0 billion, which means an increase of $30 billion (+39%) from the estimate of Islamic fund assets alone.**

PRUDENT ESG AND ISLAMIC NON-ESG FUND SUPPLY AND LATENT DEMAND (2014-2019, $BN)

	2014	2015	2016	2017	2018	2019
Islamic non-ESG funds	$51.9	$55.8	$59.8	$63.6	$67.0	$69.0
Prudent ESG funds	$ –	$9.9	$13.9	$19.8	$28.3	$37.1
Islamic non-ESG latent demand	$126.0	$136.1	$147.0	$158.7	$171.4	$185.1
Prudent ESG latent demand	$26.2	$30.5	$35.6	$41.9	$49.7	$59.2

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Fences and fields are covered with frost near the A6 highway, also known as the "Autoroute du Soleil (Highway of the Sun) near Dijon, France January 6, 2015. REUTERS/ Yves Herman

Endnotes

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13 Ibid. p. 89-90. The AAOIFI standard specifically references the Quranic limit on obligations placed on individuals that "On no soul doth Allah place a burden greater than it can bear" (Surat Al Baqarah, verse 286).

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75 EIRIS Emerging Markets Report 2012, p. 8.

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81 Based on an analysis of other mutual fund data and the age of the data (2004-2011), we believe this measure understates the total mutual fund assets in the countries. Data for Iran is estimated using the weighted average (by GDP) of the mutual fund asset share of GDP for the other 11 countries.

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