INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) FACTORS IN ISLAMIC FINANCE: TOWARDS THE REALISATION OF *MAQĀṢID AL-SHARĪʿAH*

Beebee Salma Sairally[*]

I. INTRODUCTION

Environmental, social and governance (ESG) concerns underlie the value proposition of the Sustainable and Responsible Investment (SRI) industry. Overall, the SRI industry seeks to address global challenges relating to the environment, society and corporate governance by explicitly integrating ESG issues in the selection and management of investment portfolios. It thus conveys the ideas of a socially responsible goal, a sustainable economic development agenda, a concern for human welfare, social justice, peace, and a healthy environment, as well as promotion of a fairer financial world (Domini, 2001; Brill et al., 1999). Guided by Islamic ethical values, Islamic finance, by definition, is also expected to endogenise ESG issues in its provision of Islamic financial services. ESG concerns under the Islamic finance paradigm are, however, derived from Islamic principles which are rooted in the Sharīʿah (Islamic law) as compared to the SRI industry whose values are largely socially determined, sourced from such principles as humanism, socialism, secularism, or environmentalism (Wilson, 2005).

While parallels are often drawn between the SRI industry and the Islamic finance industry on the basis that both promote socially responsible financial goals, recent deliberations have questioned

* Beebee Salma Sairally, PhD, is Research Consultant at the International Shari'ah Research Academy for Islamic Finance (ISRA). She can be contacted at salma@isra.my.

the extent of the similarity (Haneef, 2015). Previous studies which evaluated the socially responsible performance of Islamic financial institutions (IFIs), for instance, highlighted the concern of IFIs with being legally compliant with Sharīʿah rulings in all their operations rather than being proactive in becoming socially responsible and impactful (see, Sairally, 2013). Islamic investments are also reported to be largely focused on Sharīʿah-compliant sectors and financial screening ratios and limited in their focus on positive screening which incorporate ESG issues (Haneef, 2015). As such, the practice of Islamic finance is deemed lacking in initiatives to address real risks facing the world such as climate change, food shortage, extreme poverty, youth education, financial literacy and other important issues (Haneef, 2015).

This study draws from the practices of the SRI industry to reflect upon the future direction of Islamic finance in line with the realisation of the *maqāṣid al-Sharīʿah* (objectives of Islamic law). It examines the current efforts, challenges and expectations of the Islamic finance industry with regard to ESG endorsement.

II. THE SRI INDUSTRY AND ESG ENDORSEMENT

The integration of ESG issues within investment policy decisions is endorsed by the SRI industry. ESG refers to the three broad sets of non-financial qualitative factors that are central in measuring the sustainability and ethical impact of an investment in a company or business. It represents an additional set of parameters—besides the conventional criteria of financial performance and risk management—in determining the selection and management of investment portfolios (Sparkes, 2002: 22; Cowton, 1994: 215). Within these three areas of concern are a number of issues of international and domestic relevance that have come to be added over time under the ESG agenda. Some examples of these ESG issues are provided in Table 1.

Table 1: ESG Issues Underlying SRI

Environmental Concerns	Social Concerns	Governance Concerns
Climate change	Diversity	Management structure
Hazardous waste disposal and waste management	Human rights	Employee relations
Sustainable agriculture	Consumer protection	Executive benefits and compensation
Protection of biodiversity	Sin stocks including pornography, tobacco, alcohol, drugs, gambling	Employee welfare standards, including health and safety
Green technology	Animal welfare	Equal opportunities
Conservation of natural resources and resource efficiency	Social and financial exclusion	Labour rights
Fossil fuel divestment	Fair trade business and products	Information disclosure
Pollution control	Arms trade financing	Bribery and corruption
Recycling	Anti-genetically modified foods	Shareholder rights
Renewable energy, Nuclear energy, Clean energy	Relations with local communities	Whistleblowing schemes
Protection of indigenous communities and endangered species	Child labour	Stakeholder dialogue

Sources: Screening criteria of SRI funds observed from the funds' websites.

A number of international organisations like the United Nations and the International Finance Corporation (IFC) call for the integration of these ESG issues in investment practices. Accordingly, various principles and standards have been developed which aim at creating a unified approach to ESG endorsement as this sector experiences huge growth. Some examples of these principles and standards include the United Nations Principles for Responsible Investment (UN-PRI), Equator Principles, Global Reporting Initiative, and OECD Guidelines for Multinational Enterprises.

III. ISLAMIC FINANCE AND ESG INTEGRATION

Islamic finance is about finance based on the ethical tenets of Islamic law (Sharīʿah). As such, Sharīʿah compliance is considered a prerequisite requirement for the fulfilment of economic and financial transactions. The Sharīʿah stipulates the adoption of permissible (*ḥalāl*) and the rejection of prohibited (*ḥarām*) means. This stipulation upholds the responsibility of promoting productive activities and shunning harmful transactions. Accordingly, Islamic financial institutions (IFIs) adopt a set of screening criteria—similar in approach to the negative and positive screening strategies under SRI—in determining the Sharīʿah compliance of financial transactions. Many of the issues addressed by Islamic finance are categorised under the ESG issues endorsed by the SRI industry. Examples include the manufacture, supply or service of *ḥarām* (impermissible) goods and services; environmental issues; and those issues that promote moderation, balance and harmony in life. Differences between the two paradigms however rest in the promotion of alms (*zakāh*), voluntary charity (*sadaqah*), trade (*bayʿ*), fixed return modes of financing, profit and loss sharing in Islamic financial transactions, and the prohibition of *ribā* (interest) and *gharar* (uncertainty).

Recently, with the growth of the ESG sector, there has been a growing trend of convergence of the Islamic finance industry towards the ESG sector so as to reach a larger market segment of socially responsible investors from both Muslim and non-Muslim backgrounds. Some examples of the current efforts of the Islamic finance industry in explicitly integrating ESG factors include:

- The launch of SEDCO Capital Global Funds (SCGF) in 2013 representing the first ever Sharīʿah-compliant funds managed according to ESG principles (such as UN Global Compact, OECD Guidelines for Multinational Enterprises, ILO Core Labour Conventions, Environmental Conventions and Weapons-related Conventions).
- The issuance of a framework for SRI *ṣukūk* by Securities Commission Malaysia in August 2014 to facilitate the financing of SRI initiatives.
- The issuance of the first SRI *ṣukūk* by Khazanah Nasional Berhad under the SRI *ṣukūk* framework in May 2015.

- The launch of an ESG index by Bursa Malaysia called FTSE4Good Bursa Malaysia Index in December 2014.

Despite these efforts in aligning the Islamic finance sector with ESG principles, overall the Islamic finance industry is still lagging behind in supporting the ESG agenda in several aspects. These are briefly discussed below:

- The SRI sector has outgrown the Islamic finance industry manifold. The overall Islamic finance industry represents a USD2.1 trillion industry, while the SRI sector is a USD21.4 trillion industry as at the start of 2014 (MIFC, 2014; GSIA, 2014).
- A disconnect with SRI is felt as Islamic finance is deemed lacking in its vision to promote ESG issues as compared to the practice of SRI institutions. A study by Sairally (2011) which examined the best practices of SRI institutions found that these institutions take a deliberate policy decision to promote ESG values. The adoption of ESG principles forms part of an integral management strategy of these institutions. Having ESG values embedded in mission, vision and value statements creates awareness of these principles at the company level, among the staff and management. The ethical and socially responsible 'image' beheld by the company is thus projected onto society.
- The SRI institutions are also involved in a number of proactive socially responsible activities—such as community investment, support for social enterprises, generation of sustainable local employment, removal of social and financial exclusion, campaigning on ESG issues, engagement with companies to improve their ESG performance, initiatives to protect the environment, promotion of ethical consumerism, and others—which reflect on their vision, level of commitment and objective of creating real value for economies and improving people's quality of life (see, Sairally 2011).
- The Islamic finance industry, on the other hand, largely focuses on the negative screening of investments, specifically the elimination of *ribā*, *gharar*, *maysir*, and non-*halāl* activities. Given that the initial premise of financial transactions is about permissibility (*ibāḥah*), there is not much emphasis on

the positive criteria being adopted in Islamic finance. Rather, these are understood as being implicit within the practice of IFIs.

- Besides the limited focus on positive screening, the practice of Islamic finance hardly recognises other ESG integration approaches such as stakeholder engagement, community investments, sustainability-themed investments, and alignment of investments with internationally recognised ESG standards.
- As compared to IFIs, SRI institutions are seen to be more transparent in communicating their ESG criteria to investors. They publish special reports to inform investors how they screen their investments, providing details on each ESG criterion and laying out the quantitative guidelines which determine the acceptability or rejection of the company under consideration. Some of these institutions even publish details on their voting policies to influence company decisions.
- SRI institutions also tend to have well-developed marketing literature which disseminates information on company details, their ethical policies, investment criteria, company selection and monitoring process, financial products and services, financial performance, and project lists. These details assist stakeholders in forming their judgement about their ESG performance.
- Most IFIs, on the other hand, describe their products and services as being 'in compliance with Sharīʿah' without providing full information on the screening criteria they use or any explanation of why they are relevant to Sharīʿah compliance. It is also noticed that IFIs barely get engaged in promoting financial literacy, product transparency, or providing customer-centric sales incentives. Rather, IFIs are often seen to place high importance on the credentials of their Sharīʿah advisory committee (SAC) which validates their financial products. Reference to the SAC has been argued by Gambling et al. (1993: 198) to represent a source of assurance of Sharīʿah compliance to Muslim customers that they are fulfilling their religious expectations. This assurance reduces the need to provide detailed disclosure on the social responsibility of their practices, products, and services.

- Islamic finance is further seen to be lagging behind SRI practices in terms of their corporate social reporting policy. Sustainability reports, CSR reports, partnership reports, ethical consumerism reports, environmental policy reports, and corporate governance reports are published on a voluntary basis by the SRI institutions as part of their policy to be transparent to their various stakeholder groups.
- Islamic finance is deemed to be lagging behind in global ESG initiatives by not becoming signatories to such principles as the Equator Principles, UN Principles for Responsible Investment and the Global Reporting Initiative.
- Islamic finance is observed not to be considering the wider social and environmental risks of their investments. Rather, it focuses mainly on credit and market risks. As such, Haneef (2015) argues that there is a disconnect between Islamic finance practices and real risks facing the world, such as climate change, food shortage, extreme poverty, and youth education. These issues are real ESG concerns endorsed by the SRI industry.
- The practice of Islamic finance is in turn argued to fall short in its contribution to the real economy through the challenges it faces in the provision of Islamic microfinance, SME financing, access to banking services to low-banked populations, and management of untapped *waqf* assets (Haneef, 2015). These services would promote financial inclusion, represent sources for new job creation and technological innovation—in short, would be a source of real growth and development. Islamic finance needs to devote additional resources to these social finance sectors to be more impactful.

IV. EXPECTATIONS OF THE ISLAMIC FINANCE INDUSTRY: INTEGRATING ESG TO ACHIEVE *MAQAṢID AL-SHARĪʿAH*

It is often argued that the establishment of IFIs does not merely connote the fulfilment of Muslims' desire to have a Sharīʿah-compliant form of financial services in a strict legalistic (formalistic) sense, i.e. to be concerned only with what is *halāl* and *harām*. Adherence to the

Sharīʿah is also deemed to include abidance by the spirit of *maqaṣid al-Sharīʿah* (the objectives of Islamic law) which attributes a higher purpose to IFIs—that of contributing to the socioeconomic goals of Islam such as justice and fairness, common good and benefits, equitable distribution of income, wealth through values and ethics, and general human well-being. The fact that IFIs are expected to comply with both the form and substance of the Sharīʿah should thus affect the financial institutions' vision and mission, objectives, organisational structure and management, procedures, modus operandi, products and services, training requirements, regulation, and corporate governance (Hasan, 2004: 23; Parker, 2005: 7). As such, ESG integration which seeks to contribute to sustainable economic development and general human well-being should, de facto, form part of the vision and mission statements of IFIs as part of their compliance to the maqaṣid al-Sharīʿah. IFIs should thus seek to be not only formally legally compliant to the Sharīʿah (i.e. to be concerned about *ḥalāl* and *harām*) but to be compliant with *maqaṣid al-Sharīʿah* which integrate ESG values. With this vision, Islamic finance will create greater impact in the ESG areas. Haneef (2015) terms this desired move of the Islamic finance industry as representing a shift from *ḥalāl* (permissible) to *ṭayyib* (pure and good) financing.

V. CONCLUSION

Overall, this paper argues that ESG values form an integral part of the *maqāṣid al-Sharīʿah* and IFIs should not only be legally compliant to the Sharīʿah but also adhere to the spirit of the Sharīʿah, which seeks to achieve sustainable economic development and general human well-being. As such, ESG and Sharīʿah compliance objectives should be pursued hand-in-hand by IFIs as a business-led approach to benefit from a larger investor base and gain broader mainstream relevance. This requires a clear decision to be taken at the board level of IFIs to develop a long-term strategy for them to be actively involved in the ESG sector. ESG objectives will then be built within the vision and mission statements of IFIs, with explicit processes, resources and management involvement being directed for the execution, monitoring, review, and achievement of the targets set. By setting clear ESG objectives, IFIs will then be seen to take necessary steps to abide by international ESG standards, improve their information disclosure practices and engage in financing activities that would make a greater socioeconomic impact. ner does not. However, this paper will further study whether it is permissible if both parties suffer loss, but one party bears more loss than the other.

References

Brill, H., Brill, J. & Feigenbaum, C. (1999). *Investing with Your Values: Making Money and Making a Difference*. Princeton: Bloomberg Press.

Cowton, C. J. (1994). The Development of Ethical Investment Products. In Wḥrneryd, K. and Lewis, A. (Ed.), *Ethics and Economic Affairs*. London and New York: Routledge.

Domini, A. (2001). *Socially Responsible Investing: Making a Difference and Making Money*. Chicago: Dearborn Financial Publishing.

Gambling, T., Jones, R. & Karim, R. (1993). Creditable Organizations: Self Regulation v. External Standard-Setting in Islamic Banks and British Charities. *Financial Accountability & Management*. *9*(3), 195-207.

Global Sustainable Investment Alliance (GSIA). (2014). *2014 Global Sustainable Investment Review*. Retrieved from http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf.

Haneef, R. (2015, April). *Has Islamic Finance Bridged the Disconnect with the Real Economy?* Paper presented at the Strategic Roundtable Discussion of the International Shari'ah Research Academy for Islamic Finance, Kuala Lumpur.

Hasan, Z. (2004). Measuring the Efficiency of Islamic Banks: Criteria, Methods, and Social Priorities. *Review of Islamic Economics*. *8*(2), 5-30.

MIFC. (2014). *Islamic Finance and Economic Growth: Mutually Reinforcing*. Retrieved from http://www.mifc.com/index.php?ch=28&pg=72&ac=109&bb=uploadpdf.

Parker, M. (2005, March/April). A Tale of Two Corporate Identities. *Islamic Banker*. 110/111: 6-7.

Sairally, S. (2011). Best Practices in Socially Responsible Finance: Lessons for the Islamic Financial Industry from Leading Socially Responsible Financial Institutions in the UK. *Kyoto Series of Islamic Area Studies*. 6, December 2011.

Sairally, S. (2013). Evaluating the Corporate Social Performance of Islamic Financial Institutions: An Empirical Study. *International Journal of Islamic and Middle Eastern Finance and Management*. 6(3), 238-260

Sparkes, R. (2002). *Socially Responsible Investment: A Global Revolution*. Chichester: John Wiley & Sons.

Sultan, H. (2015, April). *Islamic Finance and ESG*. Paper presented at the Strategic Roundtable Discussion of the International Shari'ah Research Academy for Islamic Finance, Kuala Lumpur.

Wilson, R. (2005). The Growth of Islamic Banking and Product Development among Islamic Retail Banks. In Jaffer, S. (Ed.) *Islamic Retail Banking and Finance: Global Challenges and Opportunities* (pp. 18-28). London: Euromoney Books.